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

**Allison Gargano and Elisa McEnroe**

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# Overview of Presentation

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

# TEV to Net Cash Proceeds

<b>Cash Flow (EBITDA)</b>	<b>\$</b>	<b>10,000</b>	
<b>Multiple</b>		<b>10</b>	<b>X</b>
<b>= Purchase Price (TEV)</b>	<b>\$</b>	<b>100,000</b>	
<b>Less Debt</b>		<b>(20,000)</b>	
<b>Plus Cash</b>		<b>5,000</b>	
<b>= Equity Value (EV)</b>	<b>\$</b>	<b>85,000</b>	
<b>+/- Purchase Price Adjustment</b>		<b>?</b>	
<b>Less:</b>			
<b>Expenses</b>		<b>?</b>	
<b>Non-Cash Consideration</b>		<b>?</b>	
<b>Escrows</b>		<b>?</b>	
<b>Taxes</b>		<b>?</b>	
<b>Rollover Equity</b>		<b>?</b>	
<b>= Net Cash Proceeds</b>		<b>TBD!</b>	

# Examples of Purchase Price Adjustments

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

# Purchase Price Adjustment Logistics

- Negotiations of accounting principals
- Statement preparation/ability of Buyer to comment
- One stage or two-stage adjustment
- One-way or two-way adjustment
- Timing of adjustment calculation
- Payment Terms
- Source of funds
- 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?)
- Consistency is key
- Specification / specialization is key
- Think about how different adjustment structures might lead to manipulation
- Think about the practical ramifications of your dispute resolution mechanism

# 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, especially in a recession/down economy
- 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

# Earn-Outs / Milestones

- 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 / Milestone 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 may be preferred – less restraints on business and less exposure to credit risk of buyer; helps bring resolution sooner

# Earn-Out / Milestone Provisions

- These 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
- Earn-out / milestone covenants are drafted against this legal backdrop
- Negotiating terms can be difficult and contentious

# Earn-Out / Milestone Provisions – Drafting Tips

- For Seller
  - Expressly address earn-out metrics, including for partial year periods
  - Delineate Buyer’s obligation to maximize value
  - Partial satisfaction vs. “all or nothing”
  - Information and dispute
  - Address delays
- For Buyer
  - Business operation discretion/autonomy
  - Express disclaimer of fiduciary duty to Seller
  - Ability to offset indemnity claims against any earn-out/milestone
  - Caps on maximum earn-out/milestone payments
  - Reporting frequency/detail/supporting documentation

# Earn-Outs / Milestones – Positioning for Best Possible Litigated Outcome

- Plan on litigation at drafting and through performance
  - Fundamentally, post-closing mechanism 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/milestone
  - 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 of 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.



# Biography



**Allison D. Gargano**

New York, NY

T +1.212.309.6948

E allison.gargano  
@morganlewis.com

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.

# Biography



**Elisa P. McEnroe**

Philadelphia, PA

T +1.215.963.5917

E elisa.mcenroe  
@morganlewis.com

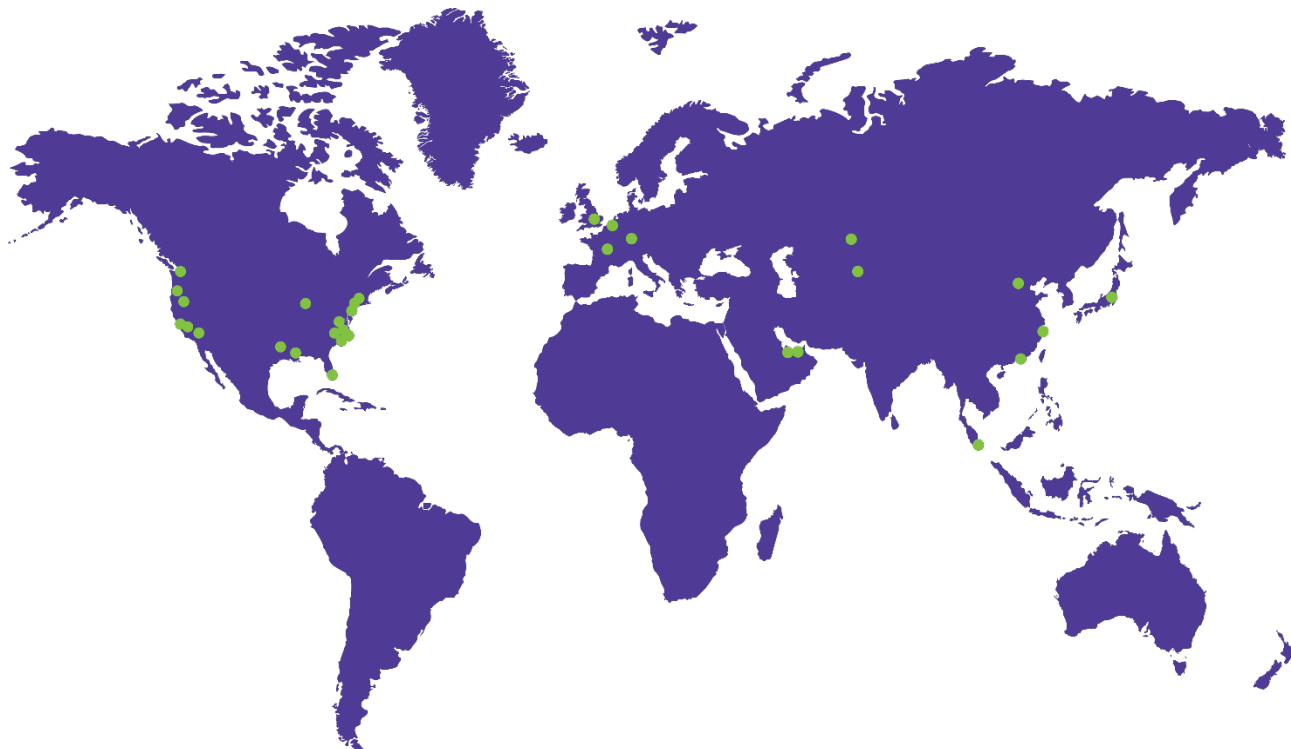
Elisa is a trial lawyer who handles business disputes, primarily commercial contract cases and indemnification issues arising from matters involving business competition, fraud, and mergers and acquisitions in both US federal and state courts, as well as alternative dispute resolution proceedings. Elisa has experience with all phases of the litigation process, from pre-complaint investigations through trial and appeals, and has tried and won both jury and bench trials. She also works closely with both large and small clients to develop and implement risk management strategies and to optimize clients' business needs while navigating a dispute. Elisa is the deputy leader of the firm's litigation practice in Philadelphia.

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