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Navigating Purchase Price Adjustments, Earn-Outs and Related Disputes

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January 11, 2022
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
Purchase Price Adjustments – The Intent

- Protection against fluctuations in the value of the target during the period that the target was initially valued and the closing of a transaction
- Minimum levels of valuation metrics necessary for post-closing operation of the business
- Intended to give the buyer comfort that the target will conduct business in the ordinary course
- Other options:
  - Indemnification
  - Walk-away / termination provisions
Examples of Purchase Price Adjustments

- Net Working Capital Adjustment
- Cash, indebtedness and transaction expenses
- Tax Liability Amount (typically in no-seller indemnity transactions) and CARES Act payroll tax referral
- Adjustments based on the occurrence, or non-occurrence, of certain events
Purchase Price Adjustment Logistics

- Negotiations of accounting principals
- Statement preparation/comments
- One stage or two-stage adjustment
- One-way or two-way adjustment
- Timing of adjustment
- Payment Terms
  - Dollar for dollar
  - Deductible/cap
  - Collars
- Dispute resolution mechanics
Purchase Price 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 (inventory counts?)

• Understand the Company’s past practices and historic positions taken under GAAP (LTM period vs. pre –LTM period for working capital)

• Consistency is key—items that were included/excluded in calculating any target amount should be treated the same in calculating the actual closing amount

• Specification is key

• Consider if items that do not actually have an impact on short-term working capital are included in the adjustment/included as another adjustment

• Think about how different adjustment structures might lead to manipulation

• Think about the practical ramifications of your dispute resolution mechanism

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Purchase Price Adjustment Disputes – Positioning for Best Possible Litigation Outcome

- An ounce of prevention is worth a pound of cure
- The best litigation outcome is probably to avoid a dispute entirely
  - At drafting, everyone should (generally) be rowing together; post-closing, the gloves can come off
- Precise, contextualized drafting should reduce the risk of post-closing disputes
  - Applies to both the body of the agreement and the attendant documents (disclosure schedules, escrow agreements, transition agreements, etc.)
- Consider expressly addressing the impact of the 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?
Purchase Price Adjustment Disputes – Positioning for Best Possible Litigation Outcome

• Dispute resolution clauses/arbitration

• Scope of arbitrator’s/referee’s review and authority
  – Lawyer or accountant?
  – Expert or arbiter?

• Scope of review/standard governing Buyer’s document/information production obligations

• Mechanics of dispute-resolution process
  – Written submissions, site/inventory inspections, witness interviews/depositions, evidentiary hearings?
  – Required business negotiations?
  – Timing from start to conclusion? (Almost always takes longer than you think it will)
  – Reasoned determination or simple issuance of final binding calculation?
Purchase Price Adjustment Disputes – Positioning for Best Possible Litigation Outcome

• 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

• Consider interest on final adjustment amounts
  – Calculation rate, timing, disputed vs. “undisputed” amounts
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Earn-Outs

- Often used to:
  - Bridge valuation gap (especially during uncertain times)
  - 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
  - Indemnification offset

- Benefits for Seller
  - Leverage post-closing synergies and opportunities to increase ultimate purchase price
Earn-Out Examples

• Earn-Out Targets
  – Financial Targets - Revenue, Net Income, EBITDA, etc.
  – Non-Financial Targets – development of products, store openings, increase in customers, contracts, etc.

• Earn-Out Period
  – Typically, one to three years but depends on target
    – Shorter periods preferred – less restraints on business and less exposure to credit risk of buyer
Earn-Out Provisions

• Earn-outs are frequently the source of litigation – a punt on valuation disputes to be fought at a later time

• 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?
  – Highly dependent on facts and circumstances, and even intent

• Earn-out covenants are drafted against this legal backdrop

• Negotiating terms can be difficult and contentious
Earn-Out Provisions – 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 and dispute
  – Address delays

• For Buyer
  – Business operation discretion/autonomy
  – Express disclaimer of fiduciary duty to Seller; Buyer controls business
  – 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 at drafting and through performance of the earn-out
  - Fundamentally, the earn-out exists because of disagreement – that will only get worse, not better post-closing

- Alternative dispute resolution
  - Same considerations as with purchase price adjustment 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)
Key Takeaways from This Session

• When drafting purchase price adjustments, specificity in how the calculation should work and consistency in the treatment of items included/excluded from the calculation are 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 earn-out 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 earn-out period.
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Allison focuses her practice on advising private equity sponsors and their portfolio companies, Fortune 500 companies and emerging market companies on mergers & acquisitions, asset purchases, dispositions and private equity investments. Allison has substantive experience in both domestic and cross-border transactions. She also advises clients on general corporate and compliance matters. Allison represents both strategic and private equity clients primarily in the retail, healthcare, life sciences, fintech and financial services industries.
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