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M&A Earnouts Increase During COVID-19 Pandemic

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The economic ripple effects of the COVID-19 pandemic in the U.S. and around the world have greatly increased uncertainty concerning the condition, performance, and prospects of businesses in a variety of industries. For businesses that are targets of M&A transactions, this uncertainty has exacerbated potential buyers' already-challenging efforts to value such businesses. At the outset of the pandemic, M&A market participants and commentators generally expected this uncertainty to result in more deals seeing a 'valuation gap' (i.e., a difference between the buyer's and seller's view of the proper valuation for the business) and argued that these valuation gaps, coupled with still large appetites for M&A, would lead to an increase in the use of so-called 'earnouts' to bridge the valuation gaps and push deals forward. Based on empirical data collected and made available from M&A transactions that have been in process or closed during COVID-19, the expected increase in the use of earnouts has materialized. In addition, the market has seen an increase in the portion of the purchase price that is subjected to an earnout.

An 'earnout' is a contingent portion of the purchase price that is paid after the closing of an M&A transaction if the acquired business meets certain negotiated goals or milestones. Earnout milestones are typically financial in nature, such as achieving threshold revenue or earnings before interest, taxes, depreciation and amortization (EBITDA) targets during a defined period, but can also be operational in nature, such as achieving regulatory approval for a product or opening a new business location. Buyers generally like earnouts because less cash is required at closing, and the contingency on payment reduces the risk of overpaying for the business and shifts at least some of buyers' pricing risk to the sellers based on assumptions of continued post-closing performance of the business (one of buyers' primary concerns due to COVID-19 and its effects). A seller may entertain an earnout because it allows the deal to move forward, while allowing the seller to ultimately receive its desired purchase price if the business performs as expected after closing. Yet for all the perceived benefits, M&A parties should consider several important issues when negotiating an earnout.

First, consider the appropriate earnout period, or the period after the closing during which the business's performance is measured for purposes of achieving the agreed milestone(s). Earnout periods often extend one or more years after closing. Sellers typically want a shorter period so they can be paid sooner, but must consider what amount of time will allow the business to meet the earnout milestone(s), which may be longer than desired due to continued COVID-19 uncertainty.

Second, consider the earnout metrics— a business's revenue or EBITDA during the earnout period are frequent metrics. If EBITDA is used, parties must consider what earnings, expenses, etc. should be included in (and which should be excluded from) the calculation of EBITDA. For example, a buyer would want to exclude funds from a forgiven PPP loan from revenue in calculating EBITDA, and a seller may want to exclude certain extraordinary or non-recurring expenses incurred under the buyer's control. To avoid disputes at the end of the earnout period, the covenants and defined terms in the agreement must be carefully drafted with respect to defining and applying the chosen metric. Parties should consider using an illustrative example of the earnout calculation and its components in the purchase agreement.

Finally, a seller is often not involved in the business after closing and almost never maintains control over the business. To maximize the possibility that earnout milestones are achieved, a seller may

Originally published in the May 2021 issue of the *DBA Headnotes*.

request certain covenants from the buyer regarding operation of the business during the earnout period and rights of the seller to audit the business's books. However, a buyer wants maximum flexibility to operate the business it just purchased and generally wants to limit any agreed restrictions on its ability to do so.

Given earnouts often result from a buyer's and seller's disagreement on the value of the target business, there is inherent potential for dispute. In addition to matters raised in this article, there are many other business and legal issues to consider with an earnout. While trends show that more deals are employing earnouts and more money is at stake in these earnouts due to COVID-19 uncertainty, we will likely see increased M&A deal litigation in the years to come. To mitigate the chance of future litigation, transaction parties using an earnout should consider in detail its terms with their tax and M&A counsel and other advisors, and ensure the agreement is highly tailored to their specific intent, and precisely drafted.

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