

A photograph of a chessboard with a vertical line down the center, splitting the board into two halves. The left half is dark wood, and the right half is light wood. Chess pieces are visible on both sides, including a king, queen, and knight on the right, and a king, queen, and knight on the left.

Morgan Lewis

# M&A ACADEMY PURCHASE PRICE ADJUSTMENTS & EARN- OUTS

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# OVERVIEW OF PRESENTATION

- Purchase Price Adjustments
  - Net Working Capital, Net Equity, Indebtedness, Cash
  - Inventory, A/R, Deferred Revenue, and Other Balance Sheet Issues
  - Litigation Risk Management Considerations
- Earn-Outs
  - General Overview of Provisions
  - Negotiation and Drafting Best Practices
  - Litigation Risk Management Considerations

# NET WORKING CAPITAL — OVERVIEW

- Net Working Capital Adjustment Provision
  - Most common fodder for post-closing dispute-resolution proceedings
  - Provides an adjustment in the event of a difference in working capital from a working capital target (typically the level at the time a deal is priced or some normalized level)
  - Elements of the balance sheet where we see the most risk are deferred revenue, accounts receivable, and inventory

# NET WORKING CAPITAL – DRAFTING TIPS

- Confer with finance and accounting to understand the Company's past practices and historic positions taken under GAAP
- Be aware that GAAP sometimes permits a variety of approaches
- Specify methodologies for calculations
  - Draft with the Company's balance sheet handy
  - Provide illustrations
  - Specify adjustments from GAAP
- Think through the post-closing process
  - Consider threshold triggering amounts
    - Avoid disputes over small amounts
  - Scope of information exchanges
  - Realism about post-closing timeline

# NET WORKING CAPITAL – POSITIONING FOR BEST POSSIBLE LITIGATED OUTCOME

- Expressly address scope of arbiter's/referee's review and authority
  - Lawyer . . . or accountant?
- Expressly address impact of Company's past practices
  - Is Buyer and/or arbitrator/referee bound by Seller's past practices irrespective of appropriateness under GAAP?
  - What is implication of pre-closing or benchmark Working Capital example/calculation/target?

# NET WORKING CAPITAL – POSITIONING FOR BEST POSSIBLE LITIGATED OUTCOME

- Expressly address scope of review/standard governing Buyer's document/information production obligations
- Expressly address mechanics of dispute-resolution process
  - Written submissions, site/inventory inspection, witness interviews/depositions, evidentiary hearings?
  - Timing from start to conclusion?
  - Reasoned determination or simple issuance of final binding calculation?

# NET WORKING CAPITAL – POSITIONING FOR BEST POSSIBLE LITIGATED OUTCOME

- Expressly consider (and address, if desired) dispute resolution risk allocation
  - Payment of arbiter's/referee's fees
    - Allocation based on success?
    - Calculation methodology?
  - Prevailing party's attorneys' fees/expert-accountant fees
    - Encourage reasonableness, resolve *de minimis* disputes
    - Focus on large disputed issues
- Expressly address interest on final working capital amount
  - Calculation rate, timing, disputed vs. "undisputed" amounts

# EARN-OUT PROVISIONS

- Can benefit both sides, if drafted carefully — but can also be fraught with peril
- Often used to:
  - Bridge valuation gap
  - Motivate Seller to perform in future
- Benefits for Buyer
  - Reduce initial purchase consideration
  - Minimize risk of overpaying
  - Incentivize Seller to support business post-closing
- Benefits for Seller
  - Leverage post-closing synergies and opportunities to increase ultimate purchase price
  - Defer taxes – but beware of employment-related contingencies
- Same accounting ground rules for purchase price adjustments apply to earn outs



# Legal Principles

- The implied covenant of good faith and fair dealing
  - Did Buyer take affirmative steps to impede the achievement of the earn-out?
  - Were Buyer's actions legitimate business decisions?
  - Obviously highly dependent on facts and circumstances, and even intent
- Earn-out covenants are drafted against this legal backdrop

# Example of Pro-Buyer Earn-Out Covenant

## (iii) Operation of the Business Post-Closing.

(A) The parties acknowledge and agree that, except as set forth in this Section 3.2(c), the Buyer shall not have any obligations to support the generation of Qualifying License and Product Revenue or attainment of Gross Margin during the Three Year Period or otherwise following the Closing. The management and operations of the Business and the sale and licensing of Products, from and after the Closing Date, will be at the Buyer's sole discretion; provided however, that the Buyer hereby agrees to not take any actions the primary purpose of which is (1) to prevent the Seller Companies from receiving all or part of the Earn-Out Consideration, (2) to delay the recognition of Qualifying License and Product Revenue so that it is not included in the calculation of an Earn-Out Period, or (3) to shift Product revenue to services revenue. To the extent that the Buyer is found to be in breach of its obligations under this Section 3.2(c)(iii), the sole and exclusive remedy shall be the re-calculation of the Earn-Out Consideration for the applicable Earn-Out Period, which shall include (without duplication of amounts previously included) in the calculation of Qualifying License and Product Revenue and Gross Margin for such period the amounts that would have been recognized in respect of any such sales in the absence of such breach, and the payment by the Buyer of the excess, if any, of such recalculated Earn-Out Consideration over the amount previously paid plus interest on such amount at a rate of 3.25% per annum accrued from the date that such Earn-Out Consideration should have been paid to the date of payment.

# Example of Pro-Seller Earn-Out Covenant

(a) Post-Closing Operation of Business. Buyer acknowledges that it intends to maintain the Business as a separate business unit of Buyer or any successor-in-interest of Buyer (such business unit, the "Surviving Business") through the end of the Measurement Period. Until the end of such Measurement Period, unless the Seller provides its prior written consent or written waiver of any of the conditions or obligations set forth below, Buyer shall comply and shall, to the extent applicable, cause the Surviving Business to comply with the following obligations:

(i) Accounting and Financial Controls. Buyer and its Affiliates shall authorize and cause the Surviving Business to retain and maintain the accounting practices and financial controls used by the management of the Seller in operating the Business prior to Closing, including, but not limited to, the ability to control expenditures, the allocation of costs, payment and incurrence of liabilities, the collection of accounts receivable and the approval of expenditures, in accordance with the terms of the Budget and Operating Plan;

(ii) Bidding & Teaming. The Surviving Business shall be allowed to bid on new contracts and opportunities using cost structures and bid rates that are consistent with the Seller's historical bidding practices in the Business and shall be entitled to team with any third parties it deems necessary or appropriate for pursuing any new contract opportunities or for supporting any existing contracts;

(iii) Customers. Buyer and its Affiliates shall allow and enable the Surviving Business to control and effect all decisions regarding communications and relationships with all customers of the Surviving Business that were customers of the Seller as of the Closing Date.

(iv) Employment Matters. Buyer and its Affiliates shall allow the Surviving Business to control and effect all decisions regarding the managers, employees and consultants of the Surviving Business, including decisions involving hiring, terminations, compensation, benefits, and the assignment of all responsibilities and duties of such managers, employees and consultants. Buyer's Affiliates shall not solicit the employment of any of the employees of the Surviving Business or engage any of the consultants of the Surviving Business;

(v) Marketing. Buyer and its Affiliates shall continue to and shall cause the Surviving Business to actively market the products and services offered by the Surviving Business in a manner consistent with Seller's pre-closing activities;

(vi) Financial Resources. Buyer and its Affiliates shall continue to fund the operations of the Surviving Business in accordance with the funding amounts set forth in the Surviving Business budget and operating plan applicable to each Measurement Period (which shall address the agreed upon funding minimums for working capital, growth and investment in operations of the Surviving Business) as mutually agreed upon by Seller and Buyer prior to Closing (the "Budget and Operating Plan") and Buyer shall make any such funds readily accessible to the Surviving Business in accordance with such Budget and Operating Plan;

(vii) Compliance with Laws. Buyer will comply in all material respects with all laws applicable to it and to the operation of the Surviving Business' business (including any statute, rule or regulation relating to employment practices and pension benefits or to environmental, occupational and health standards and controls); and

(viii) No Integration. Buyer and its Affiliates will not integrate the Surviving Business with any Affiliate of Buyer or other business division of the Buyer until after the Earnout End Date.

(ix) Best Efforts. The Buyer and its Affiliates shall use their commercially reasonable best efforts to enable the Surviving Business to achieve the maximum amount of Earnout Consideration available.

# EARN-OUTS – POSITIONING FOR BEST POSSIBLE LITIGATED OUTCOME

- For Seller
  - Carefully, expressly address earn-out metrics
  - Covenants not to divert business, operate consistent with past practices, operate to maximize earn-out
  - Partial satisfaction vs. “all or nothing”
  - Backdoor use of Buyer indemnification provisions
- For Buyer
  - Business operation discretion/autonomy
  - Express disclaimer of fiduciary duty to Seller
  - Ability to offset indemnity claims (and/or other purchase price adjustments due) against any earn-out
  - Caps on maximum earn-out
  - Reporting frequency/detail/supporting documentation

# QUESTIONS

- Dispute Resolution: Court vs. Arbitration
- Choice of Law/Forum:
  - Delaware vs. New York vs. California vs. Massachusetts vs. Illinois
  - Choice of law and forum do not need to be the same
- Internal consistency within deal documents
  - Fee recovery/cost-shifting
  - Indemnification process
  - “Losses” recoverable under various scenarios
  - Interplay with Consulting/Employment Agreement between Company and Selling Shareholder(s)

# QUESTIONS?

# Biography



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For more than 20 years, Troy S. Brown has successfully first-chaired jury and bench trials across the United States. He handles all aspects of litigation, from inception through trial and post-trial appeals across the full range of M&A and other corporate and contract litigation and injunction proceedings, as well as disputes over alleged business fraud and claims of wrongdoing against corporate executives and Boards of Directors. A former leader of the firm's commercial litigation practice, Troy has been the financial operations partner for the firm's global litigation practice for the past several years, in which he stewards the financial and operational performance of the more than 500 litigators worldwide.



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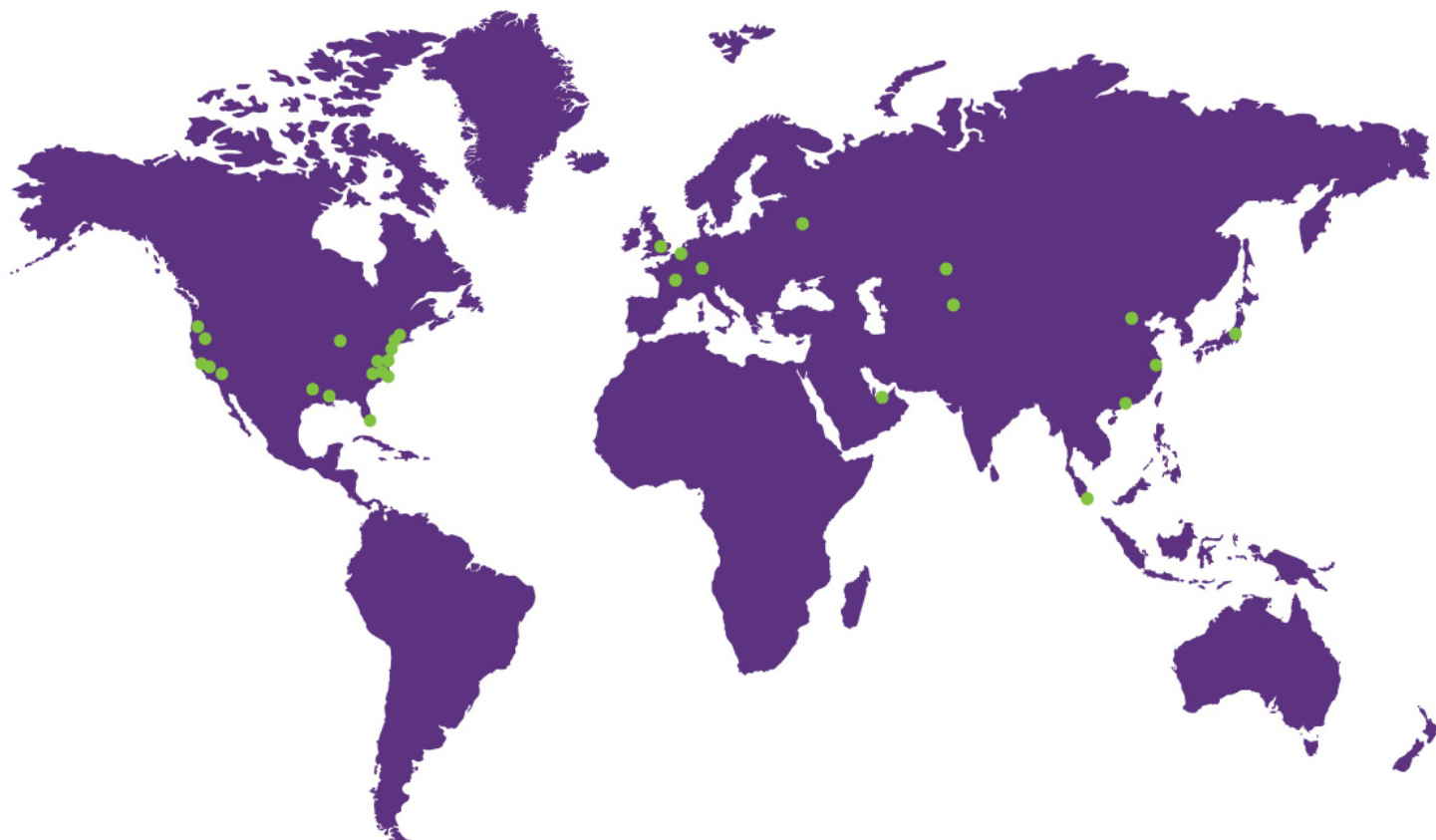
Andrew Ray is the leader of the firm's interdisciplinary corporate practice in Washington, DC, where he represents public and private companies, financial sponsors, and management teams in a broad range of industries, including technology, financial services, life sciences, real estate, and the not-for-profit sector. Various industry publications recognize Andy as a leader in both M&A and in communications law, among other fields. He recently led the team representing Oculus VR in its \$2 billion sale to Facebook, which was named the M&A Advisor M&A Deal of the Year.

## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

|          |            |               |               |                |
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| Astana   | Dubai      | Los Angeles   | Philadelphia  | Silicon Valley |
| Beijing* | Frankfurt  | Miami         | Pittsburgh    | Singapore      |
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