WASHINGTON
BUSINESS
JOURNAL

MERGERS & ACQUISITIONS 2004
ADVERTISING SUPPLEMENT TO THE WASHINGTON BUSINESS JOURNAL

Earnouts: Do They Really Work?

JOE SCHMELTER
Venable, LLP
CURTIS SCHEHR
Anteon International Corporation

Additional purchase price consideration based on the post-closing performance of the acquired company - commonly known as "earnouts" - are quite prevalent in middle market M&A transactions. This article maintains that while earnouts are common, and on their face appear to solve, or at least ameliorate, the problem of buyers' and sellers' differing views as to the value of the acquired company, earnouts nevertheless are often not a workable solution to this valuation problem.

JOE SCHMELTER

WHY EARNOUTS APPEAR USEFUL ON THE SURFACE

Buyers and sellers often discuss earnouts, and sometimes agree to includethem in their deal documents, because they disagree about the fair value of the "target" company to be acquired, and because they earnestly believe that earnouts can bridge the valuation gap. There may be several reasons for disagreements about value. The target may have experienced a very recent fiscal period in which its revenues or earnings are markedly down when compared to prior periods. The buyer may rightly be concerned that such a downturn may be the beginning of a trend. The seller, however, may justifiably believe that its recent poor performance is an anomaly, and can be explained away by one or more "extraordinary" events. Or perhaps the seller may recently have acquired one or more large contracts or customers, or may have significant proposals pending award by customers, and believes it is on a transformative growth track. The buyer may be cautious about ascribing value to the target company's pending contract award opportunities, or even the profitability of newly awarded contracts, and suspect instead that the target will soon fall back into its prior, more modest results. Whatever the reason, buyers and sellers often have difficulty agreeing on a definitive purchase price, and opt instead to try to negotiate a payment at closing and an earnout.

FROM A "PROCESS" STANDPOINT, EARNOUTS ARE PROBLEMATIC

The conventional wisdom that earnouts are a convenient "fix" to a valuation gap between buyer and seller is potentially fraught with peril. Earnouts may be more difficult and expensive to negotiate and document than are agreements on a definitive purchase price paid at closing, and can be a significant obstacleobstacle to "getting the deal signed." Sellers need sufficient post-acquisition autonomy to have a realistic opportunity to achieve the earnout's performance milestones. Thus, a seller is not inclined to permit the buyer to have the right, following the closing, unilaterally to make decisions about what opportunities the acquired company may pursue, and what costs and expenses it must incur. Buyers, conversely, desire enough authority to make the restructuring and consolidation changes necessary to achieve the synergies that made the acquisition attractive in the first place. Additionally, sellers naturally want milestones that are based on "top line" revenue numbers, so that they are free to pursue revenue opportunities aggressively, without having a disproportionate share of buyer organization "G&A" expenses imposed on the target as a part of the earnout calculation. Buyers, on the other hand, want performance measured using "bottom line" earnings-based numbers, since "EBIT" or "EBITDA" numbers are typically how the buyer first valued the target (i.e., at some multiple of the target's EBIT or EBITDA), and it is natural that some follow-up calculation of one of these earnings-based numbers should be performed to determine whether additional consideration is due and payable. The difficulties in negotiating and documenting these thorny issues may far outweigh the effort and expense that would be required for the parties to reach a definitive agreement on price. These practical, "front end" problems should persuade most buyers and sellers to forego earnouts in favor of sometimes difficult, but necessary, discussions about price. Importantly, however, these thorny issues are not the only, or even the most difficult, challenges that earnouts create.

CURTIS SCHEHR

EARNOUTS CAN MAKE INTEGRATION SIGNIFICANTLY MORE DIFFICULT

Earnouts typically fail to align the buyer's and seller's interests after the acquisition, and impede the integration necessary for a successful acquisition. Earnout recipients logically become intensely focused on the post-acquisition autonomy of the acquired company and the achievement of its performance milestones. Sellers may not be interested in integration, consolidation, cost savings or pursuing new or risky ventures during the earnout period.

Buyers, conversely, often need to reduce overhead, consolidate operations and achieve greater efficiencies in order for the acquisition to make economic sense. These competing goals are difficult, and sometimes impossible, to harmonize during the earnout period, and integration suffers as a result. For these reasons, it is not unheard of for the buyer and seller to agree to abandon the earnout midstream during an earnout period and "settle" on some mutually agreed upon contingent payment. In this way the parties can get back to the important business of integrating their businesses and ensuring a successful transaction.

CONCLUSION

On the surface, earnouts may appear to work, as they permit the buyer and seller to avoid difficult negotiations about what the target company is really worth. In reality, however, earnouts are often costly and time-consuming to negotiate and document, and may actually delay execution of the deal documents and consummation of the transaction. Additionally, and even more importantly, earnouts pit buyer and seller against each other even after the deal has been consummated, when their energies should instead be jointly focused on integrating the combined companies and making the deal successful. For these reasons, buyers and sellers are likely to find that the time and effort needed to reach final agreement on a definitive purchase price for the target company, payable at closing, are well spent, enabling the parties to avoid the potential "pain" of an earnout.

This article reflects the views of the authors and not necessarily those of their respective organizations.

Joe Schmelter (jcschmelter@venable.com) co-chair's Venable LLP's Business Transactions Group. Venable (www.venable.com), one of The American Lawyer's top 100 law firms, serves clients throughout the U.S. and around the world.

Curtis Schehr (cschehr@anteon.com) is Senior Vice President, General Counsel and Secretary of Anteon International Corporation, and has played a key role in each of Anteon's six acquisitions completed to date.

Reprinted for web use with permission from the ***Washington Business Journal***. ©2004, all rights reserved.
Reprinted by Scoop ReprintSource 1-800-767-3263