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A Review of Earnouts in M&A Transactions

Earnouts in M&A tie the sellers of a company to the post-closing results of the business. They are often used as a tool to bridge the gap between the value of the business the sellers perceive, and a buyer's willingness to pay. Typically, in an M&A earnout agreement, buyers and sellers agree to an upfront payment and a set of payments associated with targets or milestones (such as revenue or EBITDA targets) that will trigger future payments. If structured properly, earnouts can be attractive for both parties: they can contribute to lower up-front costs and financing for buyers and an overall higher business valuation for sellers.

However, while M&A earnouts may seem like an attractive solution, such a rosy prospect must be tempered by pragmatism. In this article, we discuss three keys for earnout provisions that can help maximize a successful outcome in your M&A transactions.

How to Structure M&A Earnouts: Focus on Outcomes Rather than Milestones

When companies develop their product or service, there can be many unpredictable turns in the road. Companies start down one path, determine that a different strategy makes more sense, and make appropriate changes. While this seems obvious, it is surprisingly difficult to account for when the parties negotiate and define the terms of earnout agreements. SRS Acquiom often sees earnout milestones with deadlines or specific requirements that appear to be one way, but not the only way, to reflect the value of the business acquired.

M&A Earnout Milestone Results

The result is that earnout milestones sometimes are technically missed but for reasons that are caused by changes in business strategy. It does not necessarily follow that the buyer is not getting the value sought from the company purchased.

Life Sciences M&A Transactions Present Unique Challenges

This is especially true in life sciences transactions because the earnouts in those transactions tend to be long and complex. In life sciences M&A, it is much more common for development and regulatory plans to change over time than for them to play out as planned.

For instance, the parties might determine at closing an earnout milestone payment should be made upon the first patient dosing in a phase II study in Europe, provided it starts by a certain date. A typical diligence provision may require the buyer to use efforts commercially reasonable in the industry to achieve the earnout milestones. Months or years later, the buyer might have determined for legitimate business reasons it makes more sense to do a somewhat different phase II study in India rather than Europe, and the change has resulted in a delay of several months.

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The result is the M&A deal parties may know in advance the earnout milestone defined at closing will not be technically achieved because of changes in the execution of the business plan, even though the development of the drug or product is proceeding and value is being created.

This scenario can result in earnout disputes over significant sums of money with no clearly correct answer. Moreover, other aspects of the buyer-seller relationship (such as an escrow release) are often impacted because this uncertain potential earnout dispute can be foreseen by both parties long before the earnout milestone is missed.

To avoid such scenarios, SRS Acquiom suggests the M&A deal parties acknowledge at closing that nobody really knows how future development will progress. M&A deal parties should avoid setting earnout milestones tied to the plan as it exists at closing, especially for tests that will be years into the future. Instead, they should focus on the results of what would constitute success with respect to this acquisition, or clear value inflection points that cannot be bypassed.

If the goal is to take a product to market, M&A deal parties should base earnout milestones on an event or outcome demonstrating this fact, rather than worrying about how to get there. Also, where development cycles are long and interim earnout milestones are necessary, M&A deal parties should consider providing for an alternative or second earnout milestone as an opportunity to receive the milestone payment (perhaps in an adjusted amount) if plans change and the first designated milestone is bypassed or delayed rather than simply having failed.

Approach Relationship and Earnout Management with the Buyer Overtly and with Care

Earnouts sometimes seem like great ways for buyers and sellers to achieve common goals. Buyers mitigate acquisition risk, and sellers get all or some of their capital back (possibly with some initial return) and are relieved of future funding responsibilities. But the transaction exists in the larger context of the business, and several factors can come into play:

- **Selling Shareholders May Not Be a Part of the Management Team**

A crucial difference between a merger and other types of collaborations, such as strategic partnerships, is the selling shareholders no longer have a company and may not have a management team inside the larger corporation to advocate for the program or to control its progress.

- **Internal Dynamics of the Business Can Make or Break Product Success**

Sellers must successfully navigate the internal relationships, politics, and various strategic motivations of their partner to get their product approved and to market. Once their startup is acquired, however, the mechanisms, tactics and people necessary to do so change.

- **Sellers Can Lose Influence and Control of Outcomes**

In some cases, the management team of the seller may join the buyer and continue to drive the development with the support that they need. In other cases, managers might move on to other projects or new companies. Regardless, selling shareholders seeking earnout milestone payments may not have the information and influence they were accustomed to receiving with an independent company and management team.

- **Former Employees Are a Source of Key Knowledge But Can Be a Risk**

Selling shareholders will often seek out the former management and employees of the target company to keep an ear on the buyer's progress toward meeting earnout milestones. When these resources work for the buyer, shareholders should be mindful of the employee's confidentiality obligations to their employer. Buyers may assert that the employee is bound by confidentiality agreements, and the shareholders may be putting the employee at legal risk by asking questions related to confidential or proprietary information. In addition, buyers may assert that the selling shareholders are interfering with the management of the company they purchased.

To resolve these issues, SRS Acquiom suggests the information rights section of the earnout covenants should clearly state parameters for access to employees (whether former or current). It should provide permission for the stockholders and their representative to access employees for the purposes of evaluating any earnout and claim provisions of the agreement.

In negotiating earnout covenants, it is advisable to select M&A attorneys who have expertise in negotiating earnout milestone provisions of mergers or corporate partnering agreements. Investors should ensure the shareholder representative they select has the mission, time, resources, and expertise to effectively manage the ongoing relationship with the acquiring company.

“The shareholder representative should have sufficient time, resources and expertise to effectively manage the ongoing relationship with the buyer.”

Ensure Comprehensive Information Rights in the M&A Earnout Agreement

“An earnout that isn’t performing can turn into an earnout dispute, even when relationships are civil.”

Many sellers experience the anxiety of knowing too little about an earnout that isn’t meeting expectations. Reports of a selling company’s performance often contain little information other than whether or not the earnout targets have been achieved. If the seller isn’t granted information rights under the merger agreement, an earnout that isn’t performing can descend into an earnout dispute, even if the relationship between the seller and buyer was civil when the deal closed.

Having comprehensive information rights in an earnout agreement provides insight into performance and options for solving problems before they escalate, which can preserve resources for both parties when earnout milestones aren’t met.

Ideally, information rights would include the following features:

- **Periodic written reports with a reasonable level of detail**
Report frequency depends on the nature of the business and the earnout objectives. Inadequate frequency of reporting can leave sellers grasping for more information about the performance of their business. Sellers should consider how often they must receive reports to adequately track earnout status and ensure this is reflected in the acquisition agreement. Usefulness of reports also depends on the level of detail within them. Sellers should insist financial reports include sufficient detail regarding the components of the bottom-line number. Event-based reports should provide an update on material events as of the most recent report and the ongoing activities aimed at achievement of earnout milestones.
- **Right to request reasonable supporting information**
The shareholder representative should have the right to request and review information not directly included in the report but that supports the calculations. Particularly common in financial earnouts, this would include sales reports, financial statements, workpapers, and in many cases, formal audit rights.
- **Right to request a meeting with buyer representatives**
The right to request a meeting with relevant personnel from the buyer can be crucial in keeping earnouts on track, particularly in event-based milestones. At a minimum, meetings allow deal parties to share information and establish a productive relationship. In many cases, they can iron out miscommunications resulting from written reports and resolve a brewing earnout dispute before it escalates.
- **Consistent reporting standards**
Reporting standards should be consistent whether the business is close to meeting the target or not. In some cases, the buyer is required to provide less

information to the seller if performance isn't meeting expectations than if earnout milestones are being achieved. Allowing sellers less information when things are going poorly only perpetuates a difficult situation.

Now more than ever, it is important that sellers ensure their interests in an earnout are protected. Robust information rights in the earnout agreement are a primary means to avoid a dispute if things don't go as planned.

There is no question that earnouts in M&A transactions are here to stay. Potentially attractive to both buyers and sellers, they may offer an efficient means to bridge valuation gaps between buyers and sellers. A broader perspective focused on outcomes instead of overly specific earnout milestone achievements, management of the post-closing relationship with the buyer, and detailed attention to information rights will help lead to a more positive outcome in the event your deal has an earnout provision. SRS Acquiom strongly recommends sellers and their counsel focus on these provisions and find a professional shareholder representative to navigate the terms of an acquisition to best protect them in their next deal.

About SRS Acquiom

SRS Acquiom delivers the smartest way to run a deal™ with solutions that reduce the administrative burden in complex transactions. Our M&A services include paying and escrow agent services, online document solicitation and reporting, and professional shareholder representation. For loan and credit transactions, we provide independent Administrative Agent, Collateral Agent, Sub-Agent, and Successor Agent services. Since 2007, we have helped sophisticated deal parties get deals done more efficiently, enabling them to focus on building great businesses and maximizing value.

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