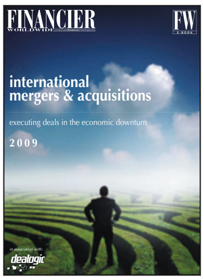
FINANCIER WORLDWIDE corporatefinanceintelligence

MORRISON | FOERSTER



REPRINT | *Morrison & Foerster*

2009 International Mergers & Acquisitions
executing deals in the economic downturn

FW E-BOOK

Earnouts in M&A transactions

BY MICHAEL O'BRYAN AND RAYMOND T. HUM

In the wake of the volatility that has affected virtually all markets, the inherently difficult task of agreeing on the price of a business in an acquisition has become even more challenging. Sellers may expect a quick recovery in their businesses or in general market valuations and hold optimistic views of values. Buyers may be focused on today's prices and unwilling to bet on a quick recovery. How can parties with these seemingly conflicting concerns reach an agreement? Increasingly, sellers and buyers are turning to earnouts, which can help accommodate different views about the long-term value of a business, but they also add complexity, and can be a basis for disputes, so require careful consideration and structuring.

Structure and terms

An earnout generally refers to an additional payment (or payments) of purchase price that the buyer makes after the closing, but only if the target business achieves specified milestones. There is no standard earnout formula, however. An earnout can be structured in a wide variety of ways, with different triggers, mixes of closing and potential post-closing payment amounts, forms of payment (cash, stock, debt, or other property), and adjustments for performance that falls short of, or exceeds, a milestone (for example, payments can be structured to be either proportional to the target's achievement of the milestone or subject to a 'cliff' where no payment is made if the milestone is missed). An earnout can also incorporate different operational covenants and other features, all of which depend on the businesses, risk tolerances, and other characteristics of the parties to the transaction.

A key element is the milestones that the target business must achieve to trigger the earnout payment. Milestones should ideally be based on events or results that are clear and not subject to interpretation. Common financial milestones include specified levels of sales or EBITDA and other income statement items, which, however, can be subject to interpretation. When using a financial milestone, parties also must consider the accounting method by which the milestone will be measured, given the discretion allowed in many accounting judgments. The level at which the milestone is set and the spacing of multiple milestones are typically the subject of extensive negotiations, with some parties seeking 'home runs' and others seeking to reward more measured, but steady, performance. Earnout milestones can also be tied to non-financial developments, such as regulatory approval of a new product or the achievement of a distribution or other marketing relationship.

The length of the earnout period is also a key element. For a financial milestone, the parties may desire a period that is long enough to minimise the effect that volatility in the operations or financial results of the target business may have on the earnout. However, the buyer generally will want a shorter earnout period so that the buyer will not be bound by restrictions on the post-closing operation of the target business longer than necessary.

Post-closing control of the business

One of the most controversial issues in negotiating earnouts is the control of the target business during the earnout period. A seller often agrees to an earnout based on the seller's understanding of how the business will be run post-closing. To maximise the opportunity to achieve the earnout, the seller will want to ensure that the target business can be operated in substantially the same manner as it was conducted prior to the sale and that the buyer is obligated to provide some minimum level of support to the target business, such as support for R&D or capital budgets, marketing expenses, and other costs, and to avoid competing products and other acts that might cannibalise the target business. The buyer, on the other hand, will want to be able to integrate the newly-acquired business into its operations as efficiently and effectively as possible, respond to changes in circumstances, and take advantage of other opportunities.

Accounting and regulatory concerns

Parties must also consider tax, accounting, securities, and other issues arising from using an earnout. Depending on its structure, the tax treatment of an earnout may vary, including the recognition, timing, and characterisation of the seller's taxable income generated by the earnout. A buyer subject to US GAAP must consider the impact of FAS 141(R), which recently became effective and now requires the buyer to record the 'fair value' of the expected earnout as of the closing date, rather than wait to see when the earnout becomes determinable. FAS 141(R) also requires the buyer to 'true up' the amount reserved for the earnout as the probability of making the payment changes, which can make the buyer's earnings more volatile. Parties must also consider whether the seller's right to payment under the earnout would be treated as a security for US securities law purposes. If the right to payment were treated as a security, the offering of that right would be, in the absence of an available exemption, subject to the registration requirements of the Securities Act of 1933, which would necessitate an expensive and time-consuming registration process.

Related payments and other issues

Using an earnout makes the amount of actual purchase price payments difficult to predict, which affects other determinations made in connection with the acquisition. For example, a financial adviser's compensation may be tied to the amount of the purchase price, and the parties may need to make assumptions about or otherwise provide for the potential variability of the earnout amount and the timing of the payments. The variability and timing questions also can complicate determinations with respect to any preferences due to preferred stockholders and any calculation of fair value when contemplating dissenter's rights that may arise under applicable law.

Disputes

Using earnouts often leads to disputes. While the parties may be willing to agree on an earnout to reach agreement on the overall acquisition, they may later disagree over the interpretation of a milestone or the measurement of the target business's performance, the support the buyer was obligated to provide, or whose fault resulted in the earnout milestone not having been met. Recognising the potential for disputes, parties often negotiate dispute resolution mechanisms specifically to address the application of an earnout. Buyers also often reserve the right to buy out the earnout by paying some specified amount, regardless of the target business's performance.

Earnouts for public company targets

While earnouts are drawing increasing interest in private company M&A transactions, earnouts remain relatively rare in public company M&A transactions. The administrative burden and the securities and other regulatory issues associated with the larger number of shareholders in a public company can be daunting. Nevertheless, these challenges can be met, and we recently have seen more earnouts used in public company M&A transactions, such as Pharmacopeia's recent acquisition of Ligand Pharmaceuticals. For public company targets, earnouts often are referred to as 'contingent value rights', and involve third parties acting as rights agents for the shareholders in public company targets.

Conclusion

Ultimately, whether an earnout should be used to bridge a gap in price negotiations will depend on the benefits and risks for a particular acquisition. In some cases, it may be more appropriate for the parties to simply focus on agreeing on the price for the acquisition without use of an earnout. Nonetheless, because of the recent market volatility and the more challenging task of agreeing on price, we expect that sellers and buyers will use earnouts with increasing frequency.

Michael O'Bryan is a partner and co-chair of the firmwide Mergers & Acquisitions Group and Raymond T. Hum is an associate at Morrison & Foerster LLP.

Michael G. O'Bryan
Partner
San Francisco
T: (415) 268-6352
E: mobryan@mofo.com
www.mofo.com

Michael O'Bryan is a partner in the firm's Corporate Finance Group and a co-chair of the firmwide Mergers & Acquisitions Group. His practice focuses on U.S. and international mergers, acquisitions, divestitures and other strategic transactions, including the representation of companies and special committees in "going private" and other related party matters. Mr. O'Bryan has worked extensively with clients in the software, telecommunications, computers and peripherals, and healthcare/pharmaceutical sectors and with investment banks in their M&A activities.

Mr. O'Bryan joined Morrison & Foerster in 1988 and worked in the firm's Tokyo office from July 1990 through May 1994 before moving to the San Francisco office. Prior to joining the firm, he worked at a Japanese law firm for two years, concentrating on cross-border transactions, including financings and joint ventures.

Mr. O'Bryan is a member of the American Bar Association's Committee on Negotiated Acquisitions and Task Force on Public Company Acquisitions. He also is a member of the Business and Intellectual Property sections of the California Bar Association.

Raymond T. Hum
Associate
San Francisco
T: (415) 268-6950
E: rhum@mofo.com
www.mofo.com

Raymond T. Hum is a corporate associate in the San Francisco office of Morrison & Foerster LLP. Mr. Hum's practice focuses on general corporate and securities matters. His experience includes advising clients in connection with mergers and acquisitions, public and private securities offerings, tender and exchange offers, divestitures, corporate governance and Exchange Act compliance and reporting.

Mr. Hum received his B.A. in Philosophy from the University of Arizona in 1998 and his J.D. from the University of California, Berkeley School of Law (Boalt Hall) in 2001. He is admitted to practice in New York and California.