SLAUGHTER AND MAY/

A BRIDGE OVER TROUBLED WATER? KEY TIPS AND TRAPS FOR EARN-OUTS IN INTERNATIONAL M&A

Beyond Borders – Part of the Horizon Scanning series

To agree a deal, you need to agree a price. But what happens if the seller and the purchaser have different views on the value of the target business? This could happen in the pre-COVID world, but may become more common where the financial performance of companies across the globe has been adversely affected, perhaps only temporarily. One solution to bridge this sort of value gap is an earn-out.

An earn-out involves at least part of the purchase price being calculated by reference to performance of the target business post-acquisition. In doing so, it has the potential to deliver a construct of consideration that is acceptable to both seller and purchaser, and ultimately a more accurate calculation of value.

In theory an earn-out should align the economic interests of the parties. But earn-outs can be somewhat contentious. This can be borne out both in the negotiation of the earn-out terms, and also after completion when it comes to the operation of the business and the actual calculation of the earn-out.

This briefing sets out some key tips and traps to avoid for when using an earn-out, including the rationale for earn-outs, structuring considerations and some practical points to bear in mind throughout the process.

Top 5 tips

1. Is an earn-out feasible - can a relevant performance metric be objectively measured in light of the business and the purchaser's post-completion plans for it?
2. Be as specific and clear as you can with the earn-out structure and drafting
3. Get specialist accountants involved from the outset and use formulae / worked examples / pro forma schedules
4. Think about the tax treatment early
5. Be alive to the potential for dispute, and try to proactively mitigate that risk

Why use an earn-out?

An earn-out can be a useful mechanism to bridge a value gap and facilitate a private M&A transaction (whether domestic or cross-border). While it will not always be appropriate, there are certain scenarios that could lend themselves to use of an earn-out, including when:

- buying a target whose real value lies in how it might perform in the future. This could be specific to the target (e.g. start-ups) or be driven by sector (e.g. a sector that is subject to significant short-term change);
- the target business has experienced a fall in revenue/earnings that may only be temporary (e.g. as a result of COVID-19); or
- buying from individual founders, management or a family who have been integral to the performance of the business to date, including where they may stay involved with the business (i.e. as a means of retaining and incentivising management to maximise the target company's success going forwards).

Of course, an earn-out will not be suitable for every transaction. For example, in distressed M&A where there is an inherent need to receive the full consideration upfront to reduce leverage or otherwise distribute to creditors.

Parties should consider the advantages and disadvantages of using an earn-out on their deals - see the box below:

SELLER	PURCHASER
Advantages	
• Bridging the value gap pre-signing • Allows seller to participate in the potential upside of future performance, without proportionate downside risk • May allow seller to participate via the earn-out in synergistic advantages of being part of a larger group	• Bridging the value gap pre-signing • Ensures that the purchase price is directly linked to the performance of the target company post-acquisition • Cash flow benefits as part of the purchase price is deferred for a period after completion
Disadvantages	
• No clean break with target business / purchaser • Can be contentious • Lack of control over how Purchaser is running the business over earn-out period - gives Purchaser ability to manipulate?	• No clean break with seller • Can be contentious • Purchaser may be unduly restricted in its ability to integrate, run, sell or add to the target business during earn-out period

Structuring your earn-out

Once you have decided to use an earn-out, the next step is to agree its structure. This will vary considerably from deal to deal. However, there are various different strands to this and it is critical to carefully consider the terms governing an earn-out arrangement and make sure they are precisely drafted.

Performance metrics

The central component of an earn-out is the performance metrics that will be used to determine if the earn-out is payable. These metrics can be financial, such as achieving a certain pre- or post-tax profit, EBITDA, or revenue target; or non-financial, such as securing regulatory approval, the completion of a specific project, or the award (or non-termination) of certain key contracts. Parties can customise these metrics as appropriate for the business in question, e.g. by tying them to the performance of a particular division or product, or within a certain geography.

In choosing financial metrics, the parties must identify which will be the best 'proxy' for the future success of the target company. No one metric is perfect. Sellers generally prefer a revenue-based metric on the grounds that this is less susceptible to purchaser manipulation. Conversely, purchasers are likely to resist revenue targets where this metric may encourage retained sellers (who remain involved in the business) to accept low-margin projects to drive up gross revenue. Purchasers are instead likely to press for net income or profit-based metrics. Of course, earn-outs can involve more than one metric, and the parties may also agree upon a combination of financial and non-financial measures.

Whichever metrics the parties choose, clarity on definition and calculation is key. This is particularly important where the financial metric in question is not defined in accounting standards and may not be presented in the reference historical accounts provided by the target company. The parties should engage accountants from an early stage of a transaction to help shape the earn-out and to advise on how accounting standards and policies should be applied to the drafting. Disconnects may arise between international parties who adhere to different accounting standards. Using formulae, worked examples or pro forma accounts schedules in the sale agreement may help avoid disputes later on.

Hand in hand with the type of metrics comes the numerical targets that are to be applied to them. Earn-outs can be all or nothing, where a seller is paid only if it achieves a certain target, or can allow for interim milestones or be paid out on a sliding scale depending on performance against the agreed metric.

There is also the question of form of consideration. While most earn-outs are cash-based, there is no reason why share consideration cannot be used in an earn-out, albeit that it can result in greater complexity in terms of mechanics and valuation at the point of payment.

Time period

The parties will need to agree a period for the earn-out. The length of the period will be influenced by a variety of factors, including the type of performance metric underpinning the earn-out calculation and any business plan used to model the earn-out. There is also the fact that the earn-out will place restrictions on what the purchaser can do with its newly-acquired business during the measurement period (see further below).

The period should be long enough for the parties to be able to account for the immediate impact of any acquisition-related disruption and expected fluctuations in performance arising. The period should not be so long, however, so as to make it unlikely that the performance of the business is still

a legacy of the seller's stewardship. A seller may also wish to negotiate the right to earn a 'catch-up' payment, whereby the seller has failed to meet the metric for a particular period, but is able to make up for it in the following period.

Typical earn-outs span a period of one to three financial years post-completion.

Adjustments

Parties may agree to adjustments intended to deal with particular matters that should be disregarded when calculating the earn-out consideration, e.g. for extraordinary or one-off items that are not part of the 'normal' profits of the business. Again, proper accountancy input is critical to make sure these adjustments are framed appropriately. Also how will any synergies arising from being part of a global or wider purchaser group be dealt with, as these may go towards the earn-out metrics (e.g. lower costs and therefore greater profit)? And as we explain below, there are likely to be protections for the seller negotiated for the earn-out period, and the recourse for breach of these protections may need to be an adjustment to the earn-out (given the usual difficulties in making and quantifying a damages claim for contractual breach in such circumstances).

Earn-out protections

As the seller's right to receive earn-out payments is dependent on the post-completion performance of the target business, which will be controlled by the purchaser, well-advised sellers will seek contractual protections for the duration of the earn-out period. In effect, protections against the purchaser artificially manipulating the performance of the business in the measurement period such as to reduce the value of the earn-out (for example, by seeking to push revenue or profit for the measurement period to a later one).

At a minimum these are likely to oblige the purchaser to carry on the target company's business in the ordinary course, not to make any material changes to the nature, scope or extent of the target company's business, and to ensure that business between the target company and any member of the purchaser's group is conducted on arm's length commercial terms. In the case of international deals, sellers may want protections that the headquarters or workforce will not be relocated. Earn-out protections can be a combination of positive covenants on the part of the purchaser and consent or access rights held by the seller.

There are different lenses here depending on the status of the seller(s) post-closing. A seller without an ongoing involvement or stake in the business following completion will want more extensive protections to cover for its lack of oversight during the earn-out period. Other sellers (e.g. of a family or founder-led business) may retain effective operational control as part of ongoing management, but will still want contractual comfort that the purchaser does not go over their heads in ways that could undermine the earn-out.

In such situations, purchasers may even seek 'reverse' protections, so as to prevent sellers with significant control from acting in a short-term or opportunistic manner with a view to maximising the earn-out at the expense of the long-term prospects of the business. In any scenario, purchasers will understandably be reluctant to become overly fettered in respect of a business it has just paid for, especially when its business plan is to integrate the target business into its wider, including global, operations.

That reflects the fundamental tension with an earn-out. The parties will first have to determine whether an earn-out is feasible in the context of their deal: i.e. whether, given the nature of, or the purchaser's strategic plans for, the business, it will be possible to measure a chosen metric over a suitable period post-closing at all (e.g. as the purchaser's rationale for the purchase is to integrate the business fully into its existing business, or perhaps to dispose of part of it). And, where an earn-out is feasible, the parties have to weigh up the level and scope of restrictions needed to protect the seller's legitimate interest against the purchaser's ability to properly carry on, invest in and integrate the target business. A balance will need to be struck through negotiation, and parties should consider practical solutions, e.g., where regulatory restrictions allow, even by agreeing a business plan which covers the earn-out period and frames the way each side is able to act during it.

On the purchaser side, where sellers will remain as employees of the business following completion, it will be important to build in "bad leaver" protections such that sellers will forfeit their right to further earn-out payments if they become a "bad leaver". This helps the purchaser to maximise the value of its investment and retain and incentivise these sellers accordingly. As is the case when it is used in other

contexts, there will be a negotiation of what constitutes a “good/bad leaver”. There is also a tax overlay to this point (see further below).

Some other relevant considerations

Purchaser covenant strength

The seller will need to consider the question of the purchaser’s covenant strength for future payments and whether security over these obligations is required, e.g. by way of cash escrow, bank or parent guarantee, or a charge on assets or the shares being sold. Purchasers will be resistant to these options and will prefer sellers to rely on contractual enforcement rights.

Set off rights

The purchaser may seek an express right to set off any warranty or other claims it may have against the seller under the sale agreement against payments that fall due under the earn-out. Sellers may even prefer this sort of set-off rather than direct claims against the monies it already holds, but will want to make sure that it is only permitted for liability that is conceded or properly determined, and not on the basis of spurious or disputed claims.

Dispute resolution process

There is clearly the potential for dispute in an earn-out, and so it is important to provide for a robust dispute resolution process. Allowing an independent expert, such as an experienced and qualified accountant, to determine earn-out disputes may provide a preferable alternative to lengthy court or arbitration proceedings. Where parties adopt this type of dispute resolution procedure, they should expressly agree the scope of the independent expert’s remit, the procedure the independent expert must follow in making their determination and the timeframe for delivering it, as well as the allocation of the independent expert’s fees between the parties.

Where parties are based in different countries, there will be the usual discussion over what the appropriate governing law is, and it becomes even more important to have confidence in this choice where you are using an earn-out (given the obvious possibility of disputes arising).

Tax

The parties should consider the tax implications of a proposed earn-out from an early stage, and whether and how that impacts the commercial aspects of the earn-out. The considerations below are primarily from a UK angle, though will differ depending on the tax jurisdictions of the sellers and the target company.

Sellers are likely to want the proceeds of an earn-out to be taxed as a capital disposal and so fall within the chargeable gains regime. How the earn-out is satisfied and what relief is available will determine the tax consequences of the earn-out.

If an individual seller remains an employee of the target business after completion, there is a risk that the earn-out payments could be treated as employment income. If any part of the earn-out payment is deemed to be remuneration for employment services, income tax and national insurance contributions will be owed on that payment.

In the event of a UK share sale, stamp duty at a rate of 0.5% of the consideration will apply, typically paid by the purchaser. Where an amount of consideration is contingent on a future event, stamp duty may be chargeable on that amount even if the event in question does not occur. The amount of stamp duty payable will be determined by reference to any minimum or maximum financial thresholds applying to the earn-out, or any estimate of the earn-out payment that could vary up or down. Where no such threshold or variable estimate is specified in the sale agreement so that the earn-out consideration is wholly unascertainable at completion, then no stamp duty should be payable in respect of the unascertainable amount.

Concluding remarks

Earn-outs can be a useful way of parties agreeing consideration for a sale: a bridge over troubled water. As with the construction of any bridge, it needs proper planning and plenty of expert advice. But if your earn-out is clearly structured and precisely drafted, it can be an excellent way of commercially unlocking a deal that works for both seller and purchaser.

If you would like to discuss this or other aspects of international M&A further, please speak with your usual Slaughter and May contact.

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This briefing is part of the Slaughter and May Horizon Scanning series

Click here for more details. Themes include Beyond Borders, Governance, Sustainability & Society, Digital, Navigating the Storm and Focus on Financial Institutions. Beyond Borders explores how crossing physical borders became challenging for most citizens during 2020, but investment flows and operations continued on a global basis. This theme looks at some key aspects of managing risk and maximising the value or opportunities in a regulatory and transactional context, and considers what is on the horizon for working beyond borders in 2021.

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