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Post-Closing Earnouts in M&A Transactions: Avoiding Common Disputes

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The prospective parties to an M&A transaction often have different views regarding the value of the subject company, which can make it difficult to agree upon a purchase price. Of course, such different valuation perspectives may not be surprising given that the value of a business typically is determined by reference to its expected future performance or cash flows. The seller may be optimistic with regard to the future prospects, and therefore ascribe a higher value to a business than the buyer, which may be more conservative. One common way to bridge the gap between the parties' valuation positions is to have a portion of the purchase price based on the future performance of the company. Such a provision, which is often called an "earnout," entitles the seller to receive additional payments if the business meets certain contractual targets post-closing.

Although an earnout may appear to be an effective means to resolve a disagreement over price, earnout provisions often result in litigation. Indeed, the Delaware Court of Chancery recently has observed as follows:

> [A]n earnout ... typically reflects [a] disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time.... *But since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome.*[1]

There are two primary types of disputes relating to contractual earnouts. First, the parties may disagree as to whether the applicable targets for an earnout payment were satisfied (*e.g.*, whether the EBITDA target was met). The other common dispute involves disagreements as to why the earnout targets were not satisfied (*e.g.*, whether the buyer adequately supported the business after the closing).[2]

1 *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del. Ch. 2009) (emphasis added).

2 The Delaware Court of Chancery has noted that "[e]arnouts frequently give rise to disputes, and prudent parties contract for mechanisms to resolve those disputes efficiently and effectively." *Aveta Inc. v. Bengoa*, 986 A.2d 1166, 1173 (Del. Ch. 2009). In fact, many agreements expressly set forth procedures for the resolution of earnout disputes, such as requiring that the disputes be submitted to arbitration. Courts will enforce such agreements, and can impose sanctions for a failure to comply. *Id.* at 1181-90 (holding the seller in contempt for failing to participate in the contractually mandated arbitration relating to an earnout dispute).

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The parties' rights and obligations with respect to an earnout provision are contractual in nature, and therefore the resolution of an earnout dispute often turns on the specific language negotiated by the parties. Set forth below is a summary of certain Delaware decisions addressing earnout disputes, which provide insight regarding how courts will interpret such provisions. More importantly, the decisions also demonstrate how certain disputes might be avoided by careful drafting of the contract language.

Disputes Regarding Whether the Earnout Target Was Satisfied

The Delaware Court of Chancery has noted that "[t]here are always choices to be made in accounting treatment" — and such choices can have a significant impact on the calculation of the earnout.[3] As illustrated by the decisions below, in light of the buyer's potential discretion in accounting for the operation of the business post-closing, parties would be well-served to carefully draft the agreement so as to make clear how the earnout should be calculated (and determine the earnout consistent with the agreement) so as to reduce the likelihood of litigation.

Comet Systems, Inc. Shareholders' Agent v. MIVA, Inc.

The Court of Chancery's decision in *Comet Systems, Inc. Shareholders' Agent v. MIVA, Inc.*[4] presents a typical case in which the dispute related to whether the earnout target was satisfied. In that case, MIVA, Inc. ("MIVA") acquired Comet Systems, Inc. ("Comet") pursuant to a merger agreement that included an earnout provision. Specifically, the earnout provided for potential additional payments of up to $10 million, half of which could be earned for meeting the performance targets specified in each of 2004 and 2005. In each year, the earnout payment was determined based on Comet's performance relative to three performance goals, with each goal worth one-third of the total possible earnout compensation for that year. Achievement of a portion of a goal would result in a *pro rata* payout with respect to that goal — except that no payment was due if the company did not achieve at least 66% of the goal.

In connection with the closing of the transaction, Comet paid a bonus (the "Bonus") of approximately $800,000 to its employees. The Bonus was referenced in the merger agreement, but was not addressed in the earnout provision.[5] In order to meet the revenue goal contained in the earnout, the revenue per user had to exceed the cost per user, which was defined as "Operating Costs Excluding Amortization and One-time, Non-recurring Expenses."[6] In calculating the earnout, MIVA treated the Bonus as an operating cost, which was not excluded as a "one-time, non-recurring expense." As a result, the revenue target was not achieved and the earnout payment was reduced significantly. The primary issue presented was whether the Bonus was a "one-time, non-recurring expense" that should have been excluded from MIVA's costs for the purpose of calculating the earnout.

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3 *Chambers v. Genesee & Wyoming Inc.*, 2005 WL 2000765, at *8 (Del. Ch. Aug. 11, 2005).

4 980 A.2d 1024 (Del. Ch. 2008).

5 The merger closed on March 22, 2004. Significantly, the earnout was based on the entire year of 2004 — both before and after the closing of the merger. *Comet*, 980 A.2d at 1027-28.

6 *Comet*, 980 A.2d at 1028.

MIVA asserted that the Bonus was an ordinary cost of business — not a one-time non-recurring expense — given that Comet regularly paid bonuses, and the purpose of the bonus was to retain and incentivize Comet's employees, which is the typical purpose of a bonus. MIVA further asserted that the Bonus was paid to encourage the employees to help make Comet successful, and that it would be inappropriate when calculating the earnout to include the revenues resulting from the employees' efforts without including the attendant expense (*i.e.*, the Bonus). Comet responded that the Bonus was materially greater than any previous bonus paid by the company, and it was based on a percentage of the merger consideration. Unfortunately, the merger agreement did not define what was intended by the term "one-time, non-recurring expense," and the Court found that the parties' reference to accounting principles was not helpful in determining the meaning.[7]

The Court concluded that the Bonus qualified as a "one-time, non-recurring expense" pursuant to the "plain, unambiguous meaning of the merger agreement."[8] In support of its conclusion, the Court focused on the purpose for which the "one-time, non-recurring expense" exclusion was being applied. Specifically, the Court noted as follows:

> Earnouts are typically used where the buyer and seller cannot agree on a price because the seller is more optimistic about the future prospects of a business than is the buyer. As a result, charges and costs which occur as a result of the merger and are not expected to be representative of future costs in the business are reasonably excluded. The natural reading of "one-time, non-recurring expenses" is to exclude exactly such charges.[9]

The primary lesson from the *Comet* decision is obvious: the parties should agree in advance — and set forth in the contract — how specific expenses should be treated for the purposes of determining the earnout. Although it is not possible to anticipate all expenses that may be incurred following closing, the Bonus at issue was expressly contemplated by the parties and referenced in the merger agreement. In addition, to the extent that the earnout purports to include or exclude certain types of revenues or expenses (*e.g.*, one-time, non-recurring expenses), the contract should define as precisely as possible what the parties intend by such language.

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7 Both sides presented testimony from accounting experts to support their positions, and the accounting experts noted that the contractual language (*i.e.*, "one-time, non-recurring expense") was similar to the definition of an extraordinary item under GAAP. *Comet*, 980 A.2d at 1031, n.26. The Court, however, did not apply the GAAP definition, noting that: "the parties chose to use the phrase 'one-time, non-recurring expense' and not 'extraordinary item in accordance with GAAP practice.' The obvious implication is that the parties chose this alternative phrase precisely because they did *not* mean 'extraordinary item in accordance with GAAP practice,' particularly in light of the fact that the parties obviously knew how to invoke GAAP standards when they wanted to." *Id.* (quotations and emphasis in original).

8 *Comet*, 980 A.2d at 1032.

9 *Id.* at 1031 (footnotes omitted).

Chambers v. Genesee & Wyoming Inc.

Another example of a dispute regarding the calculation of an earnout is described in the Court of Chancery's decision in *Chambers v. Genesee & Wyoming Inc.*[10] That decision involved two stock option agreements that arose in connection with a buyout by Genesee & Wyoming Inc. ("Genesee") of the plaintiffs' interest in Genesee Rail-One ("GRO"). The agreements contained an earnout, which was tied to GRO's EBITDA as defined in the agreements. As noted by the Court, however, "EBITDA ... can be a slippery concept, and it is this indefiniteness-plus the characteristic divergence in the sellers' and the buyers' interests that arises all too often in calculating whether the targets in 'earn-out' contracts were achieved-that has led to the current conflict."[11]

Stated generally, the agreements provided that plaintiffs would receive additional compensation, in the form of Genesee stock options, if GRO achieved $9 million of EBITDA in any of the five years, 1999-2003. Following the 1999 buyout, GRO's publicly-reported EBITDA exceeded $9 million in four of the five years covered by the earnout. Genesee, however, asserted that it was not obligated to vest the options because EBITDA *as defined in the Agreements* had not exceeded $9 million in any year.

The discrepancy arose because Genesee made adjustments to its publicly reported EBITDA in order to determine whether plaintiffs' options vested under the agreements. Not surprisingly, the adjustments served to reduce EBITDA such that plaintiffs were not entitled to additional compensation. The dispute focused on whether Genesee's adjustments were proper under the agreements.

The Court quickly rejected Genesee's assertion that, absent the adjustments, the calculation of EBITDA (and resulting additional compensation) would be "unfair." Specifically, the Court noted that the dispute was "purely commercial," and that the Court need not consider such fairness arguments or the accounting principles cited by Genesee.[12] Rather, the Court focused on "contract law" and the "plain language of the contract itself."[13] For example, although it might be appropriate and consistent with accounting principles to allocate certain costs to GRO, the agreements specifically excluded such allocations for the purposes of calculating the earnout. Similarly, the agreements did not permit Genesee to expense certain labor costs (for the purpose of determining the earnout) that it had capitalized for its public financial statements. The Court therefore concluded that Genesee's calculation of EBITDA for purposes of the agreements was flawed.

The decision in *Genesee* serves to highlight the fact that the earnout will be determined based on the contract negotiated by the parties, and not by reference to fairness or general accounting principles. Accordingly, it is important to articulate clearly how the earnout will be calculated. Moreover, to the extent that adjustments are made to the company's financial results for the purpose of determining the earnout, such adjustments must be expressly permitted under the contract.

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10 2005 WL 2000765 (Del. Ch. Aug. 11, 2005).

11 *Id.* at *1.

12 *Id.* at *6.

13 *Id.*

William J. LaPoint v. AmerisourceBergen Corp.

The Court of Chancery's decision in *William J. LaPoint v. AmerisourceBergen Corp.*[14] presented a number of issues relating to an earnout provision. *LaPoint* involved the merger between Bridge Medical, Inc. ("Bridge") and AmerisourceBergen Corporation ("ABC"). Under the terms of the merger agreement, ABC agreed to pay Bridge stockholders an initial $27 million dollars, and further consented to earnout payments to former Bridge stockholders contingent upon certain EBITA targets being met in 2003 and 2004. These payments could vary between $55 million and zero, depending on the EBITA that Bridge achieved. The Court noted that "the earnout provision provided both protection to ABC shareholders and an incentive for Bridge to perform."[15] Among other claims, the plaintiffs asserted that "ABC miscalculated the agreed-upon adjustments to EBITA in order to ensure that plaintiffs received no payment."[16]

The first dispute related to the treatment of certain transactions for the purpose of the earnout. Specifically, with regard to bundled products, the contract called for the application of a discount equal to the "average" discount in the last five unbundled contracts.[17] ABC offered numerous arguments to support its contention that the discount should be calculated using a "weighted average," reflecting the size of the transactions, which resulted in a lower earnout payment. Although the Court recognized that using a weighted averaged was a "plausible option" for the parties, the merger agreement did not so provide.[18] Accordingly, the Court rejected ABC's argument finding that ABC sought to "invoke the merger agreement that it wishes it had signed, rather than the merger agreement that it drafted."[19]

ABC also asserted that Bridge's EBITA should be adjusted downward by approximately $1.3 million to reflect the fact that Bridge spent only $2.4 million in research and development expenses.[20] The merger agreement provided, however, that such expenses could not be reduced below $3.7 million without the consent of ABC.[21] Although it was undisputed that Bridge failed to comply with the contract, the Court noted that such failure did not require an adjustment to EBITA for the purposes of the earnout. Specifically, the Court opined as follows:

> [ABC] would have done well to have included in the original draft of the merger agreement a provision stating that if plaintiffs unilaterally reduced planned expenditure in any area by more than a given amount, that amount would in turn be applied to the end of year EBITA adjustment in 2003 or 2004. Instead, the merger agreement

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14 2007 WL 2565709 (Del. Ch. Sept. 4, 2007), *aff'd*, 956 A.2d 642 (Del. 2008).

15 *Id.* at *2.

16 *Id.* at *7.

17 *Id.*

18 *Id.* at *12.

19 *Id.*

20 2007 WL 2565709, at *8.

21 *Id.*

> simply provides that Bridge shall expend a certain sum of money in R&D in 2003.... No rational reading of the contract would support the conclusion that an adjustment in EBITA would be an accurate reflection of expectation damages.[22]

The Court similarly rejected another proposed adjustment to EBITA based on the assertion that revenue recognition with regard to a specific transaction was "in violation of GAAP."[23] The plaintiffs responded that the merger agreement expressly provided for the challenged revenue recognition. Once again, the Court determined that the dispute was resolved by the language of the merger agreement, which set forth how the transaction was to be handled for the purpose of the earnout. The Court further noted as follows:

> Had defendant wished to ensure that the revenue credit due to plaintiffs was recognized only when the relevant sales were recognized under GAAP, it would have been easy to draft such a contract. Defendant did not do so, however, and cannot be heard to complain now that the standards of ¶ 34 are too lenient.[24]

The decision in *LaPoint* further serves to highlight the importance of careful drafting of the earnout provision. As explained by the Court, "[h]aving arrived at the courthouse realizing that the merger agreement exposes [it] to considerable risk, [ABC] now asks the Court to subtly rewrite it by inserting provisions that simply do not exist."[25] The Court, however, will not rewrite the merger agreement — even if enforcing the terms as written may result in a purported windfall for one party.

Disputes Regarding Post-Closing Management of the Company

The ability of a business to achieve the earnout targets will necessarily depend on the management of the business post-closing, including the resources and support that are provided to the business. This creates potential conflicts between the buyer and the seller. For example, the seller understandably wants the business managed so as to maximize the earnout payments. In contrast, the buyer may determine that it does not make economic sense to pursue a course of conduct that might otherwise benefit the seller. Not surprisingly, as illustrated by the cases discussed below, this inherent tension often results in litigation.

William J. LaPoint v. AmerisourceBergen Corp.

In *LaPoint,* which is briefly summarized above, the Bridge stockholders expressly required that ABC promote Bridge's business post closing. Specifically, the merger agreement provided as follows:

22 *Id.* at*11.

23 *Id.* at *14.

24 *Id.* at *15.

25 *Id.* at *11.

> [ABC] agrees to (and shall cause each of its subsidiaries to) *exclusively and actively* promote [Bridge's] current line of products and services for point of care medication safety. [ABC] shall not (and shall cause each of its subsidiaries to not) promote, market or acquire any products, services or companies that compete either directly or indirectly with [Bridge's] current line of products and services.[26]

In addition, the merger agreement addressed the risk that the surviving entity might exert its influence post-closing in order to avoid the earnout payments, providing as follows:

> [ABC] will act in good faith during the Earnout Period and will not undertake any actions during the Earnout Period *any* purpose of which is to impede the ability of the [Bridge] Stockholders to earn the Earnout Payments.[27]

Thus, the merger agreement provided protection to former Bridge stockholders in the event that they are unable to achieve their EBITA targets and, thus, receive their contemplated merger consideration due to action or inaction on the part of ABC.

As noted by the Court, however, much of the merger agreement "consists of the sort of aspirational statements mentioned above," which have "proven too fragile to prevent the parties from devolving into the present dispute." [28] For example, although the terms of the agreement undoubtedly required ABC to "actively" promote Bridge products, the parties disagreed as to whether ABC satisfied that "nebulous requirement."[29] Ultimately, however, the Court determined that ABC's conduct, including promoting competing products, was inconsistent with its obligation to actively and exclusively promote Bridge's products. That determination, however, did not mean that Bridge stockholders were entitled to the full amount of the earnout. To the contrary, the Court concluded that "that even had ABC acted in utmost good faith, which it certainly did not, Bridge would have been highly unlikely to earn a sale and thus contribute to the EBITA calculations for purposes of the earnout."[30] The Court further concluded that the plaintiffs failed to demonstrate that ABC's failure to promote Bridge led to damages that could be fixed to a reasonable degree, and therefore awarded only nominal damages to the plaintiffs.

In addition, the Court rejected the plaintiffs' assertion that ABC breached its contractual obligations by failing to enter into a joint venture with a third party, which was expected to increase the likelihood that the earnout would be paid. The Court held that "[a]lthough ABC could not unreasonably withhold consent from a transaction that would allow [the] shareholders to earn their earnout payments, nothing in the merger agreement obligated ABC to enter into an unprofitable transaction."[31]

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26 2007 WL 2565709, at *2 (emphasis in original).

27 *Id.* (emphasis in original).

28 *Id.*

29 *Id.*

30 *Id.* at *4.

31 *Id.* at *10 (emphasis omitted).

As illustrated by the decision in *LaPoint*, the terms of an earnout provision might have significant implications with regard to the buyer's obligations and discretion regarding the management of the business post-closing. To avoid uncertainty regarding such obligations and related disputes, it is important that, to the extent possible, the buyer's obligations be set forth in objective, rather than aspirational, terms. For example, the agreement could set forth a minimum amount that must be spent on advertising and sales support each year for the business, rather than a vague obligation to actively promote the business. Moreover, the agreement should set forth the consequences of failing to comply with such contractual obligations because, as illustrated by the Court's damages analysis in *LaPoint*, it may be difficult to establish that the earnout targets would have been achieved but for the breach.

Airborne Health, Inc.

The Court of Chancery's decision in *Airborne Health, Inc. v. Squid Soap, L.P.*[32] provides another example of a situation where the undisputed failure to support the business post-closing did not result in the payment of the earnout. In that case, Airborne acquired Squid Soap pursuant to an asset purchase agreement. Squid Soap agreed to sell its assets for $1 million in cash at closing, plus the potential for earn-out payments of up to $26.5 million if certain targets were achieved. As noted by the Court, "[b]ased on an earn-out of this magnitude (viewed in terms of the portion of total potential consideration), the plain inference is that Squid Soap believed that its business had tremendous value and was willing to bet heavily on that proposition."[33] The agreement was unusual in that it provided that, if Airborne failed to spend a certain amount on marketing and advertising to support Squid Soap's products or failed to achieve certain sales targets, the assets would be returned to Squid Soap.

Following the closing of the transaction, Airborne faced some significant problems with its existing business. As a result, Airborne failed to provide the minimum level of marketing and advertising support for Squid Soap's products as required under the agreement. In addition, Airborne failed to achieve the minimum sales targets for Squid Soap's products. Pursuant to the terms of the agreement, in light of its failure to achieve the minimum sales targets, Airborne attempted to return the assets to Squid Soap. Squid Soap refused to accept the assets, however, and instead sued for fraud in Texas.[34] Airborne responded by filing suit in the Delaware Court of Chancery for a declaration that Airborne was not liable under the agreement.

Although Squid Soap asserted numerous claims, the one most relevant to the earnout was Squid Soap's allegation that Airborne breached the agreement by failing to spend the minimum amounts set forth in the agreement to market Squid Soap's products. The Court, however, rejected this claim, noting that the agreement did not require Airborne to spend a minimum amount. Rather, the agreement provided that the assets would be returned to Squid Soap if Airborne failed to spend the minimum

32 984 A.2d 126 (Del. Ch. 2009).

33 *Id.* at 132.

34 The agreement contained a forum selection provision requiring all disputes to be heard in a Delaware court. Accordingly, the Texas litigation was dismissed. *Airborne*, 984 A.2d at 136.

amount. The Court also rejected Squid Soap's claim that Airborne committed fraud by failing to disclose certain claims and litigation against Airborne, which purportedly impaired Airborne's ability to successfully market Squid Soap's products. Once again, the Court focused on the specific language of the agreement and noted that Airborne made no representations regarding its ability to achieve the earnout targets. Ultimately, the Court concluded that the agreement provided downside protection to Squid Soap in the event that Airborne failed to adequately support Squid Soap's products — it required that Airborne return of the assets to Squid Soap. The Court therefore refused to rewrite the agreement so as to provide additional relief to Squid Soap.

This decision once again makes clear that the Court will enforce the agreement negotiated by the parties as reflected in the terms of the contract. As in *LaPoint*, the Court noted that the buyer's failure to provide the required support to the business post-closing will not result in an automatic recovery for the seller. Rather, the seller must demonstrate that such failure entitles it to relief under the contract. The decisions therefore highlight the fact that the contract should be clear and the parties should understand not simply the obligations of the buyer to support the business post-closing, but also the consequences of a breach of such obligations.

Conclusion

The earnout is a critical part of a transaction, and can represent a substantial portion of the total consideration. The achievement of the earnout, however, necessarily depends on the buyer's management of the business post-closing, and how the buyer accounts for the post-closing financial performance of the business. As a result, to the extent that the buyer has discretion, it may be incentivized to manage, or to account for, the business in a manner that reduces the additional amounts that are due to the seller. In light of this potential conflict between the interests of the buyer and the seller, it is not surprising that disputes often arise relating to earnout provisions. As explained above, however, it may be possible to avoid some of the potential disputes through careful drafting of the earnout provision.