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Agenda

• Transaction Perspective
  – What is an Earn-Out?
  – Why Use an Earn-Out?
  – What is Market?
  – The Nuts & Bolts of Earn-Outs

• Dispute Resolution Perspective
  – Recent Developments in Delaware Law
  – Case Study
Oscar A. David
Kristin D. Wickler
What is an Earn-Out?

- Consideration in an M&A transaction payable to a seller which is contingent upon the future performance of the target business and/or based on the achievement of certain milestones.
What is an Earn-Out?

• Generally structured as payments contingent on satisfying certain milestones, for example:
  – Financial Targets
    • EBITDA
    • Revenue
    • Net Income
  – Non-Financial Targets
    • FDA Approval
    • Increase in New Customers
Why Earn-Outs?

• Allow a deal to move forward when the parties cannot agree on the value of the target

• Buyer Perspective:
  – Provides additional finance options
  – Reduces the risk of overpaying
  – Defers payments
Why Earn-Outs?

• Seller Perspective:
  – Higher purchase price potential
  – Opportunity to benefit from synergies of target and buyer business integration
Why Earn-Outs?

Source of Price Uncertainty

Undeveloped Product
New Market
Financial Info Unreliable
Limited Historical Operations
Uncertain Future
Recent Restructuring
Small Companies
What is Market: ABA 2013 Private Target Deal Study*

2012 Deals
- No Earn-Out: 75%
- Includes Earn-Out: 25%

2010 Deals
- No Earn-Out: 62%
- Includes Earn-Out: 38%

2008 Deals
- No Earn-Out: 71%
- Includes Earn-Out: 29%

*Private Target Mergers & Acquisitions Deal Points Study (Including Transactions Completed in 2012): Study of publicly available acquisition agreements for transactions completed through 2012 that involved private targets being acquired by public companies.
What is Market: ABA 2013 Private Target Deal Study

2012 Deals
- No Earn-Out: 75%
- Includes Earn-Out: 25%

Earn-Out Metrics
- Revenue: 32%
- Earnings/EBIDTA: 30%
- Other: 30%
- Combo: 3%
- Not Determinable: 5%
Houlihan Lokey 2013 Purchase Agreement Study*

*Houlihan Lokey Purchase Agreement Study for Transactions Completed in 2012 and Prior Years: Summarizes middle-market change-of-control transactions in which Houlihan Lokey served as the financial advisor to either the buyer or the seller. Study includes public and private transactions.
2012 Shareholder Representative Services M&A Deal Terms Study: SRS analyzed 342 private-target acquisitions on which SRS served as the shareholder representative from 2009 through Q3 of 2012. **E.g., gross margin, meeting certain thresholds under third-party contracts, achievement of sales quotas.**
Earn-Outs in Life Sciences Deals

- 2012 Shareholder Representative Services Life Sciences M&A Study*
- Analyzed 47 Life Sciences Acquisitions
  - 28 Bio/Pharmaceutical
  - 19 Medical Devices

*Data includes 47 private-target life sciences acquisitions on which SRS served as the shareholder representative from Q3 2008 through Q2 2012.
SRS 2012 Life Sciences Deal Terms Study

• Strong prevalence of Earn-Outs in Life Sciences Deals
  – 82% of Bio/Pharma deals included earn-outs
  – 84% of Medical Device deals included earn-outs
  – 15% of Non-Life Sciences deals included earn-outs
Earn-Outs: The Nuts & Bolts

• Must agree on straightforward metrics to avoid future litigation and control perverse incentives
Earn-Outs: The Nuts & Bolts

- Agree on the **targets**
- **Measure** the targets
- Structure of the **payments**
- **Length** of earn-out period
- Seller & buyer contractual **protection**
The Nuts & Bolts: Agree on the Targets

• Financial or non-financial (or a combination)

• Targets must be:
  – Objective and measurable
  – Plainly defined
  – Consistent with the character of the target company
The Nuts & Bolts: Agree on the Targets

• Incentive issue examples

• Buyer:
  – May be less motivated to improve target performance during earn-out period to reduce purchase price
  – Long-term perspective may over-ride steps necessary to achieve short-term earn-out targets
The Nuts & Bolts: Agree on the Targets

• Incentive issue examples

• Seller:
  – Short term target achievements may trump long term interests of buyer
  – If Seller is going to run the target company, it may not be motivated to reach goals if they are set too high
The Nuts & Bolts: Agree on the Targets

• Different Perspectives: Financial Targets

• **Seller**: May prefer revenue-based targets due to decreased chance for manipulation

• **Buyer**: May prefer net income targets and especially resists revenue targets if seller involved in operation as seller may not be motivated to reduce expenses
# Earn-Out Target Examples

## Financial Targets
- EBITDA
- Revenue
- Net Income
- Net Equity
- Earnings Per Share

## Non-Financial Targets
- Regulatory Approval
- Minimum # of New Customers
- Product Development Milestones
- Number of Products Sold
- Launch of a New Product
2012 SRS Life Sciences M&A Study: Earn-out Targets/Metrics*

- Value of non-financial (blue) benchmarks: $4.0 billion
- Value of financial (green) benchmarks: $2.5 billion + uncapped royalties
- 50% of milestones (excluding Annual Sales milestones) have meaningful deadlines specified in the acquisition agreement**

* As a percentage of all milestone events, not dollars or deals.
** Contractual deadlines more than 5 years beyond the seller’s projected achievement date are not counted as meaningful here.
The Nuts & Bolts: Measure the Targets

• Most disputes are a result of seller thinking buyer manipulated measurement of target’s performance or disagreement over calculations
• Avoid these disputes through a detailed measurement plan
  
  – Who prepares the calculations/financial statements?
    • Typically buyer, but seller will try to have some control in preparation and a right to review
  
  – Accounting principles followed and how applied
  
  – What is the dispute resolution process?
The Nuts & Bolts: Structure of the Payments

• All or Nothing vs. Graduated (payment based on the extent target exceeded)
  
  – Graduated is more common
    • Buyer should negotiate a cap amount
  
  – **Caution**: All or nothing may create a strong incentive for the buyer to just miss the target
The Nuts & Bolts: Length of Earn-Out Period

- Periods range from about one to four years, depending on the target chosen. Majority of targets end after three years.
The Nuts & Bolts: Length of Earn-Out Period

Different Buyer/Seller Perspectives: Can change deal by deal

• **Buyers:**
  – Typically prefer shorter periods to minimize the amount of time they are subject to restrictions
  – May prefer a longer period to have more time to actually make the earn-out payment

• **Sellers:**
  – Shorter periods mean earlier payments
  – Longer periods give the buyer more time to achieve targets (thus increasing payment to the seller)
ABA 2013 Private Target Deal Study: Earn-Out Period

**Period of Earn-Out**

*Subset: Deals with Earn-Outs*

- **<12 months**: 6%
- **12 months**: 32%
- **>12 to <24 months**: 0%
- **24 months**: 18%
- **>24 to <36 months**: 3%
- **36 months**: 9%
- **48 months**: 12%
- **Not determinable**: 21%

*Percentages total 101% due to rounding.*
ABA 2011 Private Target Deal Study: Earn-Out Period*

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<th>Period of Earn-Out</th>
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<td>&gt;36 to &lt;60 months</td>
<td>6%</td>
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<td>60 months</td>
<td>6%</td>
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**2011 Private Target Mergers & Acquisitions Deal Points Study: Study of publicly available acquisition agreements for transactions completed through 2010 that involved private targets being acquired by public companies.**

**Percentages total 102% due to rounding.**
The Nuts & Bolts: Seller & Buyer Protection

• Sellers seek protective covenants given potentially perverse earn-out incentives
  – Require target business to operate in the ordinary course of business
  – Restrictions on disposing a portion of the target business
  – Run business to maximize earn-out
  – Good faith and fair dealing
  – Information rights
  – Additional protection if change in management (e.g., liquidated damages or acceleration of payments)
ABA 2013 Private Target Deal Study: Covenants

Buyer’s Covenants as to Acquired Business
Subset: Deals with Earn-Outs

Covenant to Run Business Consistent with Past Practice
- Not Included: 76%
- Included: 18%
  - (27% in deals in 2010)
  - (29% in deals in 2008)
- Indeterminable: 6%

Covenant to Run Business to Maximize Earn-Out
- Not Included: 88%
- Included: 6%
  - (8% in deals in 2010)
  - (10% in deals in 2008)
- Indeterminable: 6%
ABA 2011 Private Target Deal Study: Covenants

Buyer’s Covenants as to Acquired Business
Subset: Deals with Earn-Outs

**Covenant to Run Business Consistent with Past Practice**
- Included: 27%
- Not Included: 59%
- Indeterminable: 14%

**Covenant to Run Business to Maximize Earn-Out**
- Included: 8%
- Not Included: 78%
- Indeterminable: 14%
2012 SRS Life Sciences Deal Terms Study: Diligence Requirements*

*Subset of deals with earn-outs (39).
**E.g., development or marketing plan, specified expenditures, etc.
SRS Life Sciences Deal Terms Study: Information Rights*

Progress Reports Due from Buyer

- No Reports, 15%
- Quarterly Written Reports, 33%
- Annual Written Reports, 26%
- 6-month Written Reports, 26%
- No Reports, 15%

- 44% of deals with earn-outs expressly provide for in-person meetings; 5% of deals provide for meetings but not for written reports.
- Developmental/regulatory reports are most often quarterly or semi-annual.
- Commercial/sales reports are most often quarterly.

*Subset of deals with earn-outs (39).
The Nuts & Bolts: Seller & Buyer Protection

• Security for future earn-out payments
  – Security interest: Require buyer to grant security interest in target company
  – Escrow: Require buyer to put potential earn-out payments in escrow
The Nuts & Bolts: Miscellaneous Points

• Acceleration Upon Change of Control
• Offset of Indemnity Payments Against Earn-Out
• Securities Issues
• Tax Treatment
• Accounting Issues
Final Thoughts from Transaction Perspectives

- Recognize potential conflicting incentives
- Be specific re milestones, measuring methods
- Define clear set of responsibilities/contractual protections
- Difficult to enforce what is left unsaid
Dispute Resolution Perspective—Earn-Out Provisions

James P. Smith III
Recent Developments in Delaware Law re Earn-Out Provisions

• “[A]n earn-out provision often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”
• Vice Chancellor Laster, Airborne Health, Inc. v. Squid Soap, LP
Two Heavily Litigated Types of Earn-Out Disputes:

• Disputes over post-closing business operations
  – Alleged operation of acquired business in manner aimed at minimizing earn-out.
  – Alleged failure to adequately invest in acquired business.
  – Alleged failure to pursue opportunities that would have increased earn-out.
Two Heavily Litigated Types of Earn-Out Disputes:

• Disputes over post-closing accounting methodologies
  – Earn-out provision does not clearly define how earn-out thresholds are to be calculated.
  – Earn-out provision does not account for treatment of certain expenses and revenues.

“If I had to use one word to describe our strategy …”
Disputes Over Post-Closing Business Operations

Practice Pointer:

• Parties should steer clear of “aspirational” statements regarding the post-closing conduct of the business and instead draft earn-out provisions with specific guideposts.
Case Study: LaPoint v. AmeriSourceBergen Corp., 2007 WL 2565709 (Del. Ch. 2007)

• ABC agreed to pay Bridge stockholders $27 million, plus earn-out payments for two years following the merger provided certain EBITDA targets were satisfied.

• Merger agreement required that ABC:
  – “Exclusively and actively” promote products and services of Bridge;
  – Act in “good faith” during earn-out period; and
  – Not “impede” ability of Bridge stockholders to achieve the earn-out payments.
LaPoint v. AmeriSourceBergen Corp.

- Chancellor Chandler described these provisions as “aspirational statements,” “gossamer definitions,” and “nebulous requirements” that were “too fragile to prevent the parties from delving into the present dispute.”
LaPoint v. AmeriSourceBergen Corp.

• The court rejected plaintiffs’ claim that ABC breached the agreement by failing to enter into a contract that would have increased likelihood of earn-out payments to plaintiffs.
  – “Although ABC could not unreasonably withhold consent from a transaction that would allow Bridge shareholders to earn their earnout payments, nothing in the merger agreement obligated ABC to enter into an unprofitable transaction.”
• The court did find that ABC breached the agreement by failing to adequately promote Bridge’s products. However, plaintiffs could not demonstrate that the earn-out targets would have been satisfied but for the breach.
Practice Pointer:

- Delaware courts enforce the agreement’s “plain language” and are unlikely to come to the aid of a sophisticated party that could have, but failed to, negotiate contractual protections.
Case Study: Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126 (Del. Ch. 2009)

• Airborne Health acquired Squid Soap’s assets for $1 million at closing, with earn-out of additional $26.5 million if company met certain targets.

• Acquisition agreement required Airborne to return assets to Squid Soap if Airborne had not spent $1 million on marketing and achieved $5 million in sales in first year after closing.

• Shortly after acquisition, Airborne experienced substantial business difficulties due to an unrelated product and was unable to satisfy earn-out targets.

• Squid Soap sued Airborne, alleging Airborne breached the merger agreement and the implied covenant of good faith and fair dealing by failing to adequately market Squid Soap’s product.
Airborne Health, Inc. v. Squid Soap, LP

• Vice Chancellor Laster held that while a buyer cannot arbitrarily or in bad faith refuse to expend resources to deprive seller of benefits of earn-out, Airborne’s failure was not in bad faith but instead due to a “corporate crisis” that restrained its marketing and sales efforts.

• The court noted that the $1 million marketing expense was a condition Airborne had to satisfy to retain the assets, not an affirmative obligation to spend that amount. According to the court, “a mandatory commitment by Airborne to expend funds could have easily been drafted.”
Practice Pointer:

- Parties should be precise when defining the scope of their respective obligations with respect to earn-out provisions. A court will not imply a duty on the part of the buyer to maximize the earn-out.

- Merger agreement provided that Viacom would acquire Harmonix for $175 million, plus a contingent earn-out payment to Harmonix shareholders based on multiple gross profits for 2007 and 2008.

- Plaintiff argued that Viacom and Harmonix breached the implied covenant of good faith and fair dealing by negotiating a distribution agreement in 2008 that resulted in reduced earn-out payments for selling shareholders.
According to plaintiff, Viacom and Harmonix had an implied duty to negotiate a more favorable distribution agreement that would have resulted in greater earn-out payments.

The Delaware Supreme Court held that the merger agreement’s plain language did not create any obligation to maximize earn-out income.

According to the Court, because neither Viacom nor Harmonix “intentionally pushed revenue out of the earn-out period,” there was no breach of the implied duty.
Practice Pointer:

• Parties should set forth in detail how earn-outs are to be calculated. In interpreting such provisions, Delaware courts will adhere to the agreement’s plain language even if the outcome is “unfair” or results in a windfall.

• In connection with Genesee’s buyout of plaintiffs’ interest in GRO, Genesee and plaintiffs executed stock option agreements providing that plaintiffs would receive additional compensation if GRO’s EBITDA, as defined in the agreements, exceeded $9 million in any of the following five years.

• While GRO’s publicly reported EBITDA exceeded $9 million in four of the five years, Genesee argued it was not obligated to vest the options because EBITDA, as defined in the agreements, had not exceeded $9 million in any year.
Chambers v. Genesee & Wyoming Inc.

• Then-Vice Chancellor Strine, applying the agreements’ “plain language,” held that Genesee’s calculation of EBITDA for purposes of the agreements was improper because Genesee made certain adjustments not permitted by the agreements.

• The court rejected Genesee’s argument that the adjustments were proper because they were consistent with GAAP.

• The court also rejected Genesee’s argument that, absent these adjustments, the calculation of EBITDA pursuant to the agreements would result in a “windfall” for plaintiffs.
Practice Pointer:

• The agreement should set forth in detail how the earn-out should be calculated, including how specific expenses and revenues would impact the calculation.

• Pursuant to a merger agreement, MIVA acquired Comet for a cash payment and earn-out of up to $10 million. In connection with the merger, Comet paid a one-time merger bonus of $800,000 to its employees.

• In calculating the earn-out amount, MIVA characterized the bonus as an “operating expense,” which reduced the earn-out.
Comet Systems, Inc. Shareholders’ Agent v. MIVA, Inc.

• Vice Chancellor Lamb, applying the agreement’s plain language, held that the bonus constituted a “one-time, non-recurring expense” under the agreement, and thus should have been excluded from the earn-out calculation.

• The court noted that because earn-outs are typically utilized when a seller is more optimistic about the future prospects of the business than the buyer, “charges and costs which occur as a result of the merger and are not expected to be representative of future costs in the business are reasonably excluded.”
CLE Presentation Code
Questions?

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Oscar David is a partner and chair of Winston & Strawn’s mergers and acquisitions, securities, & corporate governance practice. Mr. David is ranked as a leading Chicago attorney in the Chambers Guide and the firm's practice is also ranked. In addition, the practice is ranked as a “Tier 1” firm in the area of middle market M&A by Legal 500 USA and in the top 20 among law firms for U.S. buyouts (based on volume of deals) by MergerMarket.

He concentrates his practice on public and private mergers and acquisitions, corporate governance, private equity and venture capital, and corporate finance matters. He regularly advises senior executives on sensitive challenges arising in these matters.

James P. Smith III is a partner in Winston & Strawn’s New York office and chairs the firm’s Securities Litigation practice. His practice areas comprise a broad range of complex commercial litigation, with a focus on M&A-related litigation and contests for corporate control, federal securities fraud class action defense, corporate governance litigation and advice, the defense of shareholder derivative suits, and state deceptive sales practices/consumer fraud class action defense.

Mr. Smith is a first-chair trial lawyer and has tried numerous cases (including in the Delaware Court of Chancery) and argued notable appeals before various state and federal appellate courts. He has represented clients in a variety of industries, including technology/ecommerce, commercial and investment banking, private equity, hedge funds, derivatives and securitization, insurance, energy, oil and gas, health care, biotech, semiconductors and telecommunications.
Kristin Wickler is an associate in the firm’s Chicago office who focuses her practice on corporate and transactional matters. Prior to joining Winston & Strawn, Ms. Wickler completed a Public Interest Law Initiative fellowship at Equip for Equality in the Special Education Clinic.

Ms. Wickler received her J.D. from Stanford Law School in 2013, where she served as development editor and symposium editor of *Stanford Law and Policy Review*. Ms. Wickler co-coordinated the Stanford Social Security Disability Pro Bono Project and graduated with pro bono distinction. She received her B.A., with highest honors, in Psychology from DePaul University in 2005 and her M.S. in Clinical Psychology from the University of Wisconsin-Madison in 2008.