Professional Perspective

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In the wake of the Covid-19 pandemic and the market volatility it continues to pose to global asset prices and business valuations, it should come as no surprise that M&A buyers and sellers may turn to earnouts to get deals done. Many law firms have recently extolled the virtues of earnouts, invariably reminding us that "earnouts bridge valuation gaps in a Covid-19 world." While earnouts were included in merely 22% of private-target deals from 2015-2019 according to data from SRS Acquiom, it is expected that earnouts will continue to be recommended and implemented in pandemic-era M&A practice. But care must be taken as earnout usage proliferates.

While it is true these seemingly nifty devices can help bring temporary adjournment to debates on a target company's valuation, especially when such valuation depends heavily upon uncertain future events, it is equally important to keep in mind that contingent payment mechanisms, if not meticulously designed and flawlessly implemented, can create bigger and more costly problems than those they purport to solve.

This article will survey a number of recent Delaware opinions to illustrate a few of the various problems that can emanate from dealmakers' over-reliance upon unwieldy earnout mechanisms. Focus here will be on Delaware due to its robust body of law on M&A earnouts and related contractual interpretation issues, and in light of the large proportion of acquisition agreements and M&A situations that are governed or influenced by Delaware decisions. This article will also provide practical guidance for avoiding some of the pitfalls that have dogged litigants in Delaware courts.

Background

When M&A buyers and sellers cannot mutually agree how much a business or asset is worth, a valuation "gap" is said to arise. Experienced buyers and sellers commonly employ a variety of tools to "bridge" that gap, and earnouts are among the most common of such tools in sophisticated deal practice. An earnout allows an acquiror to proceed toward the closing of a transaction when the buyer's perspective on the valuation of the target is different from that of the seller.

Buyers risk that the asset they are purchasing will not yield the value, post-closing, that was anticipated and ascribed to the price they contracted to pay pre-signing. Earnouts are intended to mitigate such risk, especially where the value to be delivered is highly conditional on the occurrence of known future events—such as the achievement of future earnings before interest, taxes, depreciation and amortization, or the attainment of regulatory approval.

For example, in the pharmaceutical and life sciences sector, acquirors of new drug companies will often defer large portions of the consideration payment to the target until such time as the target's key pharmaceutical products receive regulatory approval. In the M&A context, on the other hand, a buyer may prefer to withhold a portion of the acquisition consideration until certain highly-negotiated performance metrics have been achieved, at which point additional consideration becomes due to the seller post-closing.

M&A earnouts typically involve a negotiated "measurement period" during which the acquired business must satisfy the earnout conditions. The measurement period is usually structured as a finite period of time (such as financial quarters or years), but it can be indefinite in other circumstances (such as the achievement of a regulatory approval or the successful launch of a new product, whenever these events may occur). Earnout payments are typically structured as separate, follow-on payment obligations due on a future date, and the funds to be used to pay them are held by the buyer until payment becomes due, as opposed to being set aside in an escrow account.

As deal fatigue sets in, parties who are unable, after considerable efforts, to finalize the pricing of a transaction become tempted to relegate differences of opinion in pricing discussions to an earnout. Counsel and other advisors, in anticipation of getting the deal to closing and realizing a fee event, can be all too eager to accommodate parties' desire to implement an earnout without comprehensive scrutiny of all of the attendant factors that may influence the earnout provision's final determination. When this happens, earnout provisions can become unwieldy, omitting key assumptions, abbreviating defined concepts, and otherwise failing to enumerate crucial elements of the parties' bargain.

Sources of Problems

To put it short, the problem with earnouts is that they ensure high-stakes situations where the sellers and the buyers are not only motivated to behave in ways that are adverse to each other, but also heavily incentivized to litigate over such behavior.

Any bridge that an earnout provides across a valuation gap is temporary in nature, since an earnout merely postpones the valuation determination until a later date when the earnout conditions are tested upon the end of a measurement period. Clearly and comprehensively describing how the conditions that activate an M&A earnout obligation will be satisfied can be a very tricky drafting exercise, as the Delaware decisions discussed below will illustrate.

Earnouts are often borne out of the minds of creative business principals, so in their infancy, they can often seem very reasonable—even elegant. However, translating the business-level understanding among the parties into a workable set of contract provisions within a complex transaction agreement can devolve into a hotly-contested exercise even for skilled drafters. Harder still can be the retrospective interpretation of these provisions by a third party, to whom such provisions are inherently unfamiliar.

Since the precise description of the earnout payment conditions is an intensive exercise in both precision and creative writing (and subject to manipulation of the English language by clever litigators), these provisions often blend existing contractual defined terms and elusive business concepts, as well as the "plain" meanings of operative words and phrases. As such, most of the trouble with earnouts relates to ambiguity in their drafting—meaning the degree to which the provisions and terms within them can be reasonably susceptible of more than one meaning.

And recall that M&A earnout provisions do not exist in a vacuum within the acquisition agreement. These provisions interact heavily with other carefully negotiated provisions, such as operating covenants and indemnities. The various legal theories implicated in M&A earnout litigation resemble a law school issue spotting exam, encompassing the implied covenant of good faith and fair dealing, the parol evidence rule, conflicts of interest, fiduciary duties, and, most commonly, contractual ambiguity.

To make matters worse, at the time an earnout payment may become due, a transaction has been signed and closed—the parties disputing an earnout no longer walk arm-in-arm on the same harmonious path of courtship towards the closing table. When parties disagree on whether earnouts have been duly earned, any harmony that previously existed rapidly dissolves. Since the earnout amounts at issue in typical middle-market M&A transactions usually exceed the costs and expenses of hourly counsel, it is often rational for parties to elect to litigate these disputes.

Finally, from a procedural point of view, earnout provision ambiguity is particularly problematic since, in Delaware, when contract language is ambiguous, subsequent resolution of such ambiguity becomes a factual inquiry for a jury at trial. This means that only rarely are earnout disputes fully decided on summary judgment and that the resolution of these disputes will entail discovery and additional motion practice, making the resolution process prolonged and expensive.

Specific Problems in Recent M&A Earnout Litigation

What do the earnout provisions even mean?

Parties, and their counsel, often believe they are certain that they have captured every contingency and addressed all relevant aspects of the earnout and its triggers; why would sophisticated parties proceed to signing if they thought their contract to be unclear or incomplete? Regrettably, the product of long drafting sessions and endless revisions is not always a clear earnout provision, but rather a confusing mess that neither side can convincingly explain in dispositive fashion.

In one particularly memorable example involving two public companies with experienced advisors, Vice Chancellor Joseph Slights professed to have read a merger agreement over a dozen times without being able to "understand the relevant provisions of the contract at all, much less attach definitive meaning to them." *W. Standard, LLC v. SourceHOV Holdings, Inc.*, No. CV 2018-0280-JRS (Del. Ch. July 24, 2019).

Further, the parties' efforts at explaining their earnout provision during litigation left the court totally unable to "discern the path by which the parties intended for the earnout to be triggered and paid." As such, the Chancery Court declined to dismiss the action and ordered the parties to share certain books and records, as well as to provide more extrinsic evidence to support their arguments.

If an earnout milestone is tied to achievement of a financial performance metric, is there a clear calculation methodology that must be applied in the determination as to such achievement?

In *Windy City Investments Holdings, LLC v. Teachers Ins. & Annuity Ass'n of Am.*, No. CV 2018-0419-MTZ (Del. Ch. May 31, 2019), TIAA purchased a mutual fund and advisory business called Nuveen from Windy City for a purchase price of over $6 billion, with a potential $287 million earnout based on Nuveen's future financial performance.

In contrast to *Western Standard* above, Vice Chancellor Morgan Zurn was able to comprehend the general structure of the earnout, which was subject to an upward or downward adjustment corresponding to the Nuveen business's results. However, various inputs and definitions within the calculation methodology were unclear. Ultimately, neither party could persuade the Chancery Court as to which competing interpretation of "distribution" should carry the day, and a motion to dismiss was denied with the parties ordered to go back and collect additional evidence for further review.

What duties are applicable to the parties over the course of the contingent consideration measurement period? Must the buyer act in any specified manner to maximize the amount of the contingent payment due to seller?

Many earnout disputes feature a seller who claims that, in taking action that has thwarted earnout attainment but was not expressly prohibited by negative covenant, a buyer has violated the implied covenant of good faith and fair dealing. Under Delaware law, the implied covenant of good faith and fair dealing attaches to every contract by operation of law and prohibits a party from engaging in "arbitrary or unreasonable conduct" that prevents the other party from enjoying the benefits of an agreement. *Winshall v. Viacom Int'l, Inc.*, 55 A.3d 629, 636 (Del. Ch. Nov. 10, 2011).

However, the implied covenant of good faith and fair dealing serves only "a gap-filling function by creating obligations only where the parties to the contract did not anticipate some contingency, and had they thought of it, the parties would have agreed at the time of contracting to create that obligation." *Am. Capital Acquisition Partners, LLC v. LPL Holdings, Inc.*, No. CIV.A. 8490-VCG (Del. Ch. Feb. 3, 2014). The implied covenant is merely a gap-filler and "is not a license to rewrite contractual language just because the plaintiff failed to negotiate for protections that, in hindsight, would have made the contract a better deal."

In general, absent express covenants proscribing permitted and prohibited behaviors, the case law in Delaware has suggested that buyer actions taken with the primary intent of frustrating the earnout, such as by "dishonest purpose" or "furtive design," may violate the implied covenant. *O'Tool v. Genmar Holdings, Inc.,* 387 F.3d 1188 (10th Cir. 2004) (applying Delaware law).

Other decisions suggest that although the implied covenant prohibits a party from actively sabotaging earnout achievement, it does not represent an affirmative duty to behave in a way that maximizes an earnout payment where a seller fails to contract for reasonably foreseeable buyer conduct that would maximize the earnout payment. *Am. Capital Acquisition Partners, LLC v. LPL Holdings, Inc.*, No. CIV.A. 8490-VCG (Del. Ch. Feb. 3, 2014).

Fiduciary duties can also sometimes apply. For example, if the seller elects to "rollover" a portion of its cash acquisition consideration in exchange for buyer's securities, then after the closing, the seller becomes a stockholder of the buyer to whom the buyer may then owe corresponding fiduciary duties. However, well-counseled parties understand the complications that such a dynamic would necessarily entail and are therefore quick to waive or otherwise contract around them in the acquisition agreement—as was done in the *Collab9* agreement below. The implied covenant of good faith and fair dealing, however, is an inherent fixture of Delaware contract law and cannot be similarly waived. For these reasons, most of the current discussion in today's market surrounding duties owed to an M&A seller with an earnout right revolves primarily around the implied covenant of good faith and fair dealing.

Can a buyer 'opt out' of any requirement posed by the implied covenant of good faith and fair dealing?

Delaware courts respect parties' freedom to contract specifically as to the manner in which the parties must behave in connection with an earnout. This gives buyers and sellers broad latitude in defining what duties, covenants or other obligations apply during the measurement period. In the early stages of earnout usage, it was common for parties to remain silent as to what actions parties can permissibly take during an earnout period.

Today, Delaware law is clear that if an acquisition agreement clearly apportions complete operational control of the acquired business and absolute discretion thereover to the buyer during the measurement period, no implied covenant-related liability will be imputed to the buyer if the earnout conditions are failed to be satisfied as a result of the buyer's operation of the business. This operative language must be comprehensive and explicit.

In *Collab9, LLC v. En Pointe Techs. Sales, LLC*, No. CVN16C12032MMJCCLD, (Del. Super. Ct. Sept. 17, 2019), the earnout provision at issue provided as follows:

> Subsequent to the Closing, Purchaser shall have sole discretion with regard to all matters relating to the operation of the Business. Purchaser shall have no express or implied obligation to the Seller, the Primary Stockholder or Option Holder to take an action, or omit to take any action, to seek to maximize the Earn Out payment by seeking to maximize sales, pursuing particular business opportunities, engaging in advertising or marketing campaigns, or otherwise. Purchaser owes no duty, as a fiduciary or otherwise, to Seller, the Primary Stockholder or Option Holder in connection with its operation of the Business following the Closing.

The *Collab9* agreement also contained a clear combined integration and anti-reliance provision. When the seller brought a claim for breach of the implied covenant of good faith and fair dealing. The Delaware Superior Court found that the agreement's "comprehensive and explicit" language controlling the parties' obligations with respect to the operation of the post-closing business left no gap for the implied covenant to fill. As such, sellers' claims were dismissed.

When an earnout provision is ambiguous, where will a court look to examine the parties' intent when interpreting an earnout provision?

When parties disagree on what their earnout provision was intended to mean, as in *Western Standard* above, courts will reference extrinsic evidence to construe their intent. A recent decision in the Delaware Chancery Court illustrates how broad that universe of evidence can be.

In *Schneider Nat'l Carriers, Inc. v. Kuntz*, No. CV 2017-0711-PAF (Del. Ch. July 16, 2020), an earnout was payable to the sellers of a trucking company. The parties negotiated covenants and conditions in connection with the earnout trigger, one of which gave the buyer the right to operate the acquired business "as they see fit," and another that required the buyer to "cause one or more of the Acquired Companies to acquire, in the aggregate, not less than sixty (60) class 8 tractors."

The buyer undisputedly acquired 60 tractors per year across all of the acquired companies, but divested tractors as well, such that the acquired companies' fleet, taken as a whole, was not expanded by 60 tractors per year. Thus, the question the Chancery faced was whether the 60-tractor purchase requirement in the earnout provision was "net or gross."

What was interesting about this decision was not whether the parties intended the requirement to be net or gross (which, predictably, could not be conclusively established without a trial), but rather the scope of extrinsic information the court considered as it attempted to interpret the parties' bargain. In addition to the text of the acquisition agreement itself, the parties marshalled a broad variety of documents, with varying levels of success, to argue how the purchase requirement should be interpreted, including:

- the transaction letter of intent
- the confidential information memorandum and notes to financial projections prepared by sellers' banker
- employees' recollections of pre-signing teleconferences (and contemporaneously recorded notes thereof)
- pre-signing e-mails among business principals
- shared issues lists and previous drafts of the acquisition agreement and exhibits, including counsel's redlined document comparison files
- the target's management presentation to its board of directors
- the target's Hart-Scott-Rodino Act filing and included projection slides; and
- post-closing emails and internal discussions

Parties and their counsel do not often consider the impact that their ex ante communications and transaction documents may have on ex post matters of fundamental contract interpretation. They should. Had either party in *Schneider* taken the care to clearly and uniformly document a net (or gross) concept when describing their earnout mechanism in each of the above documents in a consistent manner, further proceedings and frustrations may have been avoided.

Practical Guidance

Keep It Simple

M&A lawyers sometimes fall into the trap of categorically believing that more detail is always better. While a long-winded earnout provision and a laundry list of triggering events can be sometimes appropriate, "over-lawyering" these provisions does not always make them clearer, as the *SourceHOV* opinion showed. Concise drafting and economy of words can help crystallize the parties' bargain, as well as render the earnout provision readily accessible to third party readers following the closing.

State the Obvious

The volume of Delaware decisions on earnouts evinces a recurring tendency of parties to vigorously dispute the meanings of plain terms. What seems obvious may therefore bear expressly stating and potentially repeating. Quantifying and qualifying the key items within an earnout trigger is crucial to administering the payout obligations effectively.

Consider using defined terms where such might ordinarily be of less importance. With respect to the most critical metrics within the earnout, assume no working knowledge on the part of third-party readers as to their inputs, and clearly and unequivocally spell out the drivers of those metrics.

Expect the Unexpected

Should an earnout be triggered in the event of an unforeseen merger or change-of-control transaction involving the acquiror-payor? How is an earnout affected by either party restructuring their debt obligations or seeking insolvency protection? Should an earnout payment obligation be voided in the event of a violation by rollover sellers of their stockholders agreement?

In the event that M&A sellers-turned-earnout holders are retained as management executives of the acquired business, should a violation of any employment or restrictive covenant agreements to which the earnout holders become party impact their ability to receive the earnout? Looking around the corners and asking "What if…?" with clients can be a helpful exercise in identifying potentially unfavorable contingencies that might drive the parties toward an earnout dispute.

Show the Math

Where the earnout provision involves an arduous calculation, do your best to describe that calculation in the contract, but also make use of illustrative earnout calculations and guidelines to demonstrate the calculation unambiguously. These guidelines can be annexed to the acquisition agreement as a schedule and discussed with auditors and financial diligence experts.

As long as illustrative, sample calculation exhibits conform to the language of the acquisition agreement and accurately reflect the parties' bargain, they can be a useful tool for third parties to quickly ascertain the numerical workings of a calculation and whether a quantitative milestone has been achieved.

Connect the Covenants

Whether an earnout milestone is achieved can depend on actions taken—and not taken—during the measurement period. Interim operating covenants, post-closing covenants, and restrictive covenants create limitations on the universe of the actions that can be taken by the management of the acquired business.

As deal processes drag on, drafters should avoid taking shortcuts instead of clearly specifying all potential permissible or prohibited actions that may be relevant during the measurement period. To the extent operational covenants interact with any actions necessary or desirable to achieve the earnout, care should be taken to make sure such covenants and earnout provisions are harmoniously synchronized and not in conflict with another.

Conclusion

Earnouts should hardly be thought of as “silver bullets” to meaningful transaction valuation polarity. No matter how much work earnouts may do in “bridging valuation gaps” as the common refrain goes, earnouts nevertheless represent an inherently sub-optimal compromise to a fully-baked deal price, since they create high-stakes situations where parties are not only motivated to behave in ways that are adverse to each other, but also heavily incentivized to litigate.

As recent Delaware cases demonstrate, even the most detailed M&A earnout provisions, drafted with the help of expensive advisors, can still be fraught with uncertainty and rife with risk. Just because an earnout provision purports to be detailed does not mean it will be effective upon review and adjudication in the event of a dispute; conversely, oversimplified earnouts can create insurmountable ambiguity. Striking the right balance between these extremes when structuring and drafting earnouts is where the value of an experienced and thoughtful deal lawyer is shown.

Should earnouts be avoided at all times in all deals? Not necessarily. Indeed, where parties have worked hard to fully negotiate and finalize all of the other terms of a deal (except for valuation-related aspects), a well-designed earnout mechanism could be better than an abandoned deal. Where an M&A earnout mechanism is capable of being neatly distilled into an abundantly clear set of binary alternatives with carefully circumscribed parameters, it can serve as the valuation gap-bridging tool that commentators praise.

At the same time, recognize that issues associated with interpreting and applying earnout provisions are not always apparent until they arise. Being clear, thoughtful, and sufficiently specific while keeping it simple is of paramount importance in leveraging earnout mechanisms to mitigate valuation volatility in today's M&A market.

