AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Value & Cents

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The Earnout Provision: A Tool for Mitigation, or a Path to Litigation?

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Where the parties to a transaction are unable to agree on a purchase price prior to a closing, or where buyer financing is constrained, the disparity between the parties' perspectives on value or the gap between the purchase price and available financing might be bridged with an earnout-adjustment provision. Simply stated, an earnout adjustment is a legally binding contract under which a portion of the purchase price that is expected to be paid in the future is contingent on the achievement by the sold company of predetermined financial and/or operational targets.[1] Not so simple, however, are the complexities, direct and tangential, that might be considered in designing an earnout structure.

For example, in a leveraged buyout, the buyer might enter into a credit facility with terms requiring that earnout payments be subordinated to the lender. Of equal import are any covenants, accounting principles and operating practices that could decrease the likelihood that the sold company will be in a position to make payments. Less obvious, as illustrated in the chapter 11 case of *In re SunEdison Inc., et al.*,[2] the outcome of nondebtor earn-out litigation has the potential to affect the value of a debtor's bankruptcy estate. Notwithstanding, mitigating the risks associated with the characterization that "an earn-out provision often converts today's disagreement over price into tomorrow's litigation over the outcome"[3] can be accomplished with provisions having specific guidelines and well-defined obligations and with precise details as to how the earnout(s) should be calculated.

In re SunEdison Inc., et al.

The debate in *In re SunEdison Inc., et al.*, over whether a debtor is entitled to use Rule 2004 of the Federal Rules of Bankruptcy Procedure to seek discovery into nondebtor litigation illustrates the tangential risks of an earnout. Specifically, pursuant to a purchase agreement dated Nov. 17, 2014, TerraForm LLC, TerraForm Inc. and SunEdison acquired renewable energy firm First Wind Holdings LLC and its operating subsidiary from D.E. Shaw Composite Holdings LLC and Madison Dearborn Capital Partners IV LP for consideration of up to $2.4 billion.[4] The consideration included $510 million in "earnout project payments" over 2.5 years, contingent on First Wind's "substantial completion" of certain wind projects acquired in the transaction. The deferral of the payments was circumscribed by the requirement that the remaining balance of any "earnout project payment" would be due from both SunEdison and TerraForm LLC immediately on the occurrence of an "acceleration event."[5] The acceleration event included any bankruptcy, reorganization, debt arrangement or other proceeding under any bankruptcy or insolvency law, or any dissolution or liquidation proceeding, instituted by or against SunEdison.

By the fall of 2015, SunEdison had failed to timely make the earnout project payments and indicated it would not do so in the future. Thereafter, in February 2016, TerraForm LLC denied its liability for the balance of the earnout project payments in the event of an acceleration event. SunEdison ended up filing its chapter 11 case on April 21, 2016. With the balance of the earnout project payments totalling

1 Robert F. Bruner, *Applied Mergers and Acquisitions*, at 609 (John Wiley & Sons Inc. 2004).
2 *In re SunEdison LLC*, Case No. 16-10992-smb (Bankr. S.D.N.Y. 2016).
3 *Airborne Health Inc. v. Squid Soap LP*, 984 A.2d 126, 132 (Del. Ch. 2009), *available at* casemine.com/judgement/us/5914b119add7b04934757061 (unless otherwise specified, all links in this article were last visited on April 12, 2018).
4 TerraForm Power Inc. Current Report (Form 8-K) at 3 (Nov. 17, 2014), *available at* sec.gov/Archives/edgar/data/1599947/000159994714000029/a8-kprojecthurricane.htm.
5 TerraForm Power Inc. Annual Report (Form 10-K (Dec. 31, 2014), Ex. 10.19(d), §§ 1.01 and 2.04, *available at* sec.gov/Archives/edgar/data/1599947/000119312515004583/d827028dex1019.htm.

approximately $231 million, Shaw and Madison filed suit seeking a declaratory judgment that the payment obligations sparked by the acceleration event applied to TerraForm LLC as a buyer and to TerraForm Inc. as guarantor.[6] TerraForm LLC and TerraForm Inc., though not included in SunEdison's bankruptcy, moved to have the action dismissed or stayed pending the conclusion of SunEdison's bankruptcy proceedings, arguing that SunEdison was a necessary party to the action as a joint obligor.[7]

Subsequently, SunEdison, TerraForm Inc. and TerraForm LLC filed a Rule 2004 motion seeking discovery of documents related to Shaw and Madison's understanding of the key terms of the earnout project payments, and of the rights and obligations of the parties in an acceleration event.[8] The motion was precipitated by a March 6, 2017, agreement, in which Brookfield Asset Management had agreed to acquire a controlling interest in TerraForm Inc., which if completed would result in SunEdison owning 36.9 percent of TerraForm Inc.'s Class A shares. As such, it was argued that a ruling adverse to TerraForm Inc. and TerraForm LLC would reduce the value of the equity retained by SunEdison subsequent to the Brookfield acquisition. In turn, this reduction in value could reduce recoveries for the estate's pre-petition creditors, and obligate TerraForm Inc. and TerraForm LLC to issue additional Class A shares to Brookfield to make up for its loss of equity value.

Choice of Target

An earnout provision can be based on financial targets, non-financial targets or a combination thereof.[9] Financial targets can include measures such as (1) revenue; (2) gross profits; (3) earnings before interest and taxes (EBIT); (4) earnings before interest, taxes, depreciation and amortization (EBITDA); (5) cash flow; and (6) earnings per share. Non-financial, operational benchmarks include the (1) development and introduction of new products; (2) completion of capital projects; (3) attainment of regulatory approvals; (4) acquisition of new customers; and (5) number of product units sold.

In principle, the selection of an earnout should be guided by the overarching goal of determining a payment structure that circumvents disincentives to achieving long-term growth and profitability. Further, the payment should be objectively definable and measureable, meaningful within the context of the sold company's operating characteristics, and not subject to manipulation by the buyer or seller. In practice, however, realizing these goals and arriving at a "win/win" solution can be challenging given, for example, the diverse interests of the parties, among other factors.

From an operational perspective, the buyer might be intent on integrating the company's operations and managing them to realize synergies expected from the transaction. The seller, however, if not provided with an incentive by a continuing management role or equity position in the company post-sale, might be most interested in seeing the company managed to maximize the earnout adjustment. Sellers not involved in the management of the company post-sale might also favor revenue-related targets, as the buyer's operating decisions and accounting practices might have fewer effects on revenue than other measures.

Conversely, buyers might not be persuaded by a revenue target unless the company's production costs and overhead are relatively fixed. Further, where the sellers have a continuing role in the management of the company post-sale, it is generally not in the buyers' best interests to agree to revenue-based targets, as they might not encourage behavior that is conducive to controlling costs and might lead to sales growth at the expense of profitability. Rather, buyers prefer net-income targets, as that allows them to exert more control over the results of the sold company.

As is often the case, the parties might settle on earnings measures such as EBIT, EBITDA or adjusted EBITDA. Each measure accounts for the net of revenues over cost of goods sold and services, as well as selling, general and administrative expenses. However, both EBIT and EBITDA exclude interest and taxes, while EBITDA also excludes depreciation and amortization. In this respect, the effects of the buyer's capital structure and financing are controlled for.

Structuring the Payment

Amount

The earnout amount will, like the choice of target, entail a tradeoff based on the parties' risk preferences.[10] In a reduced form, the amount will be equal to the difference between what the seller wishes to receive and what the buyer will pay at closing. However, getting there entails consideration of the incentives created for the sold company's management and option-like characteristics of the earnout payment's being contingent on the realization of a target in the future. The total dollar value of an earnout is also commonly capped due to the uncertainty inherent in future performances, with the majority of earnouts ranging from 20-70 percent of the purchase price.

Term

The term of the earnout should be evaluated in conjunction with the time period that is required to judge the value of the sold company, and, in cases where the sellers continue in management post-closing, the period over which the buyer wishes to incentivize their performance. In practice, most earnouts run from one to five years, varying with the size of the earnout. The longer the earnout period, the greater the likelihood of disputes arising from the integration of the sold company with the buyer's other businesses and changes in accounting principles.

Based on what might be concluded from the use of the discounted-cash-flow (DCF) method to value an earnout, as is common practice,[11] sellers might still prefer a shorter earnout period in order to increase the payment's present value. However (although not standardized or exchange traded), in substance, an earnout is a form of call option on the economic benefits of the sold company's future performance.[12]

6 *D.E. Shaw Composite Holdings LLC v. TerraForm Power LLC*, Index No. 651752/2016, D.E. 2 (N.Y. Sup. Ct. April 3, 2016).

7 *D.E. Shaw Composite v. Terraform Power LLC*, Index No. 651752/2016, D.E. 18 (N.Y. Sup. Ct. July 5, 2016).

8 *In re SunEdison Inc.*, Case No. 10-10922-smb, D.E. 2692 (Bankr. S.D.N.Y. 2016).

9 Jerry M. Hansen, Christen L. Morand and Gregory E. Wolski, "Merger and Acquisition Transaction Disputes," *Litigation Services Handbook: The Role of the Financial Expert, Fifth Edition*, 21.14 (John Wiley & Sons Inc., Roman L. Weil, Daniel G. Lentz and David P. Hoffman eds., 2012).

10 Bruner, *supra* n.1 at 617.

11 Enrique R. Arzac, *Valuation for Mergers, Buyouts and Restructuring*, at 206 (John Wiley & Sons Inc. 2008).

12 Bruner, *supra* n.1 at 615.

As such, given that long-lived options are more valuable than short-lived ones, and that the value of an option increases along with increased uncertainty and volatility, sellers might prefer a longer earnout period.

Calculation

A variety of formulas might be used to calculate an earnout.[13] Certain agreements call for the buyer to pay the seller a percentage of the amount by which the sold company's performance is equal to or greater than the target chosen. Other agreements set a fixed dollar amount payable on reaching a specific threshold. Alternatives include the achievement of a contractually defined benchmark; a percentage of performance; a multiple of performance; or some weighted combination thereof based on historical results or that is expected in the future from choices, including (1) existing products, services and customers; (2) services, products and customers to be developed or acquired in the future; or (3) a specific line of business or subsidiary.

Timing

The timing of earnouts might be formulated as (1) a single lump sum payable at the end of the earnout period based on the sold company's cumulative performance; (2) a staggered series of payments due at the end of specified fiscal periods; or (3) a sliding, graduated scale of payments based on the achievement of partial performance.[14] Shortfalls in prior-period performance might be accounted for by reducing the amount due in the current period. Similarly, performance exceeding that required in the current period might be used to offset shortfalls in prior periods.

Areas of Dispute

Accounting Matters

Similar to what is sometimes provided for in a post-closing net working capital-adjustment clause, earnout provisions might require that the target — for example, adjusted EBITDA, though not itself a Generally Accepted Accounting Principles (GAAP) measure — be calculated based on the company's financial statements, prepared using past practices in accordance with GAAP.[15] If so, disputes can arise with respect to the (1) underlying choice of GAAP; (2) consistency in its application over time; (3) resolution of past practices that violate GAAP; (4) time periods of the prepared financial statements that were used for negotiations and closing; and (5) treatment of subsequent events.[16]

As pertains to the calculation of the target *per se*, disputes might occur over what expenses should be subtracted in deriving the threshold.[17] To illustrate, under GAAP, research and development costs, arguably the lifeblood of a technology company, are expensed when incurred despite that the gains from such investments might extend after the end of the earnout period when the seller receives no benefit. A taxonomy of costs that a seller could object to being deducted by a buyer, despite the buyer's claim that doing so is consistent with GAAP, might also include (1) integration and restructuring charges, (2) acquisition costs, (3) changes in accounting principles and (4) goodwill impairments. The normalization of the sold company's financial statements in order to calculate its sustainable, recurring earnings exclusive of the effect of transitory and unusual items can likewise be a source of controversy.

As might be expected given the complexity of the issues and nature of GAAP, the calculation of earnout targets and treatment of associated expenses and revenues are frequently litigated. Given this prospect, the parties should enumerate in detail how the earnout is to be calculated, and provide for how specifically identified revenues and expenses are to be treated.[18] In light of the potential for GAAP to change over the earnout period, consideration should be given to defining GAAP as GAAP existed in the sold company's audited financial statements on the date of closing. It might also be advisable to keep separate accounting records for the sold company.[19]

Management Decisions

While revenue might be calculated in accordance with GAAP at both the beginning and end of the earnout period, in between, the buyer may have chosen to (1) add, discontinue or merge product lines; (2) develop or terminate important customers; (3) acquire new businesses; or (4) engage in a wholesale restructuring to reflect a new corporate strategy or changing market.[20] Moreover, with time, the operations of the sold company might have become integrated with that of the buyer, even if by happenstance, making it extremely difficult — if not impossible — to assess the performance of the sold company as a standalone enterprise. Practically speaking, it can also be impractical or counterproductive to operate the sold company separately from the buyer.

Provided that the buyer's initiatives prove successful, the earnout target should be met with the seller walking away with the consideration for which it bargained. If not, the seller might allege, as is frequently asserted in such litigation (among other things), that (1) the buyer failed to invest sufficiently in the business, (2) operated it in a way to minimize the earnout or (3) failed to pursue opportunities that would have increased the earnout. To head off such disputes, the agreement between the parties might include clauses that (1) free the buyer from any obligation to continue to operate any line of business; (2) specifically identify the products, services or lines of business on which revenues are to be calculated; (3) obligate the buyer to run the business consistent with its past practices and operations; and (4) cause the buyer to continue the business as a separate unit for the period of the earnout.

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13 "Earnout Provisions and Disputes," *AICPA Forensic and Valuation Services Practice Aid, Mergers and Acquisitions Disputes*, at 37 (American Institute of Certified Public Accountants 2013), *available at* aicpa.org/interestareas/forensicandvaluation/resources/mergers-and-acquisition.html.

14 Bruner, *supra* n.1 at 619.

15 A. Vincent Biemans and Gerald M. Hansen, *M&A Disputes, A Professional Guide to Accounting Arbitrations*, at 323 (John Wiley & Sons Inc. 2017).

16 Boris J. Steffen, "Understanding the Purchase-Price-Adjustment Clause," XXXVI *ABI Journal* 9, 22-23, 62-63, September 2017, *available at* abi.org/abi-journal. These include different procedures that might be used to close a firm's books depending on the fiscal period. For example, the procedures used to close the books for an interim (*i.e.*, quarter) reporting period will likely not be as comprehensive or definitive as that used at year-end.

17 "Earnout Provisions and Disputes," *supra* n.13 at 40.

18 Oscar A. David, James P. Smith III and Kristin D. Wickler, *Advanced Earn-Out Issues, Transaction and Dispute Resolution Perspectives* (The Real Deal 2014), *available at* winston.com/images/content/7/6/v2/76231/Advanced-Earn-Out-Issues2.pdf.

19 Biemans and Hansen, *supra* n.15 at 323-24.

20 "Earnout Provisions and Disputes," *supra* n.13 at 39.

Conclusion

An earnout is an agreement in which a portion of the purchase price to be paid in the future is contingent on the achievement of financial or operational targets. The earnout should be objectively defined and measureable, reflective of the sold company's operating characteristics and not subject to manipulation. Determining the amount requires a balancing of the incentives created and option-like characteristics of the earnout. The term should correspond with the period required to judge the value of the sold company, and over which the buyer wishes to incentivize management.

In substance, an earnout is a form of call option on the economic benefits of the sold company's future performance. Some agreements call for the buyer to pay a percentage of the amount by which the sold company's performance is equal to or greater than the target, while others set a fixed dollar amount payable on reaching a specific threshold. Earnout payments might be structured as a single lump sum, as a staggered series, or as a sliding, graduated scale. The calculation of earnout targets, treatment of associated expenses and revenues and results of management decisions post-closing are frequently the subject of earnout litigation. Mitigating these risks can be achieved with provisions having specific guidelines, well-defined obligations and precise details as to how the earnout(s) should be calculated. abi

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