A bridge to troubled water?

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Guest Commentary

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For dealmakers in M&A and private equity, securing a good deal is only half of the battle.

Post-completion disputes often centre on earn-outs, an increasingly popular mechanism for bridging gaps between a buyer and seller's estimates of a target's value, under which sellers are entitled to additional remuneration if the target business performs as they expect.

Corporate acquirers face real risk when earn-out clauses are unclear or poorly governed: disputes can disrupt operations, delay future exits, and inflate acquisition costs. Failure to adhere to strict notice provisions can lead to lengthy litigation, as recently demonstrated in the English High Court case involving the DXC Group, which centred on the sellers' response to two earn-out calculation determinations sent by the buyers via email, in disregard of the contractual notice provisions. Ultimately, the court ordered the parties to specifically perform the dispute resolution procedure under the share purchase agreement, which had not been adhered to.

Below, we outline why earn-out clauses often go wrong, and how private equity sponsors and other corporate acquirers can mitigate the risks they present.

Define performance metrics clearly and include fallback mechanisms

Earn-outs depend on the accurate calculation of a company's performance using financial metrics such as EBITDA. Yet even when metrics are agreed, parties often fail to sufficiently specify the accounting principles or procedures to be used (including what should occur if a particular independent party cannot or will not act as envisaged under the contract). The lack of clarity can result in conflict, and while the English court may come to the parties' rescue by implying necessary terms into their agreement, this is far from a certainty.

A well-drafted share purchase agreement will define performance metrics clearly and set out specific, measurable benchmarks for assessing performance. This approach helps to minimise ambiguities and ensures that evaluation of earn-out targets is objective.

Parties should also account for robust fallback processes, so that it is clear to both parties what can be done should an expert or accounting firm be unwilling or unable to act in accordance with the requirements set out in the agreement.

Clarify post-acquisition obligations

The need for specificity is also apparent where prescriptive covenants form part of the earn-out mechanism. Disputes can arise when sellers believe that the buyer has managed the post-acquisition business in a way that suppresses performance and reduces the earn-out. English law does not impose a general duty of good faith in commercial contracts, so unless the SPA contains express covenants, the buyer is under no obligation to maximise the seller's return.

Clauses requiring the buyer to act 'in good faith' or not to 'frustrate' the earn-out should be carefully negotiated and clearly drafted to avoid disputes that turn on whether the buyer's conduct was 'reasonable', a standard that provides considerable room for argument. The SPA should clearly outline each party's ongoing responsibilities after the acquisition to prevent misunderstandings and manage post-deal expectations.

Align timelines

Earn-out provisions in SPAs often involve tightly defined processes and timelines, including deadlines for raising objections and bringing claims. Parties should consider how the warranty provisions (including limitations on liability) interact with any purchase price adjustments such as an earn-out when drafting the SPA. Issues can arise if there is ambiguity or misalignment between the timelines for bringing warranty claims and the determination of an earn-out payment under the SPA. Such misalignment can create uncertainty about when claims become actual and quantifiable, and thus when limitation periods for issuing proceedings begin.

Aligning the SPA's performance periods with the overall acquisition schedule can help minimise the risk of disputes that arise from conflicting deadlines, while including specific wording in the SPA can reduce ambiguity that might otherwise lead to costly disputes.

Notice provisions

Failure to consider the practical requirements of notice provisions that interact with earn-out provisions can have severe consequences. If strict notice provisions set out in an SPA – a requirement for personal or postal service, for example – are not followed when delivering communications such as earn-out determinations, the validity of those determinations may be challenged, and a court could ultimately find them to be invalid.

Care should be taken when drafting notice provisions, including whether notices should be sent to specific email or physical addresses and whether fall-back methods of delivery should be provided in case there are technical failures. Those in receipt of a notice (such as the sellers in the recent DXC Group case discussed above) should also exercise caution before and when responding to ensure they are not waiving their ability to challenge it in the future.

Earn-outs are both a commercial opportunity and a litigation risk. When structured poorly, they can become flashpoints for dispute, delaying integration, distracting management and diminishing returns. However, with clear drafting, careful alignment of timelines, and well-defined procedures for performance assessment and dispute resolution, these risks can be significantly reduced.

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