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Trends in Private Company M&A: Earn-out Consideration

by **Jennifer McGuire, James Byrne**

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Earn-out consideration has been a feature of M&A transactions for many years. There has been no indication that earn-outs have become any less popular. Indeed their use has, if anything, increased somewhat.

Earn-out arrangements allow parties to bridge valuation gaps, hedge risk on the performance of their investment, and incentivise retained management shareholders.

What to consider when providing for an earn-out

Synergies

A buyer is likely to factor into their purchasing decision perceived synergies post-acquisition between the buyer's group and the target company. Where an earn-out is contingent on financial targets or performance milestones of the target post-acquisition, a question arises as to whether the sellers should benefit from such synergies. The acquisition agreement may need to provide for adjustments to be made to the earn-out accounts discounting value attributable to identified synergies with the enlarged buyer's group.

Funding

A buyer might consider the impact that earn-out arrangements may have on their financing requirements for the transaction. To the extent that upfront consideration can be reduced in favour of earn-out consideration, the buyer would require a lower cash amount for the upfront consideration. This should provide savings on the opportunity cost of funds and, where bank financing is involved, savings on the interest incurred and lowering repayment amounts. The buyer may also be able to fund the future earn-out payment through profits of the target company.

Deferring consideration through an earn-out may also result in a reduced initial stamp duty liability. Revenue guidance set out in their Stamp Duty Manual (revised July 2017), suggests a 'wait and see' approach to paying stamp duty in respect of the element of consideration that is not yet ascertainable. Once the consideration is determined, an amended return should be filed to pay any additional stamp duty due.

There are also tax considerations for the seller, as their capital gains tax liability on the sale of their interest in the target may be payable on the full value of the target upfront, rather than just the initial consideration paid. It is important for the parties to take tax advice in M&A transactions.

Restricted Transactions

A seller will have made an assessment of what they expect the eventual earn-out payment will be, and will have to some extent based their decision to sell on this expectation. For this reason a seller will demand contractual protections in the acquisition agreement providing that the buyer will not take certain actions post-acquisition that would unfairly reduce an earn-out payment.

The general effect of these restrictions is to ring-fence the business of the target until the earn-out has been calculated. However, this may affect the buyer's post-acquisition integration plans as matters such as merging a target company with another company within the buyer's group or acquiring another business would be restricted transactions often included in acquisition agreements. Therefore the parties will need to consider and negotiate what restricted transactions are to apply.

Drafting Points

The parties should consider the following matters relating to an earn-out at heads of terms stage, and the heads of terms or the acquisition agreement should reflect these as appropriate:

1. The basis upon which the earn-out payment is to be measured.
2. The timeframe and dispute mechanism for calculating and finalising the earn-out payment.
3. How earn-out payments are to be satisfied (i.e. cash, non-cash), and the timing for making payment after the earn-out payment has been determined.
4. Whether a minimum earn-out payment will be specified (perhaps subject to certain exceptions).
5. Are there circumstances in which the earn-out payment should be nil?
6. Are there circumstances in which the earn-out payment should be accelerated or delayed?
7. Will interest be payable on late payment?
8. Will the buyer have to provide security in respect of the earn-out payments (e.g. an escrow, or parent guarantee)?

Conclusion

By including earn-out consideration in an acquisition agreement there will be some level of uncertainty as to the final amount payable, and there will be some level of costs and management time required to deal with earn-out calculations.

However, our experience suggests that parties are now more aware of earn-out arrangements and seek to use earn-out consideration to ensure that the price paid for the target accurately reflects what it is worth.

A well drafted acquisition agreement, addressing the considered position of each party in light of their respective valuations of the target, will help to ensure the desired outcome is achieved.

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