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Mergers & Acquisitions: Five Legal Issues Entrepreneurs Should Consider Before Agreeing To an Earn-Out in M&A Transactions

By: Julia Nguyen

In technology company mergers and acquisitions, there is an inherent asymmetry of information between the skeptical buyer and the optimistic seller on the valuation of the target company and its future profitability. This is especially true when the target company has little operating history but significant growth potential, or has a new product or technology that may increase its profitability in the future. To bridge this valuation gap, buyers and sellers may compromise on an earn-out, which is a deal structure where part of the purchase price is deferred until after closing and is calculated based on the performance of the target company over a set time period. The following are five legal issues to consider before agreeing to an earn-out.

1. Initial Structure of an Earn-Out

In general, earn-outs have the potential to create contentions between the buyers and sellers over the interpretation of the earn-out terms and the operation of the target company during the earn-out period. Earn-outs can vary widely and generally are tailored to suit the target company and the parties' expectations, so clear terms and expectations should be set forth in a written agreement. These terms should include the source of the earn-out, the benchmarks to measure performance, a formula for calculating the payment amount, and the period of time over which the earn-out will be measured.

2. Performance Metrics

Many disputes over earn-outs arise when the seller disagrees with the buyer's calculations of the target company and whether the seller has met the performance metric. The most common performance metrics used in an earn-out formula are: revenue, net income, EBITDA and earnings per share. Sellers may want to choose revenue because it can be easier to

achieve and is less easily manipulated by the buyers. Buyers may want to choose net income because it takes into account costs. The parties often compromise on EBITDA, which accounts for operation costs and expenses, but excludes non-operational items such as interest, tax, depreciation and amortization expenses. With technology companies, it may be difficult to set financial targets if there is no historical information to use as a basis. Non-financial performance metrics like number of users, product development, number of products sold or launch of a new product may be more appropriate. Choosing a non-financial performance target will oftentimes lead to fewer disputes because the focus is on the operational effectiveness of the target company and it is harder to manipulate by altering accounting practices.

3. Post-Closing Covenants

Once the buyer absorbs the target company, the seller may not have sufficient control to manage the target company to achieve the performance metric. The seller should consider covenants that will set some limitations on the buyer's ability to operate the target company. Such restrictive covenants may require the buyer to operate the business consistently with how it was operated prior to closing and prevent the buyers from making significant changes that reduce the earn-out purchase price—like discontinuing products, reducing the sales force or shifting sales and costs of the target company. The seller should require the buyer to act in good faith and use reasonable efforts to take every action necessary to maximize the earn-out purchase price. The seller may also want acceleration rights that would result in immediate payment of the earn-out purchase price if events occur that negatively impact the earn-out performance metric—such as a subsequent sale of the target company or a change-in-control of the buyer.



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4. Integration of the Target Company with the Buyer's Business

Because buyers may have the opportunity to manipulate the financial performance of the target company, issues may arise if the target company is merged into the buyer's other businesses. Sellers should consider requiring the buyer to maintain separate books and records for the target company to be reviewed by the sellers and their accountants to avoid the potential for such manipulations and future disputes.

5. Earn-Outs Tied To Future Employment

Buyers may want to tie the earn-out purchase price to future employment of the founders and certain key employees of the target company, because this may be important to the future success of the target company. Before sellers agree to this earn-out arrangement, they should consider the tax implications. Earn-out payments may be taxed as compensation income when tied to the seller's continued employment as opposed to the more tax advantageous capital gains rate. Furthermore, this earn-out arrangement could prevent the seller from getting a clean break from the target company and moving on to the next great idea.

As the M&A market continues to heat up in 2015, many tech companies will be faced with deciding whether the flexibility offered by earn-outs is outweighed by the complications they often present.



Julia Nguyen is an attorney in the firm's Corporate Practice Group in the Orange County office. She can be reached at 949.224.6238 or jnguyen@buchalter.com.