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**Navigating Purchase Price Adjustments,  
Earn-Outs and Related Disputes**

**Russell Franklin and Dana Becker**

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# Overview of Presentation

- Purchase Price Adjustments
  - General Overview
  - Negotiation and Drafting Best Practices
  - Litigation Risk Management Considerations
- Earn-Outs
  - General Overview
  - Negotiation and Drafting Best Practices
  - Litigation Risk Management Considerations

# Why Have Purchase Price Adjustments?

- Means to ensure the value of the target
- Protection against fluctuations in the value of the target during the period that the target was initially valued and closing
- Minimum level of operating capital
- Means to give the Buyer comfort that the target will conduct business in the ordinary course
- Other options:
  - Indemnification
  - Walk-away / termination provisions

# Types of Purchase Price Adjustments and Other Logistics

- General Types
  - Net Working Capital Adjustment
  - Adjustments based on the occurrence, or non-occurrence of certain events
  - Cash, indebtedness and transaction expenses
  - Tax Liability Amount
- Material Considerations
  - Timing of adjustment and how are adjustments paid
  - One part or two-part adjustment
  - One-way or two-way adjustment
  - What accounting principals apply
  - When are payments made (i.e., dollar for dollar adjustment/deductible-cap/only if results fall outside of a predetermined range)
  - Dispute Resolution mechanics

# Net Working Capital Adjustment Drafting Tips

- Think about which accounting standard is most favorable to you and how to ensure that the closing adjustment is calculated in accordance with that standard
- Understand the Company's past practices and historic positions taken under GAAP
- Consistency is key—items that were included/excluded in calculating the target amount should be treated the same in calculating the actual closing amount
- The more specific the calculation the better
- Consider if items that do not actually have an impact on short-term working capital are included in the adjustment
- Think about how different adjustment structures might lead to manipulation
- Think about the practical ramifications of your dispute resolution mechanism

# Net Working Capital— Positioning for Best Possible Litigation Outcome

- An ounce of prevention is worth a pound of cure
- The best litigation outcome is to avoid a dispute entirely
- Precise, contextualized drafting of the agreement will reduce the risk of disputes arising post-closing
- 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 the implication of pre-closing or benchmark Working Capital example/calculation/target?

# Net Working Capital— Positioning for Best Possible Litigation Outcome

- Dispute resolution clauses/Arbitration
- Expressly address scope of arbitrator's/referee's review and authority
  - Lawyer . . . or accountant?
- Expressly address scope of review/standard governing Buyer's document/information production obligations
- Expressly address mechanics of dispute-resolution process
  - Written submissions, site/inventory inspections, 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 Litigation Outcome

- Expressly consider (and address, if desired) dispute resolution risk allocation
  - Payment of arbitrator's/referee's fees
    - Allocation based on success?
    - Calculation methodology?
  - Prevailing party's attorney 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



# CLE

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# Earn-Out Provisions

- Often used to:
  - Bridge valuation gap
  - Motivate Seller to perform in future
  - Help early stage companies for which value is better represented by future, not past, performance
- 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
- The number of non-life science private deals with earn-outs dropped by almost 50% when comparing 2018 to 2017 year over year.

# Earn-Out Provisions

- Earn-outs are frequently the source of litigation – a punt on valuation disputes to be fought at a later time
  - “What an earn-out (and particularly a large one) typically reflects is disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earn-out solves the disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more. But since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome.”

*Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del.Ch.,2009) (VCL)

- 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

# Earn-Outs – Drafting Tips

- For Seller
  - Carefully, expressly address earn-out metrics, including for partial year periods
  - Clearly delineate Buyer's obligation to maximize earn-out (e.g. covenants not to divert business, operate consistent with past practices, etc.)
  - Partial satisfaction vs. "all or nothing"
  - Information rights
- 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

# Earn-Outs – Positioning for Best Possible Litigated Outcome

- Plan on litigation, beginning at the drafting stage and through performance of the earn-out
- Alternative dispute resolution
  - Many of the same considerations as with working capital disputes
- Documenting performance of the earn-out
  - Creating the record that demonstrates a breach of the implied covenant (representing Seller) or mere exercise of business judgment (representing Buyer)
- The role of experts

# Key Takeaways from This Session

- When drafting working capital purchase price adjustments, specificity in how the calculation should work and consistency in the treatment of items included / excluded from the calculation of working capital is critical.
- Consider the likely drivers of disputes and draft precise language to minimize the risk.
- Dispute resolution procedures should expressly address the forum, applicable law, scope of review and authority, and the mechanics of the dispute resolution process (including, for example, if the prevailing party can recover attorneys' fees and costs).
- When structuring an earnout provision that contemplates a significant percentage of the purchase price in the form of a contingent payment, draft with litigation in mind.
- Operationally, the client – whether Buyer or Seller – will need to document performance (or non-performance) during the earnout period.

# Biography



## **Russell Franklin**

New York, NY

T +1.212.309.6210

E russell.franklin  
@morganlewis.com

Russell Franklin counsels private and publicly held companies in connection with structuring, and effecting, complex strategic transactions. This includes structuring and negotiating mergers and acquisitions (M&A), minority investments, and joint venture transactions for strategic and financial clients. His practice also includes general stock and asset transactions, and purchases and sales resulting from bankruptcy and out-of-court restructurings.

By focusing on understanding what his clients are looking to achieve, and leveraging his experience, Russell strives to provide creative solutions that allow his clients to meet their business objectives. In some instances, this amounts to Russell providing advice to clients throughout the entire lifecycle of a target including acquiring the asset, managing the asset and, where applicable, ultimately disposing of the asset.



# Biography



## **Dana E. Becker**

Philadelphia, PA

T +1.215.963.4628

E dana.becker  
@morganlewis.com

Dana E. Becker is a litigator who handles complex business disputes, primarily commercial contract cases and disputes involving business competition, trade secrets, intellectual property, and various business torts, in both US federal and state courts as well as alternative dispute resolution proceedings. Dana also has experience in antitrust and class action litigation as well as government investigations and qui tam actions brought under the False Claims Act. Dana handles all phases of litigation, from pre-complaint investigations through complex discovery, trial, and post-trial appeals.

Dana has federal jury trial experience, which includes preparing witnesses to give testimony, examining witnesses, and preparing and opposing pre- and post-trial motions and other submissions.

Dana has knowledge across a broad range of industries, including the medical device, pharmaceutical, technology, publishing, energy, financial services, and insurance industries. She also has experience managing a portfolio of litigation and providing strategic business advice, including based on her time as in-house counsel managing commercial litigation for a global media and technology company. Dana works closely with both large and small clients to develop and implement risk management strategies.





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