Earn-out Disputes In Private Mergers And Acquisitions

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Introduction

This paper will address common areas of dispute involving earn-outs. An earn-out is a contingent post-closing payment toward the purchase of a company if the acquired business meets certain targets, and often the earn-out is seen as an effective way to bridge the gap in the negotiation of the sale price where buyer and seller have materially different views of the value of the business. *See Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del. Ch. 2009) ("What an earn-out… typically reflects is 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."). Earn-out provisions vary widely but also share common features:

> First, earnout provisions tie the payment of additional merger consideration to the seller's accomplishment of certain specified targets or milestones during the post-closing period. Earnout targets are often proxies for seller or seller product performance and fall into one of two general categories: financial or nonfinancial targets. Financial targets may include some measure of top-line revenues, cash flow, EBITDA, profitability, or other costs that can be directly tied back to the financial performance of the seller. Nonfinancial targets may include some nonfinancial proxy for revenue—for example, unit sales or licenses. Alternatively, nonfinancial targets may include market share targets, or specific customer-oriented goals…technological achievements or regulatory approvals….
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> Second, parties may negotiate triggers for contingent payments in a number of forms: sliding scale, cliffs, or binary…Binary triggers authorize payment of the earnout only upon the meeting of the stated milestone….
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> Third, the length of earnouts typically varies anywhere between one and five years. In general, the term of the earnout provision should be long enough to resolve the uncertainty that caused the fundamental disagreement over valuation. Fourth, the size of an earnout relative to the total consideration in the transaction also varies. In general, the size typically reflects the degree of uncertainty between the parties with respect to the seller's value….

Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts In Corporate Acquisitions*, 81 U. Cin. L. Rev. 127, 135–36 (2012).

As one court noted, since earn-outs arise from disparate views of the value of the acquired business, the post-closing performance and its effect on the earn-out often gives rise to litigation: "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." *Airborne Health, Inc.*, 984 A.2d at 132. A survey of the case law shows that disputes over earn-outs often fall into one of three categories: (1) disputes over the proper way to perform the accounting necessary to determine the earn-out payment; (2) disputes alleging that the buyer mismanaged the acquired business thus reducing the earn-out; and (3) disputes alleging that the buyer intentionally managed the acquired business so as to reduce or eliminate the earn-out. If there is a primary lesson to learn from the case law, it is that earn-out provisions must be drafted with specificity or the parties run the risk of costly and uncertain litigation over implied terms that may be imposed by a court to fill in the gaps in the drafting. These three areas of earn-out litigation will be addressed below.

Finally, a pending merger or acquisition may incentivize one shareholder to buy out another shareholder in advance of the deal, especially when a lucrative earn-out is obtained in the sale of the business. An unknowing shareholder that cashed out just prior to the acquisition may be motivated to bring suit if the shareholder was unaware of the pending acquisition and missed an opportunity to capitalize on the merger or acquisition. This paper will briefly address the potential duties on shareholders to disclose merger or acquisition negotiations to other shareholders.

I. Earn-out Disputes

A. Disputes Over Accounting

Privately held businesses often employ accounting practices tailored to their unique business. Nevertheless, earn-out provisions that provide for contingent payments based on financial milestones often dictate that GAAP will be applied in determining whether the milestones are met. Disputes often ensue when the historical accounting methodology would result in a different earn-out payment than GAAP calculations. In these sorts of disputes, courts have shown resistance toward after-the-fact attempts to alter the agreed upon accounting provisions.

Illustrative of this category of litigation is the recent decision in *Vysyaraju v. Management Health Solutions, Inc.*, in which plaintiffs sold their business to the defendant and incorporated an earn-out provision providing for a payment if the business achieved "Qualifying Revenue" of at least $2,900,000. No. 12 Civ. 4420 (JGK), 2013 WL 4437236, at *2 (S.D.N.Y. Aug. 19, 2013). The agreement specified that "Qualifying Revenue" would be calculated according to GAAP even though the seller's warranted financial statements provided to the buyer were created in accordance with GAAP "consistent with past practice." *Id.* at *2–3. When the Qualifying Revenue computed based on GAAP was $590,200 less than it would have been if calculated according to past practice, the plaintiff sellers sued for breach of the sale agreement and a declaratory judgment that the calculation was required to be done according to past practice because the term GAAP was ambiguous. Applying New York law, the court dismissed the declaratory judgment action, holding that the term GAAP was not ambiguous. *Id.* at *6. The court also rejected the breach of contract claim because what the plaintiffs were arguing "was not the provision that the parties included in the contract," noting that elsewhere in the contract "when the parties described financial statements or calculations that differed from a straight application of GAAP they specified that in the Agreement." *Id.* at *7.

In another recent case applying Delaware law, a similar result was reached. *Starr v. Firstmark Corp.*, No. CV-12-4023 (SJF)(AKT), 2013 WL 4811371, at *7 (E.D.N.Y. Sept. 9, 2013). Under the sale agreement, the buyer agreed to pay interim earn-out payments and a final earn-out payment based upon the business' earnings before interest and taxes ("EBIT"). *Id.* at *2. To determine the EBIT, the purchaser was required to prepare financial statements in accordance with GAAP for each of the two 12-month periods ending on February 29, 2012 and February 28, 2013, which were basically the two years following the closing. *Id.* After the defendant

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