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A Tale of Two Earnouts

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Earnouts, while often used to bridge valuation differences during negotiation of an agreement to sell a company, frequently lead to post-closing disputes. Two Court of Chancery decisions issued earlier this year highlight pitfalls associated with the period during which an earnout is measured (the "Earnout Period"). In *Edinburgh Holdings, Inc. v. Education Affiliates, Inc.* (June 6, 2018), the court held that the covenant to operate the acquired business "consistent with past practices" during the Earnout Period precluded disposition of the earnout-related dispute at the early pleading stage of litigation. The court stated that the covenant necessitated a facts-intensive analysis of what past practices were and what the practices during the Earnout Period had been. In *Glidepath Limited v. Beumer Corporation* (June 4, 2018), the court rejected the plaintiffs' request for reformation of the acquisition agreement to change the dates of the Earnout Period based on a delay in signing and closing the agreement (which had led to the anomalous result of the Earnout Period commencing before the closing).

Key Points

***Edinburgh* serves as a reminder that, without *specific* covenants relating to operation of the business during the Earnout Period, a covenant to operate in accordance with a general standard (such as "consistent with past practices") may lead to *non-dismissal at the pleading stage* of a claim for breach of an earnout payment obligation.** We note that the inclusion of specific covenants *in addition to* a general standard could provide an answer to, or at a minimum could provide context for, a determination whether an action taken during the Earnout Period was or was not permissible (and thus might permit disposition of such a dispute at the pleading stage). In the case of the *Edinburgh* agreement, the parties had agreed that the buyer would operate the acquired business during the Earnout Period "consistent with past practices" and there were *no* specific covenants relating to operation of the business during the Earnout Period. As discussed below, counsel for both sellers and buyers should carefully consider the benefits of including specific, business-contextualized covenants to govern operation of the business during an Earnout Period. (Of course, even when parties endeavor to include specific covenants, different interpretations and unanticipated events may in any event lead to disputes which the court deems to be unresolvable at the pleading stage.)

These decisions also serve as a reminder of the prevalence of post-closing disputes relating to earnouts. Although earnouts are used frequently to solve valuation disagreements between parties during negotiation of a sale agreement, they commonly lead to post-closing disputes relating to the earnout itself. Thus, parties should seek to structure the purchase agreement to limit the potential for disputes and to incentivize their settlement in the event that they arise. Where the potential amounts involved are not large, parties should consider whether they would be advantaged by settling valuation disagreements upfront (or utilizing an alternative to an earnout) rather than relying on an earnout.

Statistics on earnouts. Earnouts were utilized in about 28% of the private target transactions entered into in 2016 and the first half of 2017, according to the 2017 ABA Private Target Deal Study (which analyzed 139 deals with purchase prices between $30 million and $500 million). This rate is consistent with the rate generally over the past decade, which has ranged from 20-30% (with a spike to 38% in 2014). With respect to the agreements with earnouts:

- 21% included an express covenant requiring the buyer to run the business consistent with past practice, and 33% expressly permitted the buyer to operate post-closing in its discretion;
- 8% included an express covenant requiring the buyer to seek to maximize the earnout
- 5% included an express acceleration of the earnout payment(s) on a change of control (in recent prior years, 11-27% of agreements with earnouts included this type of acceleration)
- 51% of agreements expressly permitted the buyer to offset indemnity payments against the earnout (in recent prior years, 58-81% of agreements with earnouts expressly permitted offsets); and
- 32% provided for calculation of the earnout based on revenues, 27% based on earnings/EBITDA, and none based on a combination of revenues and earnings.

Edinburgh

Background. In 2013, the American Society of Professional Education, Inc. (the "Seller") sold its proprietary education business (the "Business") to a subsidiary of Educational Affiliates, Inc. (the "Buyer") pursuant to an asset purchase agreement (the "APA"). The APA provided for $6 million to be paid at closing and four contingent annual installment payments based on the Business's revenue. The seller's managers of the Business pre-closing continued on as the management post-closing and, under their new employment agreements, had "significant autonomy in running the [Business]." The APA required that the Business be operated during the Earnout Period "in a reasonable manner and consistent with past practices of [the seller]." The APA provided as follows with respect to calculation of the earnout payments: (i) for each of 2013, 2014 and 2015, the payment will be equal to 50% of the "Pre-Tax Profits" if the "Total Revenue" is less than $13 million and 65% if the Total Revenue is $13 million or more; (ii) at the end of 2016, if $2 million or less has been paid in the aggregate, then an additional amount will be paid so that the aggregate amount paid equals $2 million; and (iii) for 2016, the payment will be equal to 25% of Total Revenue if Total Revenue is $8 million or more.

Total Revenue was $12 million the first year of the contingent payout period and rose each year thereafter, reaching $12.64 million in the final year. The buyer made the first three contingent payments, but refused to make the final payment (of $4.7 million). The seller sued to obtain the

final payment. The buyer sought dismissal of the claim on the basis that (among other things), the Business had not been operated by the seller's former management to optimize revenues and, specifically, had not been operated "consistent with past practices" as required under the APA. Vice Chancellor Slights refused to grant the motion to dismiss the breach of contract claim on the basis that the issue whether a business was operated consistent with past practices is facts-intensive and therefore cannot be decided at the pleading stage.

Without more detailed, specific covenants relating to operation of the business during the Earnout Period, a covenant to operate "consistent with past practices" (or other general standard) may lead to non-dismissal at the pleading stage of a claim for breach of an earnout payment obligation. The court stated that the issue of compliance with a covenant to operate consistent with past practices "is fact intensive." The court wrote: "[T]o answer [the question] dispositively, the Court must consider evidence of [the seller]'s past practices and compare those practices to the practices employed after the [sale] was consummated. Such evidence is not before the court and, in any event, could not be considered on a motion to dismiss." As noted above, the inclusion of specific covenants in addition to the general standard—as is fairly typical—could well lead to a different result by providing an answer, or least context, for a determination whether an action taken during the Earnout Period was or was not permissible.

The court rejected the seller's contention that the implied covenant of good faith applied to the buyer's conduct during the Earnout Period. The court stated that the implied covenant "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." Here, the seller contended that the implied covenant required that the buyer could not deprive the seller of the fruits of the bargain by "actively preventing" the Business from making acquisitions requested by the seller that would have grown revenues. (The seller maintained that the buyer prevented these acquisitions because the buyer was "singularly focused" on securing funding from non-government sources—in order to meet a regulatory requirement for this type of educational institution that not more than 90% of revenues be obtained from government funding.) The court ruled that the implied covenant did not apply because the APA expressly covered the subject of the claim by setting forth a standard for operation of the business during the Earnout period—*i.e.*, that the Business was to be operated consistent with past practices. If the contract "expressly addresses a particular matter, an implied covenant claim respecting that matter is duplicative and not viable," the court wrote. In effect, inclusion of the covenant to operate consistent with past practices left no "gap" in the agreement as to what the parties had agreed with respect to operation of the Business (*i.e.*, they had agreed to the general standard of consistency with past practice). However, the content of that general standard as applicable in the particular case was not knowable without fact-finding at trial (*i.e.*, determining what actions would be consistent with past practices and what actions were taken).

Glidepath

Background. The parent of Glidepath Limited (together with Glidepath, the "Sellers") sold 60% of the equity in Glidepath to Beumer Corporation (the "Buyer"). The Acquisition Agreement and an Operating Agreement (the "Agreements") contemplated a period of shared management (albeit with the Buyer in control) for three full years. The consideration consisted of (i) a cash payment at closing of $1 million; (ii) an earnout payment equal to 60% of the net profits generated by

Glidepath during the 'Earnout Period,' up to a maximum of $1.56 million; (iii) a distribution equal to 40% of the net profit generated by Glidepath during the Earnout Period, up to a maximum of $1.04 million (i.e., with the earnout payment, the Sellers would receive the benefit of all of the net profit generated by Glidepath during the Earnout Period, subject to the earnout cap); and (iv) a payment of an amount between $400,000 and $2.4 million (depending on Glidepath's net profit during the Earnout Period) in return for the remaining 40% of Glidepath's equity if the Buyer chose to exercise a call at the end of the Earnout Period.

Glidepath did not perform as expected and the Buyer notified the Sellers that, using the Earnout Period provided for in the Agreements, no earnout payment would be payable. The plaintiff-Sellers brought suit, alleging contract and fiduciary duty breaches and seeking reformation of the Agreements. The court requested that the parties address first the reformation claim (as, without reformation, the contract claims would fail and the deadline for bringing a fiduciary claims would have expired).

The Agreements stated that the Earnout Period covered "fiscal years 2014, 2015 and 2016" (i.e., April 1, 2013 through March 31, 2016). When the Agreements were drafted, the parties anticipated that the closing would occur shortly after Glidepath's fiscal year-end of March 31, 2013. For valid business reasons, however, the signing and closing were delayed and did not actually occur until January 2014. The Agreements were dated effective as of January 1, 2014; but the dates for the Earnout Period remained unchanged from the initial draft. The Sellers argued that they believed and the parties intended that the measurement period for the earnout would be three full years from the effective date of the Agreements (*i.e.*, January 1, 2014 through December 31, 2016). They argued for reformation of the Agreements to provide for these dates as the Earnout Period. Vice Chancellor Laster rejected the plaintiffs' request for reformation of the contract.

The court found that the party seeking reformation of the contract did not prove by clear and convincing evidence that the parties had agreed to a different earnout measurement period than the period that was set forth in the final, written agreement. The court reviewed that the party seeking reformation of a contract has the burden of proving, by clear and convincing evidence, that (i) it was mistaken about the contents of the final, written agreement; *and* (ii) its counterparty either (a) was similarly mistaken (so-called "mutual mistake") or (b) knew of the mistake and remained silent so as to take advantage of the error (so-called "unilateral mistake"); *and* (iii) there was a "specific meeting of the minds" regarding a term that was not accurately reflected in the final, written agreement (*i.e.*, that there was an actual agreement between the parties that was not reflected in the final, written agreement). To establish proof by "clear and convincing evidence" requires proving that it is "highly probable, reasonably certain, and free from serious doubt," the court wrote. To prove mutual mistake, the plaintiff must show that both parties were mistaken as to a material portion of the written agreement.

According to the court, the evidence established as follows: (i) The Sellers mistakenly believed that the Agreements would use calendar years to measure the relevant Periods, but did not show that the Buyer was similarly mistaken. The court found credible the Buyer's testimony that the Buyer had assumed that the dates that were set forth in the Agreements would be the applicable dates. The court noted the Buyer's testimony that, in a recent prior acquisition (by the Buyer with a different counterparty), a similar set of circumstances unfolded in terms of a delayed closing, no

changing of the dates for the Earnout Period based on the delayed closing, and thus an Earnout Period that commenced prior to closing—with, in that case, no objection from the sellers. (ii) The Buyer ultimately came to understand that the Sellers had made a mistake, but this happened *well after signing* (at which time the Buyer "gained no advantage by remaining silent," the court noted). (iii) While both sides agreed that the original bargain contemplated that the Earnout Period would span three full years after closing, and that understanding assumed that the closing occurred shortly after March 31, 2013, there was no evidence of any meeting of the minds as to how the dates would operate if (as actually occurred) the closing were delayed.

The court also noted as persuasive evidence cutting against the plaintiff-Sellers' position that the issue of use of calendar versus fiscal years for the acquired business post-closing had been specifically discussed between the parties, without those discussions prompting any discussion of whether the fiscal years specified in the Agreements should be changed to calendar years. In addition, the court noted that the Sellers, while "unhappy" when they heard that there would be no earnout payment, did not challenge the conclusion until four months later and only disputed the dates set forth in the Agreements "after [the] dispute arose."

Practice Points on Earnouts

Parties should consider not relying solely on a vague, general standard for operation of the business, but including clear, specific, business-contextualized covenants. As a general matter, parties should not rely solely on a standard such as "consistent with past practices," "in the ordinary course," or "in a reasonable manner," but should include specific covenants tailored to the business and industry at issue and to all reasonably anticipated developments. Parties should consider requiring that the acquired business, to the extent feasible, be operated pursuant to pre-agreed, detailed business plans and budgets that specify the important aspects of operation for the particular business (such as acquisitions, expenses, marketing, R&D, intercompany support services, tax-sharing agreements, etc.)—with such changes as the parties agree to over time. While specificity with respect to the parties' obligations during the Earnout Period can reduce the risk of disputes and/or make settlement more likely, we note that, in any event, a buyer, if it will be running the business post-closing (and depending on other circumstances) may wish to provide instead for a *general* standard, without any specificity, so as to have the maximum flexibility for running the business.

Risks presented when "carryover" employees are involved. If the acquired business is to be managed by former employees of the seller ("carryover employees"), there are potential risks for the buyer, the seller and the carryover employees—particularly if the carryover employees will be providing the information upon which the earnout calculations will be determined and/or will be receiving a significant portion of any earnout payments made. *A buyer should consider* whether provisions should be included to address the risk of potential non-loyalty to the buyer. For example, the buyer could consider providing for a specific right to object to or double-check the information provided, or a process for correction, if it believes that the information provided is fraudulent or inaccurate. A mechanism for ongoing or periodic oversight of compliance with covenants applicable to the running of the business during the Earnout Period also could be considered. Alternatives to an earnout should be considered—such as performance-related employee compensation or bonuses (subject to tax and other considerations); contingent value rights (CVRs); or, where the achievement of specific non-financial milestones are critical, milestone payments tied to those achievements. *A seller and carryover employees should*

consider whether provisions should be included to address the risk of the buyer reducing or changing the carryover employees' duties or authority to run the business and/or of the buyer directing the carryover employees to take action that is (potentially) inconsistent with the sale agreement. A seller should also consider generally the possibility of the carryover employees' greater loyalty to the buyer than to the seller going forward.

Disclaimers should be included. In *Edinburgh*, the plaintiff claimed that the seller had made extra-contractual "promises" to achieve revenue growth. Although the court decided that the statements made by the seller were only forecasts and that no binding obligation to grow revenues had been made, the issue was complicated by the fact that there was no express disclaimer in the purchase agreement relating to reliance on extra-contractual statements. Generally, a seller should include an integration clause with an explicit anti-reliance statement by the buyer (*i.e.*, a provision stating that the written agreement is the sole agreement between the parties with respect to the subject matter of the agreement and supersedes any previous agreements, and that the buyer is not relying on any representations made or information provided to it other than as expressly set forth in the agreement). In addition, a buyer should seek to expressly disclaim any obligation to ensure or maximize the earnout payments; conversely, a seller may seek to negotiate to include a provision to the effect that the buyer must conduct its businesses following the closing so as to seek to maximize the earnout payments.

The parties' specific objectives in adopting an earnout should be scrutinized and the appropriateness of an earnout considered. As noted, earnouts often prevent disagreements during the negotiation of the deal price only to result in post-closing disputes over the earnout itself. We note that in some transactions the earnout is utilized to bridge a relatively small valuation gap and the parties may be better served with a compromise upfront rather than risking later litigation (or even arbitration) with respect to the earnout.

A well-crafted earnout provision involves significant challenges in terms of both negotiation and drafting. Earnouts implicate numerous interrelated provisions involving the metrics for the earnout formula, the accounting principles that will be applicable to calculation of the formula, the process for making the earnout determinations, and the seller's rights and the buyer's obligations with respect to the operation of the acquired business during the Earnout Period (including the general level of efforts, and any specific efforts, by the parties that will be required with respect to enabling the business to reach the targets). When an earnout takes the form of "milestone payments," which are payable upon the occurrence of specified events (such as, in pharma deals, regulatory approvals being received for drugs in development), the nature of the trigger events, specificity as to the parameters relating to the trigger events, and the parties' respective obligations (if any) in promoting the occurrence of the trigger events, need to be addressed. In addition, an earnout will create special considerations for the governing law, remedies and many other provisions in the sale agreement. Specific covenants relating to operation of the business during the earnout measurement period should be drafted with a focus on anticipated events or issues that could adversely impact operations, and should include key actions that the parties contemplate will be taken.

Lawyers and business people who understand the specific company and its industry, its business operations, and its accounting practices should work closely together in crafting provisions that are as clear and specific as possible and are contextualized for the specific business at issue. Litigators should review the provisions to ensure clarity and an effective

dispute resolution mechanism. Review by tax and employee benefits lawyers is also advisable, as issues relating to the treatment of items such as tax or employee expenses, accruals, rebates, reserves, and so on, often arise and can have a significant dollar impact on an earnout formula. The parties may also want to consider including in their agreement general statements of their mutual intent with respect to the earnout generally (or with respect to specific provisions) in order to help guide resolution of any future dispute. In addition, hypothetical examples of earnout calculations for illustrative purposes should be considered.

A buyer does not have a legal duty to ensure or maximize the earnout—but the buyer cannot purposefully frustrate the earnout. Generally, in Delaware, *except to the extent that the parties expressly provide otherwise in their agreement*, the buyer has no obligation to take or refrain from taking action, and no implied obligation to use any form of best or reasonable efforts, to ensure or maximize an earnout. However, the courts have held that the implied covenant of good faith and fair dealing requires that the buyer not take any affirmative action for the purpose of frustrating the achievement of earnout targets. The courts tend not to view actions as having been taken for the purpose of frustrating payment of an earnout if (i) there is any basis for the actions to be viewed as legitimate business decisions and the sellers' complaint as a dispute concerning business strategy and/or (ii) there are countervailing factors indicating efforts by the buyer that supported the relevant business (such as the investment of funds in the business, the hiring of additional sales people for it, and so forth). Thus, there is a generally high bar to succeeding on a claim that a buyer frustrated an earnout—but, because the factual context is critical, and because earnout provisions often are not sufficiently specific, the result of litigation relating to earnouts has a relatively high degree of uncertainty. (Note that the law of other states varies, with some states, such as California and Massachusetts, imposing an implied obligation that a buyer take "reasonable efforts" to achieve an earnout—at least in the absence of an express disclaimer to the contrary.)

Particularly in light of the prevalence of post-closing earnout-related disputes, the parties should consider including provisions that mitigate the risk of litigation and encourage settlement of disputes. In addition to seeking to avoid disputes through clear and specific drafting (as discussed above), the parties should consider the following possibilities for discouraging litigation and incentivizing settlement of disputes that do arise.

- ***Arbitration.*** The parties should consider providing for arbitration of disputes to be the exclusive method of resolving disputes, with the arbitrator's decision being final and binding on the parties. (We note that, if the agreement provides for arbitration *without* the arbitrator's decision being final and binding, there is a risk that, in future proceedings, a party may be deemed to have waived any issues and considerations not reflected in its initial calculations of the earnout and/or in the initial objections it made to the arbitrator's decision.) Some acquisition agreements limit the scope of arbitrable disputes by requiring that the buyer and the seller prepare and agree on a written description of the accounting issues in dispute and that the arbitrator limit its decisions to those issues, with the arbitrator's decisions based solely on the arguments and theories raised by the parties.
- ***Graduated formula.*** A graduated formula (*i.e.*, a percentage payment on partial satisfaction of performance targets), as opposed to an all-or-nothing structure (*i.e.*, a single payment, triggered only if performance targets are fully met), may avoid an incentive for the buyer to just miss achievement of the target or an incentive for the seller to stretch to just make the target (albeit to the detriment of the business) to the extent that

doing so is within the party's control. A graduated formula could also reduce the amount of discrepancy that could be subject to dispute.

- ***Floor or cap.*** The parties could consider including a floor and/or a cap on the earnout payments so as to limit the range of discrepancy that can be subject to dispute.
- ***Fee-shifting.*** The parties may wish to consider including fee-shifting provisions so that the party whose position is rejected (or is only minimally successful) in arbitration or litigation would bear some or all of the other party's expenses.
- ***Specified remedies.*** As it can be difficult to prove that benchmarks would have been achieved but for breaches by the buyer, the seller should consider seeking to specify remedies for breaches of the sale agreement—such as liquidated damages (which, as a stimulus to compliance with the earnout provisions, could be in excess of the aggregate payments that could be earned under the earnout formula); specified adjustments to the metrics of the earnout formula; or payment of all or a specified percentage of the earnout.
- ***Offset rights and carrybacks.*** The parties should specify whether there will be any right to use the earnout payments as an offset against any required payments under indemnification claims or otherwise. A seller may seek to delay other payments being made until the earnout is finally determined. The parties should consider whether there will be any adjustment with respect to payments made (or missed) in previous installments based on subsequent performance.

Distinguish earnout disputes from other disputes. If a post-closing earnout dispute arises, the sale agreement should be carefully analyzed to distinguish and separate from the earnout dispute any issues that actually give rise to claims of breach of non-earnout-related representations and warranties, fraud, indemnification, or other issues. The agreement also should provide whether the buyer can offset indemnity claims against earnout payments.

The risk associated with the final earnout payment. In a number of cases (including *Edinburgh*), all earnout payments have been made other than the *final* payment due. This not uncommon pattern suggests that *throughout the period* the parties should monitor the performance of the business with respect to the calculation of the earnout and be aware of and try to resolve disputes as they arise.

Selecting dates for the Earnout Period. Determining the optimal length of an Earnout Period will involve, for either party, a balancing of factors. Perhaps most importantly, a longer period will provide a more reliable look into how the business performs, but will also entail a longer period during which there are restrictions on the business, a longer wait for the earnout payment, possibly longer involvement by the seller in managing the business, and an increased potential for the business's performance to be affected by *general* industry or market conditions (or other factors not related to the specific business acquired). At the same time, of course, a longer period may be preferred by a seller to provide sufficient time for the business's value to grow. Thus, the preferred route will depend on the specific factual context.

As highlighted in *Glidepath*, dates for the Earnout Period included in a draft agreement should be reconsidered and (if appropriate) revised if the signing and closing date of the agreement extends beyond the date that the parties initially anticipated.

Further practice points relating to specifically tailored earnout terms, and discussion of the major Delaware earnout decisions, are included in our article, *The Enduring Allure and Perennial*

Pitfalls of Earnouts (January 2018), https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts.