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Negotiating Earnouts in M&A Transactions: Effective Approaches to Bridging the Valuation Gap

Structuring Clauses to Protect Buyers and Sellers and Reduce Post-Closing Disputes

THURSDAY, JULY 25, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Christopher Letang, Managing Director, Professional Services, **SRS Acquiom**, Denver

Tatjana Paterno, Member, **Bass Berry & Sims**, Nashville, Tenn.

Tyler J. Sewell, Partner, **Morrison & Foerster**, Denver

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Negotiating Earnouts in M&A Transactions:

Effective Approaches to Bridging the Valuation Gap

BASS BERRY SIMS

MORRISON | FOERSTER

SRS ACQUIOM

Presenters

Tatjana Paterno
Bass, Berry & Sims PLC

Tyler J. Sewell
Morrison & Foerster LLP

Christopher Letang
SRS Acquiom

BASS BERRY + SIMS

MORRISON | FOERSTER

SRSACQUIOM

Roadmap

- Basic concepts
- Advantages and disadvantages
- Metrics and examples
- Structure
- Buyer and Seller protections
- Security
- Other considerations
- Case law

General

- An earnout is a deal pricing mechanism where a portion of the purchase price is contingent on post-closing results of the target business
- Typically structured as payments contingent on achievement of certain targets or benchmarks after closing, which may be financial or operational
- Benchmarks can be based on revenue, net income, EBITDA or certain events
- For non-life sciences deals, the earnout period is typically one to three years

General

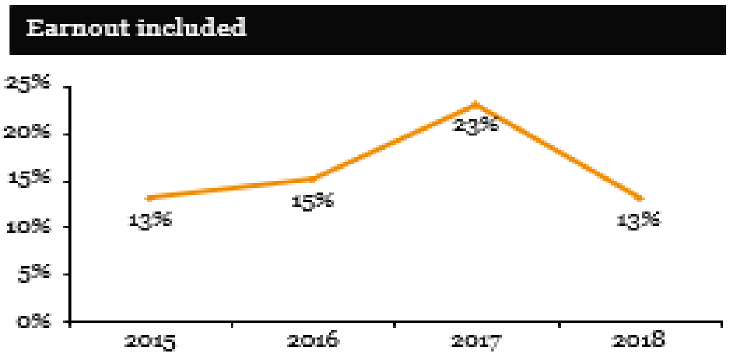
- Used to help narrow the gap when parties cannot agree on deal value

- Valuation gaps:
  - Hot market sectors
  - Early stage companies where there's limited operating history
  - Limited information to accurately measure the value of business
  - Companies that are financially dependent on new product lines or technologies that have not been proven in the market
  - Companies that have experienced significant short-term growth
  - Turnaround acquisitions

- Used to provide downside risk protection for Buyers

SRS Acquiom 2019 M&A Deal Terms Study: Use of Earnouts

Earnouts (Non-Life Sciences Deals*)



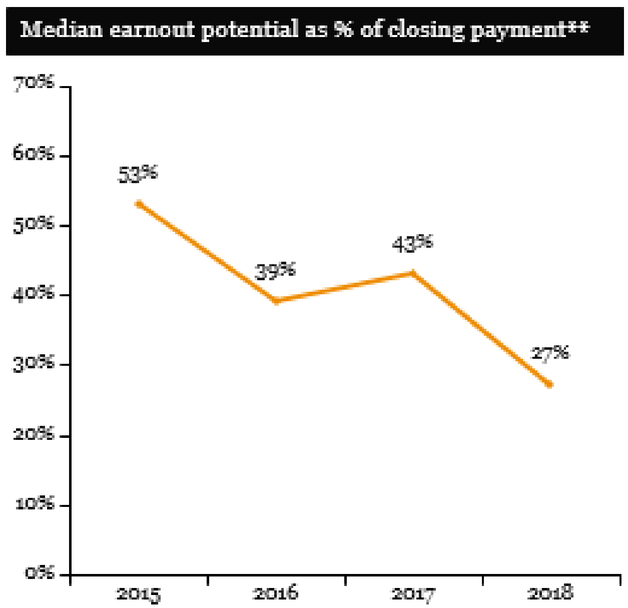
Earnouts are more common for life sciences deals than for other acquisitions:

- 73% of biopharmaceutical deals in 2015–2018
- 55% of medical device deals in 2015–2018
- 16% of all other deals in 2015–2018

* *For a more detailed analysis of SRS Acquiom's life sciences deals, please see the 2017 SRS Acquiom Life Sciences M&A Study.*
** *Earnouts can include more than one metric, such as a combination of revenue and earnings.*
*** *Examples: unit sales, product launches, divestiture of assets.*

SRS Acquiom 2019 M&A Deal Terms Study: Size of Earnouts

Earnouts (Non-Life Sciences Deals*)



** For a more detailed analysis of SRS Acquiom's life sciences deals, please see the 2017 SRS Acquiom Life Sciences M&A Study.*
*** Calculated as the sum of potential earnout payments over the amount paid at closing (including escrowed amounts).*
**** Measured by the date the latest earnout period ends.*

Earnout Advantages

- Buyer's perspective:
  - Lowers up-front payments (i.e., financing mechanism)
  - Provides an opportunity to see actual performance of the target before paying full purchase price
  - Reduces the risk of overpaying
  - Lays foundation for management performance incentives (and potentially aligns interests)
  - Provides security/remedy for indemnity

- Seller's perspective:
  - Gets an opportunity to obtain higher purchase price as compared to a fixed price transaction
  - Opportunity to benefit from synergies of target and buyer business integration
  - Allows for exit without forfeiting ability to share in future growth of the company

Earnout Disadvantages

- Increases potential for post-closing disputes regarding the earnout payment
- Requires additional time, resources and cost to negotiate and draft effective earnout provisions and to calculate the earnout
- Introduces potentially conflicting incentives between the parties as to how business should be operated post-closing
- Could hinder a Buyer's ability to freely run the target post-closing
- Could make Seller vulnerable to buyer's actions

The Basics:
Agree on the Metrics

- Metrics are generally:
  - Financial: revenue, net income, EBITDA, free-cash flow
  - Non-financial: e.g., product development milestone
  - A combination
- Considerations when setting an earnout metric:
  - Does the metric make sense for:
    - The target company?
    - Its business operations?
    - Its industry?
  - Does it capture the value to be measured?
  - Is the target objective, measurable and plainly defined?

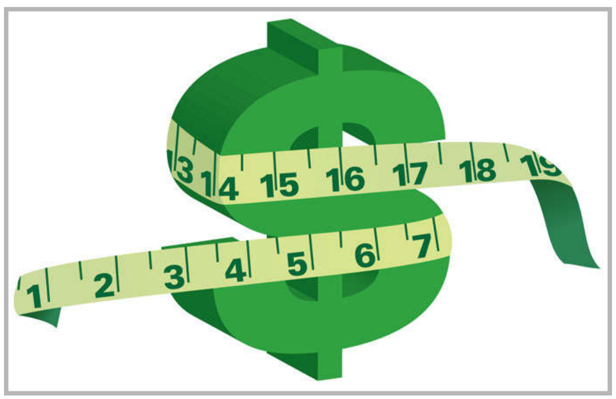
The Basics: Agree on the Metrics

- **Financial Metrics**
  - Buyer and Seller may prefer different metrics
    - Sellers generally prefer revenue targets because they are less easily manipulated
    - Buyers may prefer net income targets because they incentivize Sellers who are involved in post-closing operations to control costs
    - EBITDA can be a compromise because it factors in operational costs but excludes certain non-operational costs
  - Sellers and Buyers can also consider using an earnout formula that is based on deal valuation (*e.g.,* EBITDA if Buyer valued the deal based on a multiple of EBITDA)
  - Key to focus on sustaining long-term growth of business, so that earnout is not driving short-term cost cutting measures (quality of materials, marketing, advertising, etc.) at the expense of the long-term performance of the business
- **Non-Financial Targets**
  - When used appropriately, may limit potential disputes because these targets are often binary and it is clear when they are met

Earnout Target Examples

Financial Targets

- Revenues
- EBITDA
- Net Income
- Earnings per share



Non-Financial Targets

- Product development milestones
- Regulatory approvals
- Number of
  - Products sold
  - Customers
- Launch of a new product

Examples of Definitions

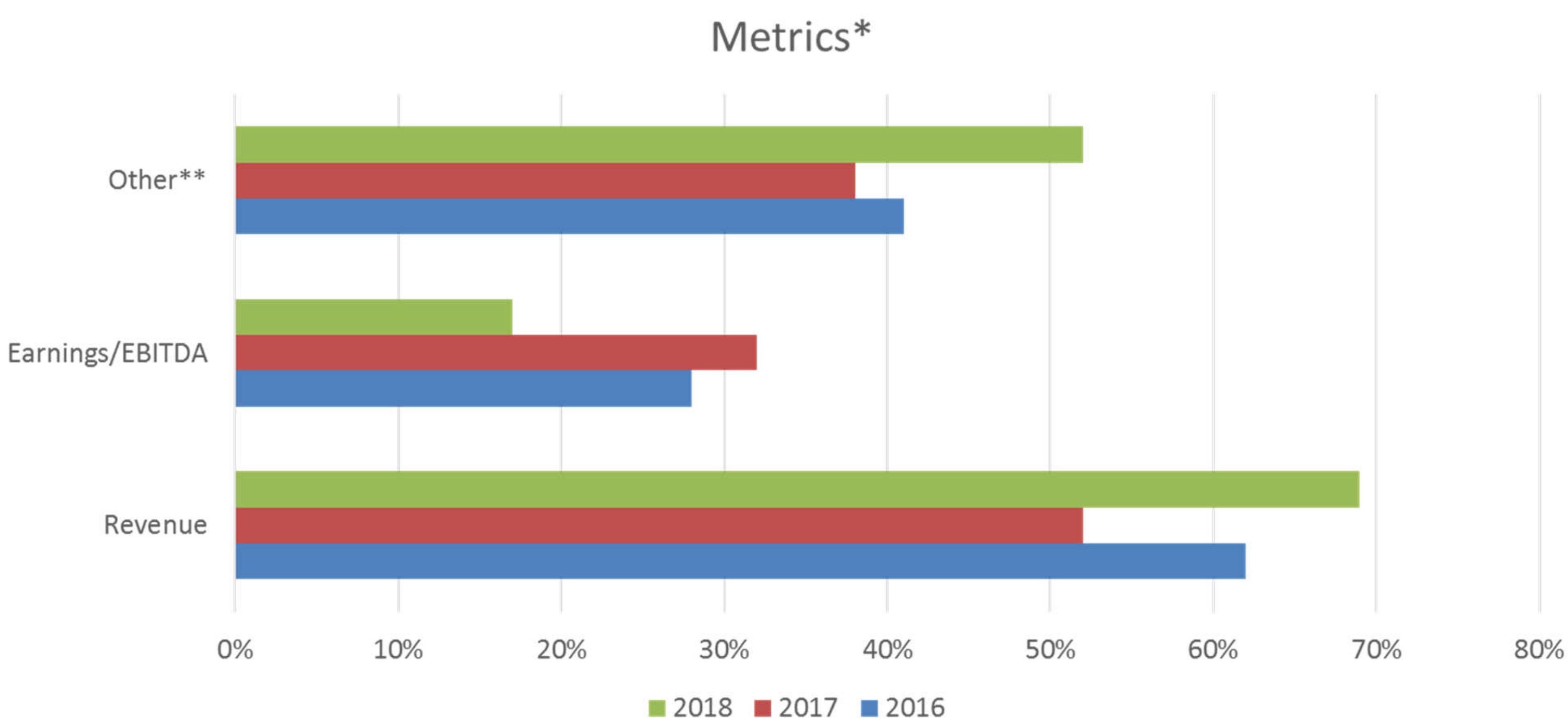
- "**Revenue**" means all revenues that are earned and received by the Target during the fiscal year ending December 31, 2018; provided, that if the Specified Receivable has not been paid or settled in the fiscal year ending December 31, 2018, then such revenues shall include the revenues that would be generated from the payment or settlement of the Specified Receivable.

- "**Revenue**" means, for any Earnout Period, Parent's revenues, on an accrual basis under GAAP, as applied consistently with Parent's past practices and as audited by Parent's independent auditors, generated from (1) the existing client relationships of the Acquired Companies as of the Closing, and (2) new clients sourced and serviced solely by the [__________] business line of Parent, if and as applicable that sign investment advisory agreements with Parent or Subsidiaries of Parent from and after the Closing; provided, for avoidance of doubt, that "Revenue" shall not include any revenues from any subsequent add-on acquisitions by Parent (i.e., any asset acquisitions, mergers or similar transactions following the Closing Date between Parent and a third party under which Parent acquires client relationships (including by the assignment of client contracts) from such third party in exchange for purchase price consideration).

Examples of Definitions

- "**EBITDA**" means (without duplication), with respect to any applicable period, the net income of the Company and its subsidiaries, on a consolidated basis, *plus*, the amount of interest expense (net of any interest income) deducted in determining net income, *plus*, the amount of Taxes related to the earnings or income of the Company and its subsidiaries (whether accrued or paid in cash or deferred) deducted in determining net income, *plus*, the amount of depreciation and amortization related to the Company and its subsidiaries deducted in determining net income; and EBITDA shall not include:
  - (i) any overhead charges or any management fees paid to Purchaser or any Affiliate of Purchaser (other than expenses paid for goods and services procured on an arms-length basis in the ordinary course of business such as insurance, fuel, employee benefits, etc.),
  - (ii) goodwill and other intangibles amortization, that are a result of Purchaser's purchase of the Purchased Equity,
  - (iii) any gain, loss, income or expense resulting from any changes in Purchaser's accounting methods, principles or practices or a material change in GAAP, and
  - (iv) any "extraordinary items" of gain or loss as that term is defined in GAAP.

SRS Acquiom 2019 M&A Deal Terms Study: Earnout Metrics



*Metrics presented are from a subset of the study (non-life science deals with earnouts) and may include more than one metric, such as a combination or revenue and earnings.
**Examples: unit sales, product launches, divestiture of assets.

Earnout Metrics

- Drafting considerations:
  - Can metrics be defined objectively?
  - Is the metric susceptible to manipulation?
  - Who prepares the calculations?
  - What accounting methods will be used?
  - How will a dispute be resolved?
  - Can parties leverage work done in connection with purchase price adjustments or deal valuation to determine earnout calculations?

Amount and Structure of the Payments

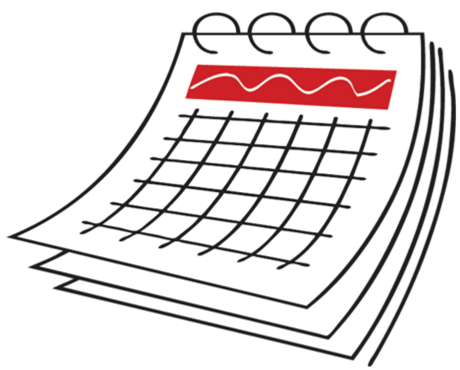
- **Structure of payments**: all or none, or graduated, catch-up payments
  - Graduated is more common and may avoid incentive to Buyer to just miss the target or for Seller to stretch to just make the target
  - Avoid a large "cliff" before a significant portion of the earnout becomes payable (e.g., for any earnout to be paid, revenue must be $25M, and if $25M in revenue is achieved, $20M or 50% of earnout becomes payable)
- **Earnout period**: one or multiple
- **Earnout payments**: per period or cumulative
- **Floors and caps**: floors on minimum earnout and caps on maximum earnout

Earnout Computation

- Financial Metrics - Accounting/Metrics/Information Considerations
- Separate books and records during the earnout period
- Audit and review rights
- Use of GAAP
- Typical issues:
  - Exclusion of transaction expenses from calculations
  - Address non-cash items, such as heightened depreciation expenses that may arise as a result of step-up in basis
  - Which overhead expenses will be allocated to the business
  - Whether indebtedness incurred as a result of the deal should be included
  - Treatment of inter-company transactions as if at arm's length
  - Treatment of reserves and provisions for losses and bad debts

Length of Earnout Period

- Periods of one to three years are most common in non-life sciences deals
  - If the period is too short it may not provide a reliable look into the performance of the business
- Some periods will be as long as four to five years



Length of Earnout Period

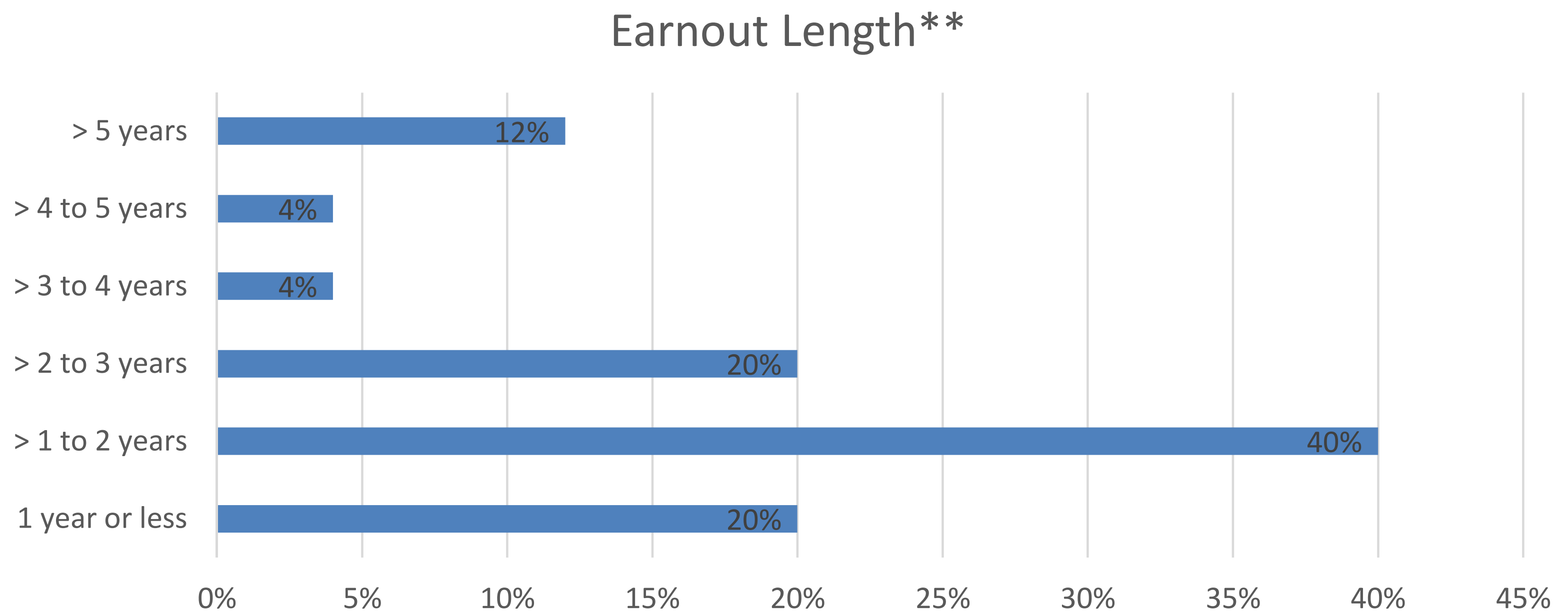
Buyer's perspective:

- Shorter periods
  - Minimize the length of time Buyers are subject to restrictions
- Longer periods:
  - Provide a more reliable picture of the performance of the target company

Seller's perspective:

- Shorter periods
  - Minimize the wait time to receive an earnout payment
- Longer periods
  - Provide additional time to achieve targets
  - In graduated structure, may also provide opportunities to receive partial earnout payments

SRS Acquiom 2019 M&A Deal Terms Study: Earnout Period*



*Periods presented are representative of a subset of the study (2018 non-life science deals with earnouts) and are measured by the date the latest earnout period ends.

**The median earnout length in 2018 was 24 months.

Seller Protections

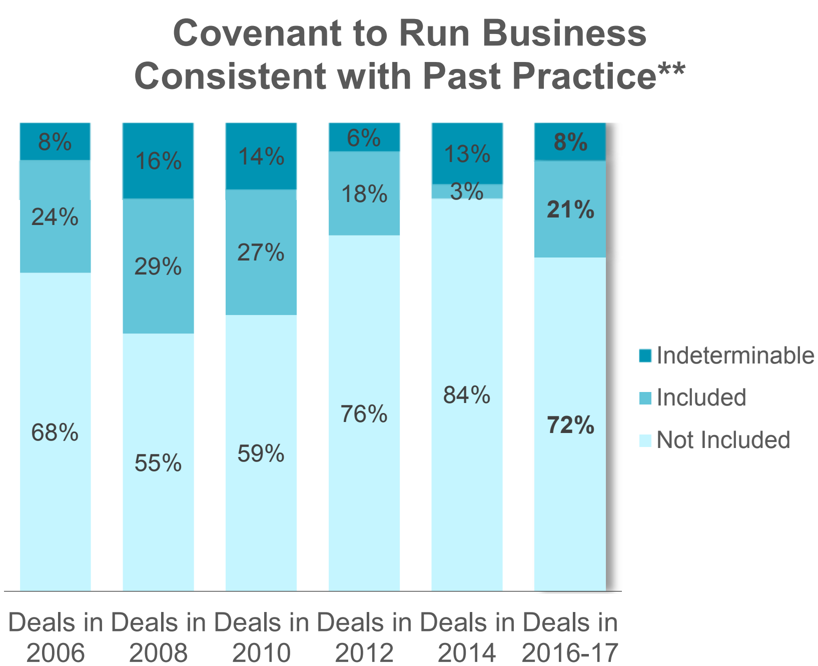
- Seller's goal is to retain as much control over post-closing operations as possible and obtain other protections:
  - Covenant to operate consistent with past practice or in a manner as to maximize earnout
  - Restrictions on disposing a portion of the target business and veto protection for major business decisions (e.g., hiring and firing of key employees, discontinuing a product line, etc.)
  - Buyer guarantees use of corporate assets, budgets, hiring authority, marketing and education of sales force
  - Parties agree on a formal business plan, with targets and allocation of funds to meet those targets
  - Reporting and information rights (but be careful not to make obligations too burdensome)
  - Additional protection in the event of a change in management, change in control
  - Covenant of good faith and fair dealing

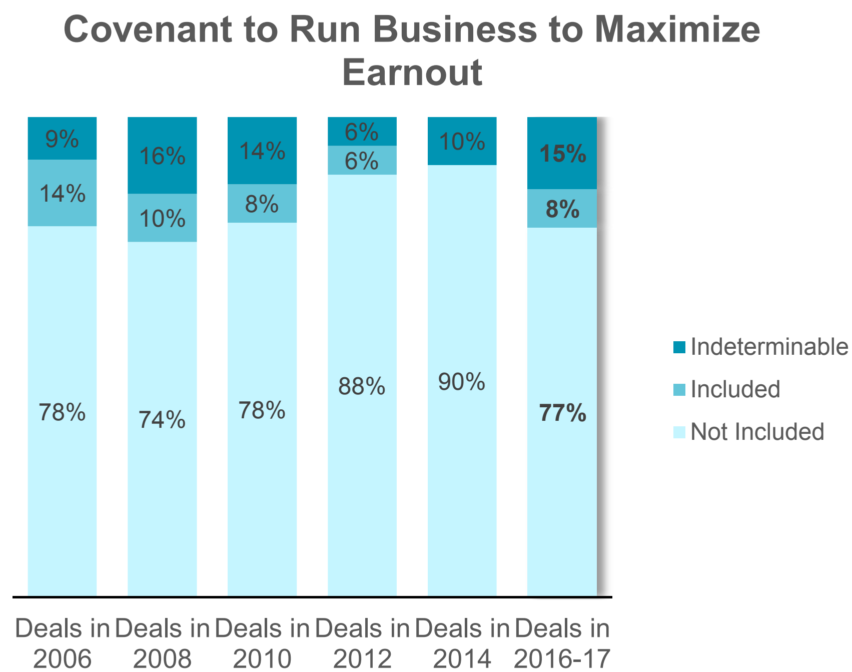
Examples of Clauses

- **Operations**. From the Closing Date until the earlier of December 31, 2023 or the payment to Seller of the maximum amount of the earn-out payment: (i) Target's business will be operated as a separate business unit of Buyer and (ii) neither Buyer nor Target will take any actions in bad faith that would have the purpose of avoiding or reducing the earn-out payment.
- **Disclaimer**: Seller acknowledges that neither Buyer nor any of its representatives owe any fiduciary duties or any other duties (express or implied) to maximize the applicable earnout revenue in any applicable period.
- "**Acceleration Event**" means Parent fails to materially comply with any covenant set forth herein following written notice of such non-compliance delivered by Seller to Parent, and such non-compliance is not cured by Parent within 30 days following receipt by Parent of such notice.
- **Acceleration Events**. In the event of (i) a disposition of the Target or any of its material assets during the Earnout Period that materially and negatively impacts the achievement of the Earnout Amount or (ii) a Purchaser Change of Control, the Earnout Amount shall be deemed to be accelerated in full, deemed to equal $20,000,000, and paid on the date of the closing of such transaction, whether or not the Net Revenue was, or was likely to be, greater than the Net Revenue Target.

ABA 2017 Private Target Deal Study: Covenants

(Subset: deals with earnouts*)



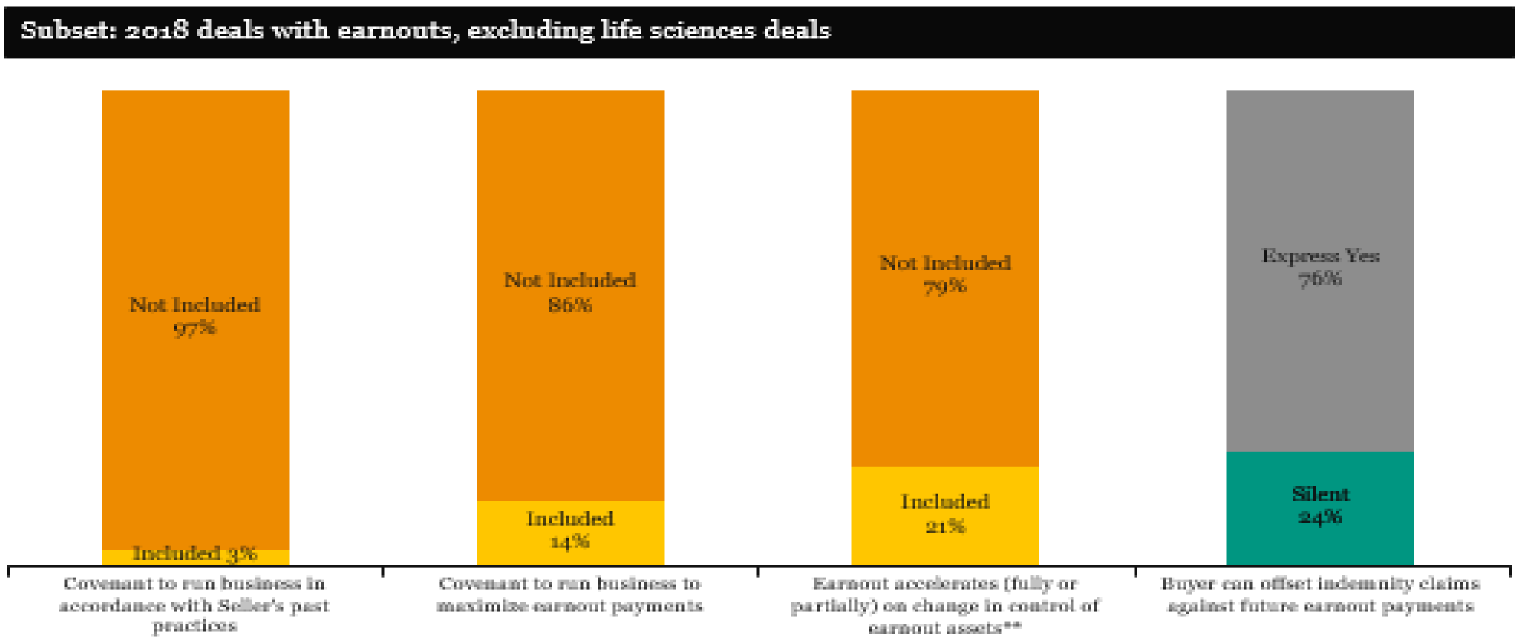


* Excludes three deals with unfiled earnout provisions.

** At least 28% of the deals with earnouts contained one of these covenants; no deals contained both covenants.

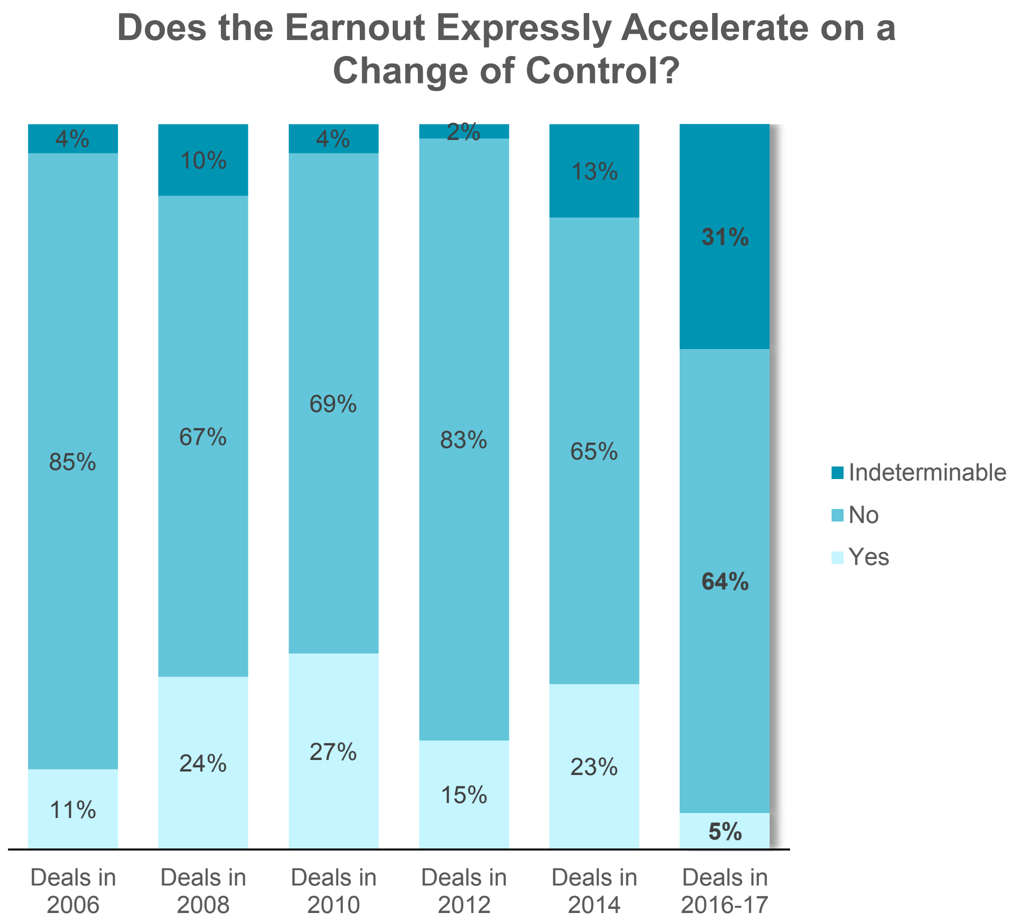
SRS Acquiom 2019 M&A Deal Terms Study:

Earnouts (Non-Life Sciences Deals*): Covenants, Acceleration, and Offsets



** For a more detailed analysis of SRS Acquiom's life sciences deals, please see the 2017 SRS Acquiom Life Sciences M&A Study.*
*** Generally subject to exceptions, such as if the subsequent buyer assumes the earnout obligations.*

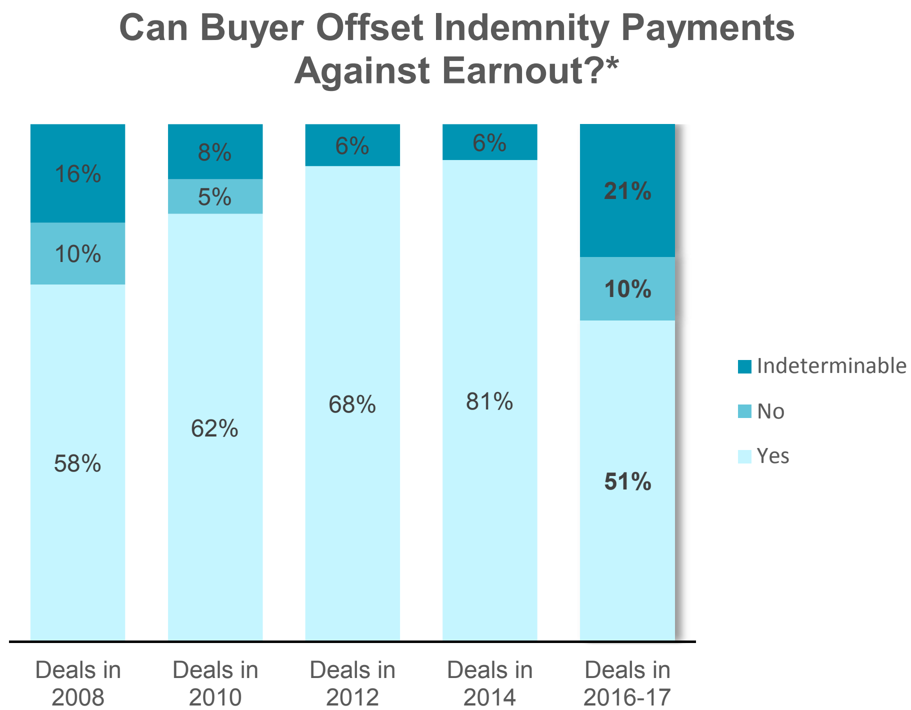
ABA 2017 Private Target Deal Study: Change of Control



Additional Protections - Security Interest and Escrow

- Security for future earnout payments
  - Security interest: Require Buyer to grant security interest in target company
  - Parent guaranty: Require Buyer's parent to guaranty the Buyer's obligation to make the earnout payments
  - Escrow: Require Buyer to put potential earnout payments in escrow

ABA 2017 Private Target Deal Study: Offset of Indemnity Payments



* Excluding deals that are silent as to whether buyer may offset indemnity payments against earnout.

Other Considerations

- Tax treatment
  - Buyer: basis in the stock or assets
  - Seller: purchase price vs. compensation for services
  - Seller: timing of gain recognition
- Accounting issues
- Potential conflicts
- Confidentiality issues

Dispute Resolution Perspective – Earnout Provisions

Recent Developments in Delaware Law re Earnout Provisions

"*[A]n earn-out provision often converts today's disagreement over price into tomorrow's litigation over the outcome*." Vice Chancellor Laster, Airborne Health, Inc. v. Squid Soap, LP (2009)

Typical Earnout Disputes:

- Post-closing accounting methodologies or definitions
  - Earnout provision does not clearly define how earnout thresholds are to be calculated
  - Earnout provision does not account for treatment of certain expenses and revenues
  - Earnout provision does not clearly define the earnout period
  - Revenue recognition
  - Post-closing changes in accounting guidelines
- Disputes over post-closing operations of the business

"Consistent with Past Practice"

Edinburgh Holdings, Inc. v. Education Affiliates, Inc., 2018 WL 2727542 (Del. Ch. 2018)

- Buyer and Seller agreed to certain earnout payments contingent upon meeting certain revenue projections, and the purchase agreement included a general covenant that, during the earnout period, the business be operated "***in a reasonable manner consistent with [Seller's] past practices***."

- Seller sued following Buyer's failure to make timely earnout payments, and Buyer brought a motion to dismiss arguing that the business was not operated by the Seller's former management "in a reasonable manner consistent with past practices."

- In denying Buyer's motion to dismiss, Vice Chancellor Slights noted the fact-intensive nature of the question of whether management conducted the business "in a reasonable manner consistent with past practices," and held that the case was not susceptible to disposition at the early pleading stage of litigation and that discovery would be necessary.

- Accordingly, in order to dispose of the claim, the court explained that it would need evidence of both:
  - Seller's past practices in conducting its business; and
  - The practices employed by Buyer post-closing.

"Consistent with Past Practice"

Edinburgh Holdings, Inc. v. Education Affiliates, Inc.

- Take-aways:
  - General covenants, such as a covenant to operate "in a reasonable manner consistent with past practices," lend themselves to litigation that may continue beyond the pleading stage of a claim for breach of an earnout payment obligation.
  - Detailed and specific covenants to accompany general standards, such as the one in *Edinburgh,* should be considered while drafting earnouts relating to the operation of the business during the earnout period.

Implied Covenant of Good Faith and Fair Dealing

Glidepath Limited v. Beumer Corporation, 2019 WL 855660 (Del. Ch. 2019)

- Beumer acquired 60% of the equity of Glidepath in a deal that included potential earnout payments, which were conditioned upon the profitability of Glidepath during a three year period of shared management.

- Shortly after the transaction closed, Beumer reoriented the company towards larger, long-term projects and, as a result of this new strategy, failed to produce enough net profit to trigger certain earnout payments to Glidepath.

- Glidepath sued Beumer alleging that Beumer breached various express terms of the agreement and violated the implied covenant of good faith and fair dealing by "taking action designed to frustrate the Sellers' ability to receive the Contingent Consideration."

- Glidepath also claimed that the Buyer breached its fiduciary duties.

Implied Covenant of Good Faith and Fair Dealing

Glidepath Limited v. Beumer Corporation

- Vice Chancellor Laster held that Beumer did not breach the implied covenant of good faith and fair dealing because "[the implied covenant] cannot be invoked where the contract itself expressly covers the subject at issue," and Glidepath failed to identify a gap in the governing documents.

- The court held that Beumer did not violate its fiduciary duty to Glidepath by pursuing projects in pursuit of its long-term strategy because "the Company's fiduciaries had a duty to act in good faith to maximize the value of the Company over the long term" and "[t]he Company's fiduciaries did not have a duty to maximize the value of the contract claim to the Contingent Consideration."

Implied Covenant of Good Faith and Fair Dealing

Glidepath Limited v. Beumer Corporation

- Take-aways:
  - While a Buyer cannot purposefully frustrate an earnout, Buyers do not have a legal duty to maximize an earnout.
  - Practice Pointer: A purchase agreement should specify the level of support given by a Buyer during the earnout period if Seller anticipates that the support of Buyer will be required to generate earnout payments.

Implied Duty to Use Reasonable Efforts to Achieve Earnout

Sonoran Scanners, Inc. v. PerkinElmer, Inc., No. 09-1089 (1st Cir. Oct. 29, 2009).

- Facts:
  - Potential earnout (up to $3.5M) was equal to purchase price paid at closing ($3.5M); a significant portion of purchase price at closing was paid to Seller's creditors rather than shareholders.
  - Purchase agreement contemplated a campaign to market Seller's technology over the earnout period (5 years).
  - Business failed shortly after acquisition and Buyer sold the assets.
  - Seller alleged failure to use reasonable efforts to develop and promote the acquired technology which could have allowed achievement of the earnout.

- Court held that under Massachusetts law, Buyer was bound by an implied covenant to use reasonable efforts to develop and promote the Seller's technology that was the subject of the earnout.

- Take-away:
  - It's important for Buyers to expressly disclaim any implied duties in the purchase agreement, or at least add an acknowledgement that the buyer has the right to operate the target's business as it sees fit and that it is under no obligation to cause the earnout to be achieved.

Earnout Payment Procedures and Buyer's Diligence With Respect to Earnout Payments

GreenStar IH Rep, LLC v. Tutor Perini Corp., 2017 WL 5035567 (Del. Ch. 2017)

- Tutor acquired GreenStar in a deal that provided for earnout payments to be paid to GreenStar's Interest Holder Representative (the "IH Rep") in each of the first five years after closing.
- Each payment would be equal to 25% of GreenStar's "Pre-Tax Profit" subject to a cap each year (with amounts in excess of the cap being carried over to the next year).
- The agreement provided that Tutor was required to calculate Pre-Tax Profit and to provide a Pre-Tax Report to the IH Rep within certain time periods after each year-end.
- If the IH Rep accepted the Report (or did not object), Tutor was required to pay the amount it had calculated. If the IH Rep objected to the Report, then the parties were required to try to resolve the dispute for a specified time period, and, if they could not, to submit it for binding arbitration by an independent accountant.

Earnout Payment Procedures and Buyer's Diligence With Respect to Earnout Payments

GreenStar IH Rep, LLC v. Tutor Perini Corp.

- Following each of the first and second years, Tutor prepared the Report largely based on input from the former CEO who remained as the CEO of a GreenStar subsidiary.
  - CEO was the person who was entitled to receive the largest share of any earnout payments.
- The first two years, Tutor paid the earnout amount and carried an excess of $9.2 million for potential payment in future years if the earnout amount did not reach the cap.
- After each of the third and fourth years, Tutor again prepared the Pre-Tax Report based in large part on the information provided by the CEO and delivered the Report to the IH Rep. However, Tutor did not pay the earnout amounts.
  - Tutor withheld the payments, alleging that CEO had been providing fraudulent information to Tutor to inflate the earnout amount.
- After the fifth year, Tutor neither prepared a Report nor made any earnout payment.

Earnout Payment Procedures and Buyer's Diligence With Respect to Earnout Payments

GreenStar IH Rep, LLC v. Tutor Perini Corp.

- Vice Chancellor Slights held that the agreement did not provide for Tutor to withhold earnout payments even though it doubted the accuracy of the information that was provided to calculate Pre-Tax Profit.

- Rather, the Vice Chancellor emphasized the precise procedure laid out in the agreement, which required that an earnout amount be paid based on the Report (absent an objection by the IH Rep).

- The court ordered that earnout payments be made with respect to the third, fourth and fifth years.

Earnout Payment Procedures and Buyer's Diligence With Respect to Earnout Payments

GreenStar IH Rep, LLC v. Tutor Perini Corp.

- Take-aways:
  - Buyers should proceed with caution when relying on a member of the Seller group to calculate earnout payments - consider engaging an outside accountant to review the financials or calculate the earnout payments.
  - Long earnout periods have a greater risk of resulting in a dispute.
    - Also, despite a significant downturn in revenue after year two, the ability to carryover excess amounts resulted in seller receiving ~90% of the total amount available.
  - Buyers should have complete confidence in the earnout calculations it submits to Sellers.
  - Draft (and follow) specific procedures for earnout provisions that are informed by the specifics of the target's business and deal dynamics.

Contact Information

Tatjana Paterno
Bass, Berry & Sims PLC
Email: tpaterno@bassberry.com
Phone: (615) 742-7928

Tyler J. Sewell
Morrison & Foerster LLP
Email: tsewell@mofo.com
Phone: (303) 592-2215

Chris Letang
SRS Acquiom
Emaill: cletang@srsacquiom.com
Phone: (303) 957-2855

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