Earnouts in Private M&A: Negotiation, Drafting and Strategy

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Part 1: Overview

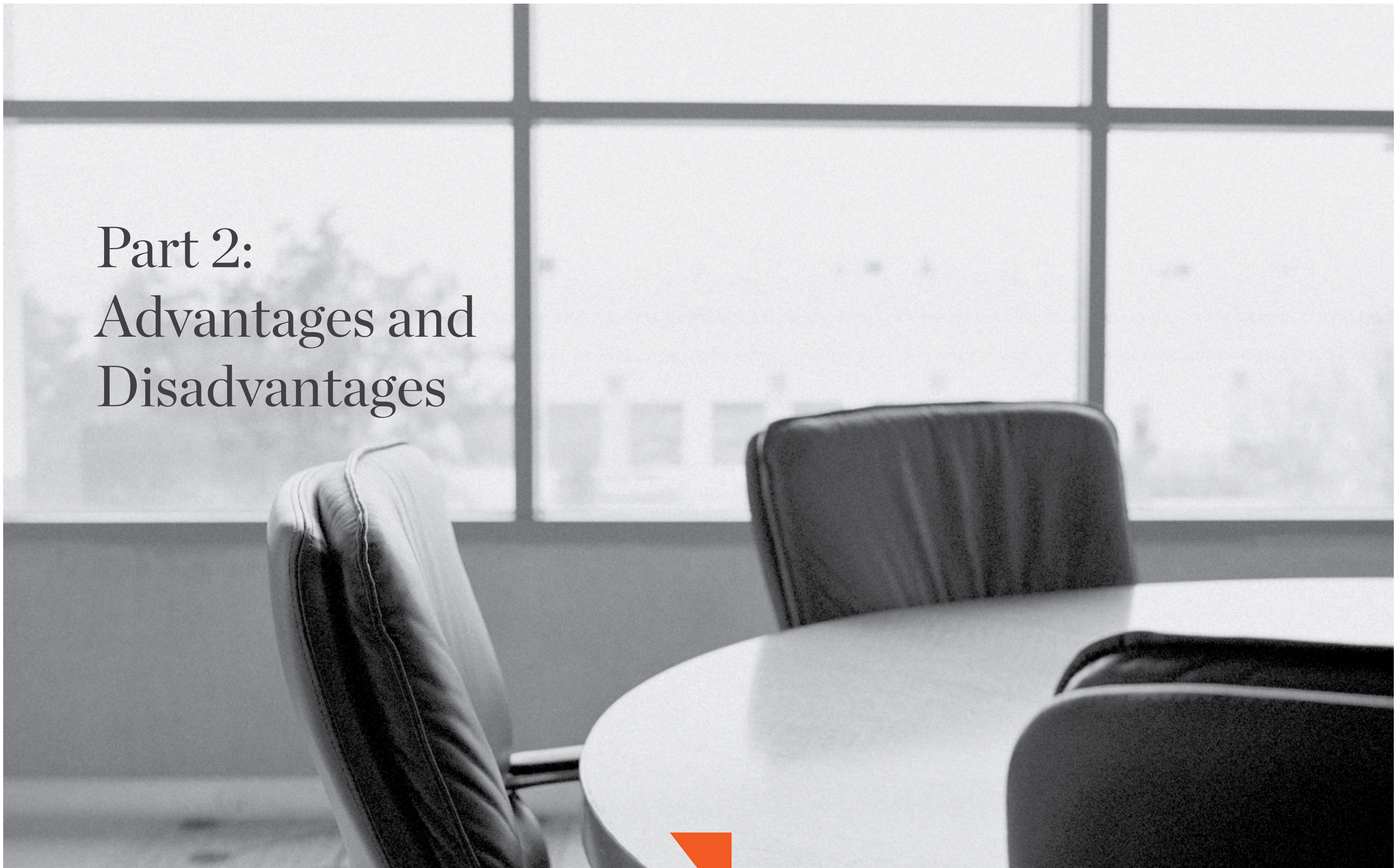
An earnout is a contractual provision used in private M&A transactions that makes part of the purchase price contingent in some respect on the post-closing performance of the target business being sold.

The use and structure of an earnout is inherently deal-specific. Earnouts are by nature bespoke and tend to be highly negotiated. Earnouts may also be more susceptible to post-closing dispute than some other private M&A deal terms. The result is that careful and informed earnout negotiation and drafting is critical to achieving the parties' objectives and fairly reflecting how the value of the target business is determined.

To assist, we have reviewed the most instructive earnout caselaw and commentary from the last two decades to prepare this concise but comprehensive practical guide to earnout structuring, negotiation and strategy. While earnouts have attracted increased attention – and more frequent use – in recent years, they are a well-established deal mechanism that will remain common in private M&A going forward, even as market conditions continue to evolve.

To discuss earnouts further, contact any of this guide's authors or any other member of Fasken's M&A or Private Equity groups. For Fasken's other M&A and Private Equity thought leadership, visit our Capital Markets and M&A Knowledge Centre.

A carefully constructed earnout can be a win for both the buyer and seller.



Part 2: Advantages and Disadvantages

Why Are Earnouts Used?

The most common reason that M&A parties use an earnout is to resolve or "bridge" some level of disagreement between the buyer and seller as to the value of the target – known as a "valuation gap". Explanations for a valuation gap can include that the target business:

- Is in an early development stage with limited operating history, but has significant growth potential
- Plans to introduce a new product or technology, or enter a new market, that may significantly increase profitability or value
- Will gain access to buyer technology, intellectual property or other resources that may significantly increase profitability or value
- Operates in a volatile industry that can adversely affect the target's profitability or cause its value to fluctuate widely
- Has recently experienced material growth in revenue or earning and there is risk these gains are not sustainable
- Is subject to some significant risk to its business such as uncertain regulatory approvals, customer commitments, pending or threatened litigation or other factors that can be challenging to quantify
- Has recently experienced a drop in earnings, or is in financial distress, but there is reason to expect a turnaround

While a common reason M&A parties use an earnout is to bridge a valuation gap, the valuation gap can arise from various different factors.

Apart from a valuation gap, another reason that M&A parties may use an earnout is that the buyer seeks to retain and incentivize key personnel (e.g., a founder) who are deemed critical to the target's future success. Where such sellers agree to remain as employees of the business, an earnout gives them an increased financial stake in the ongoing performance of the target business.

Finally, a buyer may also use an earnout where it is cash-constrained and seeks to reduce the amount of the purchase price payable on the closing date (in which case the earnout doubles as a financing vehicle). However, from a tax perspective the use of an earnout should still be justified in principle. If that justification is absent, a straight balance of sale may be more efficient.

What Advantages and Disadvantages Do Earnouts Have?

When considering an earnout, M&A parties should weigh the different "pros and cons" earnouts present both generally and from their particular perspective as buyer or seller.

Advantages and Disadvantages Generally	
Advantages	Disadvantages
The target may be valued more accurately, i.e. given the earnout is based on actual performance in some future period rather than projected future performance.	Earnouts can be challenging to negotiate and draft, including as they relate to future and uncertain circumstances, particularly for longer earnout periods.
Risk may be apportioned more fairly, i.e., given the potential risks and rewards of future performance are shared by buyer and seller (rather than borne exclusively by one or the other).	The complexity presented by earnouts can impose additional costs as most earnouts are often bespoke in nature and typically require additional input of finance, accounting and legal experts.

Advantages and Disadvantages from the BUYER's Perspective	
Advantages	Disadvantages
The buyer is protected against overpaying, as the earnout provides for valuation to be adjusted based on actual post-closing performance.	Earnouts require additional post-closing monitoring of the target's performance, imposing time and cost burdens.
The buyer's lower up-front purchase price can (1) facilitate financing, e.g., by reducing reliance on third party financing, and (2) facilitate making higher bids in an auction context.[1]	Should the buyer desire a clean break from the seller, an earnout complicates this by giving rise to a post-closing interest of the seller in the target, e.g., an earnout often involves some degree of seller access to information rights.
Deferral of part of the purchase price (1) can effectively amount to an interest-free loan during the earnout period, and (2) can allow the buyer to use the revenues of the target business to pay part of the purchase price.	The buyer's post-closing earnout obligations can impede or complicate the buyer's future business plans, e.g., by complicating full integration of the target with the buyer's other businesses.
Where key sellers (e.g. founders) are retained post-closing, an earnout can be a significant incentive to maximize the performance of the target going forward.	The buyer's compliance with its earnout undertakings could require prioritizing short-term performance to the disadvantage of long-term considerations.
Earnouts payable to sellers can be set off against buyer indemnification claims.	A prospective acquirer of or lender to the buyer could view outstanding earnout obligations as a drag on the buyer's value.

Advantages and Disadvantages from the SELLER's Perspective	
Advantages	Disadvantages
The seller can negotiate for a higher cumulative purchase price than the buyer was willing to pay in the absence of the earnout.	The seller will not receive all purchase consideration on closing and may ultimately receive no additional consideration should the target underperform post-closing.[2]
Where key sellers (e.g. founders) are retained post-closing, they may have greater influence over the future operation of the target business and thereby perhaps a greater likelihood the earnout triggers are met.	Due to unexpected developments, the earnout triggers agreed at execution may not prove a relevant metric later on.
The seller may benefit from synergies achieved by integrating the target with the buyer's business where such integration has a positive impact on the target and the pursuit of the earnout triggers.	Should the sellers desire a clean break from the buyer, the earnout will require the continued dedication of seller resources post-closing, e.g., to monitor the target's performance and exercise information rights.[3]
If structured properly, the seller is usually able to defer taxation of the earnout payments while preserving capital gains tax treatment for such payments.	If not properly structured, earnout payments may be taxed as ordinary income from property rather than as capital gains. When paid to a non-resident of Canada, additional issues could arise.

1 This benefit may be particularly attractive to private equity buyers when debt financing is constrained.
2 This risk may be particularly unattractive for private equity sellers.
3 For this reason, it may not be a feasible option for sellers such as private equity firms in an exit scenario.

Part 3: Structuring Earnouts – Essential Terms

There are several essential terms required for an earnout to function effectively from a mechanics perspective.[4] These terms are typically included within the definitive purchase agreement but on occasion may be set out in a separate ancillary transaction agreement. These essential terms are listed below and explored in further detail in the rest of this Part 3. These should be carefully thought through and negotiated to fit the target business and each party's expectations.

Earnout Triggers. Earnout triggers can be based on either financial or non-financial metrics (i.e., thresholds or milestones), or a combination of both. Earnouts are often based on the performance of the target as a whole, but can also be based on the performance of a specific target division or product or service.

Earnout Payments. Payment amounts can be either flat or formula-based or a combination of both.5 Flat payments are common in connection with a milestone-based trigger. Formula-based payments are common in connection with a financial-based trigger. Examples of formulas include a multiple (e.g., where the payment is a multiple of the amount by which the target exceeds the earnout trigger), and a percentage, (e.g., where the payment is a percentage of the amount by which the target exceeds the earnout trigger).

The use of a formula in an earnout calculation will be primarily driven by how the parties value the target (e.g., an EBITDA multiple).

4 For other key (but non-essential) earnout terms see Part 4: Structuring Earnouts – Other Key Terms.

5 If the buyer is a public company and payments are to be made in buyer shares, various securities law issues will need to be addressed.

Earnout Periods. The appropriate length of the earnout period or periods partly depends on the nature of the earnout triggers and the amount of time reasonably anticipated to achieve them. Short earnout periods (one year or less) typically involve a single potential payment. Multi-year periods typically involve multiple potential payments at specified intervals. Earnout periods are typically not longer than three years except in certain sectors such as the pharmaceutical industry.

Buyer Obligations. Earnouts typically include buyer covenants applicable during the earnout period. Among the most critical of these are those clauses addressing how – and to what extent – the buyer is obligated to take certain actions (e.g. make available capital and personnel) or refrain from taking certain actions (e.g. reduce budgets, reassign or terminate personnel) in pursuit of the earnout triggers.

Reverse Earnouts

In a reverse earnout the buyer issues a promissory note to the seller at closing for the maximum amount that could be paid under the earnout. As such, the consideration paid at closing includes the entirety of the potential earnout payment in the form of the promissory note and on the assumption all earnout triggers will be hit and all possible earnout payments will be maximized.

Afterwards:

- If the earnout trigger(s) are met such that an earnout payment is due, then payment is made under the promissory note
- If one or more earnout triggers are not met, then the corresponding unpaid balance of the promissory note is forgiven, and the seller may seek to claim a capital loss on the promissory note

Reverse earnouts generally tend to be attractive to sellers if (A) there is a risk that payments under conventional earnouts would be taxed as ordinary income from property, and (B) the earnout period does not exceed three years. Payments under a reverse earnout also usually secure capital gains tax treatment (at the cost of pre-paying tax on the maximum potential earnout payment).[6]

Reverse earnouts employ conditional promissory notes for the maximum potential earnout payout and can be more attractive to sellers than a conventional earnout for tax reasons.

Earnout Triggers – Financial Metrics

Where financial metrics are used the parties should agree on the appropriate accounting principles and their application. It is generally insufficient to merely specify GAAP (generally accepted accounting principles). First, GAAP permits a wide range of accounting policies and practices that often differ between businesses, even within the same sector. Second, GAAP includes both IFRS (international financial reporting standards) and ASPE (accounting standards for private enterprises) and there may be conflicting principles within either IFRS or ASPE. Third, GAAP may not be represented in the historical financials of the business. Fourth, a business may choose to apply GAAP differently from year to year.

Common financial metrics include (1) revenue, (2) net income, (3) EBITDA, (4) earnings per share, and (5) net equity.

6 For further discussion, see Part 9: Tax Considerations.

The parties should attempt to be as specific as possible regarding the intended treatment of matters material to the earnout calculations, e.g., by identifying and agreeing upon line items that will be a supplement (or an exception) to GAAP as well as any applicable assumptions. Potential examples for express treatment include:

- Costs arising from the buyer's acquisition of the target
- Accounting for buyer post-closing acquisitions or divestitures impacting the target
- Accounting for the buyer's integration of the target with its other business operations
- The appropriate allocation of costs shared by the target with the buyer's other businesses

The Seller should generally seek to ensure, so far as possible, the earnout calculation provides an "apples to apples" comparison between the target's pre-closing and post-closing performance. The earnout can therefore require the application of accounting principles and the preparation of financial statements consistent with the target's past practice. If the buyer disagrees with this approach and seeks to impose different accounting practices, these should be addressed in reasonable detail.

A well-crafted earnout will often include a schedule setting out detailed line items, how each is calculated, and sample calculations. To the extent possible, the parties will want to avoid ambiguity as to the manner in which the financial metrics are determined. In many cases, this will require collaboration among legal counsel, accountants, tax and financial advisors involved in the transaction representing each party.

Sellers and buyers typically have different preferences regarding potential financial triggers, with buyers preferring net income triggers and sellers preferring revenue-based triggers. The key difference is that the former accounts for costs while the latter does not.

Earnout Triggers – Non-Financial Metrics or Milestones

Depending on the target business, milestones may be more suitable for earnout triggers than financial metrics. Milestones typically involve the occurrence of a specific event that significantly affects profitability or value, such as:

- Attaining a minimum level of new customers or sales
- Obtaining a key regulatory approval
- The commercial launch of a new product or service
- Certain key personnel remaining with the target business in some capacity for a set period of time post closing

Non-financial milestones are often easier to negotiate than financial metrics because (1) they are simpler to draft, (2) achieving them is generally in the common interest of both parties, (3) their satisfaction is more objectively verifiable and thus less subject to dispute or manipulation, (4) the target may have limited historical financial performance, and/or (5) it may be challenging to integrate the financial reporting of the target business into that of the buyer. That said, getting to agreement on specific milestones can be complicated too (e.g. where a milestone payment is dependent on obtaining a patent or series of patents, but only some of the patent claims may ultimately be granted).

Milestones can be easier to negotiate than financial triggers, but may not be appropriate depending on the target's business or how the parties value the target.

In our experience milestones are used considerably less frequently than financial metrics and are more common in certain sectors, such as the pharmaceutical industry.

Buyer Obligations

As mentioned, earnouts typically address how – and to what extent – the buyer is obligated to take certain actions or refrain from taking certain actions in pursuit of the earnout triggers. These clauses can vary widely in substance – ranging from buyer-friendly to seller-friendly to middle ground approaches – and are often fiercely negotiated.

They are therefore difficult to categorize, but can be broadly defined as consisting of two main parts. First, the efforts undertaking of the buyer, if any. Second, more particularized components, including various positive and negative covenants.

A material disagreement among sophisticated parties over the target's post-closing business strategy does not necessarily indicate that the buyer has breached its earnout obligations.

Efforts Undertakings in Canada

Efforts undertakings in Canada benefit from a relatively clear hierarchy among three commonly used formulations.[7] These are:

- **Best Efforts**: is a demanding standard that requires all reasonable steps to achieve the objective being pursued, carrying the process to its logical conclusion, and leaving no stone unturned.
- **Reasonable Efforts**: is a lower standard than "best efforts" and requires a prudent and moderate measure of sustained diligence working toward the objective being pursued.[8]
- **Reasonable Commercial Efforts**: is also a lower standard than "best efforts" and imposes a cost/benefit analysis whereby the obligated party need not push past the point where continued expense, given the objective being pursued, would not make commercial sense.

Canadian courts will generally seek to give effect to a hybrid efforts formulation, e.g., "commercially reasonable best efforts". However, caution is prudent here as the resulting efforts standard may be difficult to predict.

The parties should choose carefully among the different efforts standards available for application to an earnout and try to avoid hybrid formulations.

Example Buyer Obligation Formulations

Where an efforts standard is applied, it will often be incorporated into a broader clause outlining the buyer's obligations (or lack thereof) regarding the earnout. To illustrate, we provide example buyer-friendly, seller-friendly, and middle ground formulations:

- **Example Buyer-Friendly Formulation**: The buyer has (1) sole discretion to operate the target post-closing, (2) no express or implied duty to pursue the achievement of any earnout triggers or the maximization of any earnout payments, and (3) no duty to dedicate any particular resources to the pursuit of any earnout triggers.
- **Example Seller-Friendly Formulation**: The buyer shall (1) use reasonable commercial efforts to operate the target to pursue all earnout triggers, and (2) ensure the target has and maintains all resources, whether financial, technical, human or otherwise, reasonably necessary to pursue all earnout triggers and the maximization of all earnout payments.

7 For a comparison with Delaware, see Part 7: Key Differences Between Canada and Delaware.

8 The term "reasonable efforts" is the subject of significantly less caselaw than the "best efforts" and "reasonable commercial efforts" standards. However, it is generally understood that "reasonable efforts" lies somewhere between "best efforts" and "reasonable commercial efforts".

- **Example Middle Ground Formulation**: The buyer shall (1) in good faith pursue all earnout triggers and the maximization of all earnout payments, and (2) not take any action in bad faith or with the intention of undermining the pursuit of any earnout triggers or the maximization of any earnout payments.[9]

Numerous courts have rejected the notion that duties of good faith necessarily require the buyer to operate the target so as to ensure or maximize potential earnout payments.

Additional Buyer Obligations Formulations

Because of the inherent flexibility of earnouts, numerous additional approaches to the buyer's obligations are available. Examples include that the buyer shall:

- Operate the target in the ordinary course and consistent with the target's past practice[10]
- Give the development and promotion of the target's business the same priority as the buyer's other businesses
- Operate the target as would a reasonable, similarly-situated company with similar resources and similar growth potential

Positive Covenants. Another possible approach is for the buyer to make certain specific positive undertakings. These could include an obligation to (1) make a specified amount of advertising and marketing expenditures, (2) ensure a minimum amount of target working capital, (3) provide the sellers one or more seats on the target's board, (4) operate the target in accordance with an agreed budget and business plan, and (5) provide certain timely reporting of financial and other metrics.

Negative Covenants. Similarly, the sellers may seek to have the buyer covenant not to take certain specified actions without the prior consent of the sellers, for practical purposes typically exercised through a single seller representative.[11] Examples include (1) the hiring or firing of key target personnel, (2) the implementing of any related-party transactions, (3) divesting of select target capital assets, (4) incurring additional target debt, and (5) delaying or failing to make budgeted capital investments.

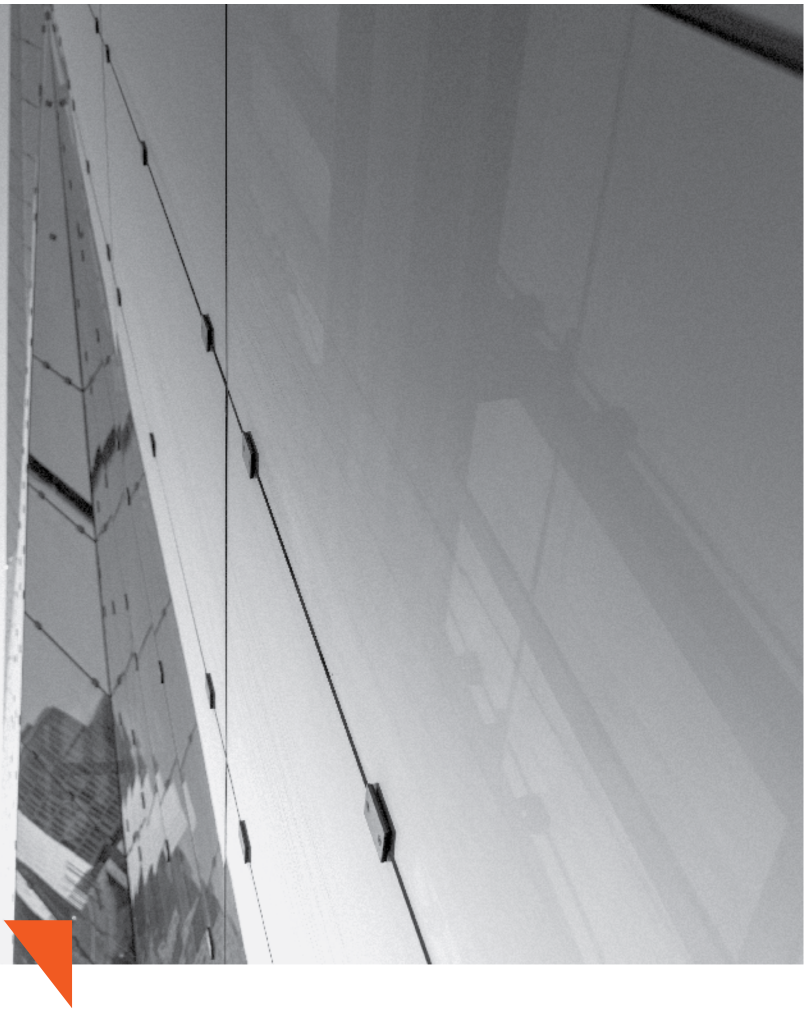
The buyer's obligations regarding the earnout can be highly customized based on the target's business and the buyer's plans.

9 A common alternative formulation here is that the buyer shall not take any action "a primary purpose of which" or "the primary purpose of which" is to undermine the earnout.

10 A buyer will likely be more open to a "consistent with past practice" obligation where the target's management team is to remain with the target post-closing.

11 A common related negotiation point is whether the prior consent of the sellers is at the seller's sole discretion or cannot be unreasonably withheld.

Part 4: Structuring Earnouts – Other Key Terms



In addition to essential terms, an earnout can include a variety of other financial and legal terms.

Structuring Earnouts – Other Key Financial Terms

Caps. Where an earnout payment is formula-based, the buyer will often seek a cap on the earnout payment even if the targets are exceeded. A cap can limit the earnout payment only for a particular period with the cap resetting after each period, or the cap can limit the total amount of earnout payment across the total earnout period.

Floors. A floor can apply to each individual earnout period or to the total amount of potential earnout payments across the total earnout period. A floor may also specify that there is no maximum cap on the earnout payment, e.g. in the case of a multiple.

Where financial metrics are used, including caps and floors has the benefit of narrowing the range of potential calculation discrepancies that can give rise to subsequent disputes.

Carry-Forwards. Where multiple potential earnout payments apply to multiple earnout periods and a cap limits the amount of the payment for the applicable period, a carry-forward rolls any excess amount that went unpaid due to the cap to subsequent earnout periods. Sellers pursue these for facilitating the maximization of earnout payments over the total earnout period. Buyers may resist these as they can result in larger payouts even when the target business may not be performing well.[12]

12 Alternatively, buyers may find carry-forwards appealing as a way to keep sellers retained post-closing motivated if a target business is under performing in the early part of an earnout period but the target business still shows promise into the future.

Carry-Backs. Essentially the opposite of a carry-forward, a carry-back applies any shortfall in achieving an earnout trigger to earlier earnout periods. Buyers pursue these as they help to minimize earnout payments over the total earnout period. Sellers resist these as they can result in the seller having to refund all or part of an earlier earnout payment.

Structuring Earnouts – Other Key Legal Terms

Information Rights. Sellers often negotiate for reasonable access to the books and records of the target post-closing. Seller information rights can include (1) periodic performance reports prepared on a consistent basis, (2) the right to request additional reasonable supporting information (e.g., interim financial statements and sales reports), (3) the right to information meetings with buyer representatives, and (4) in some cases, periodic formal audit rights. The buyer may also be required to maintain separate books and records for the target business.

Acceleration. An acceleration clause requires the immediate or accelerated payout of outstanding earnout obligations upon one or more specified events. These protect the seller from events that can adversely impact the likelihood that the target will meet the earnout triggers, or the ability of the buyer to make earnout payments once due. Examples of acceleration triggers include (1) a change in control of the buyer, (2) the sale of the target (or a substantial part of it), (3) a material breach by the buyer of its earnout obligations (e.g., a positive or negative covenant), (4) the termination without cause of a key seller (e.g. the founder) who stayed with the target post-closing, (5) a default by the target or the buyer under its credit facilities or other material contracts, and (6) the insolvency or bankruptcy of the target or the buyer.

Buyout. A buyout option entitles the buyer to pay a set amount, prior to the end of the earnout period, in order to satisfy its outstanding earnout obligations. This can be priced at the net present value of the remaining earnout payments, and can factor in the probability of the remaining earnout payments becoming due. It can also include a discount based on the earlier receipt of funds by the seller. A buyout benefits a buyer who may want to (1) sell the target before the expiration of the earnout period, or (2) make changes to the target business which are incompatible with the buyer's earnout obligations (e.g. restrictive covenants).

An acceleration clause can trigger the immediate payout of the outstanding earnout payments upon certain events. A buyout option entitles the buyer to pay a set amount to satisfy the outstanding earnout payments.

Security for Payment. As an earnout exposes the seller to the buyer's credit risk, the seller can negotiate for some sort of security that payments will be made.[13] Examples include: (1) a guarantee from the parent or other affiliate of the buyer, (2) a security interest in the assets or shares of the target during the earnout period, and (3) for some or all of the potential earnout payments to be put into escrow (e.g., for release to the seller or buyer, as applicable, at the end of each earnout period).[14] Applicable time periods can be tolled in the event of a formal earnout dispute under the purchase agreement.

Loss of Earnout. The buyer can negotiate for specified instances where the seller loses its right to outstanding earnout payments. Triggers can include (1) if the buyer terminates a key target employee for cause, (2) a key target employee resigns prior to the end of the earnout period, and (3) a breach by a seller of a non-complete or other restrictive covenant post-closing.

13 Buyers should be mindful that some security measures can limit its freedom to raise capital or otherwise operate its business.

14 The parties should discuss (1) any potential restrictions (i.e. negative covenants) on the buyer's ability to make the earnout payments imposed by the buyer's debt instruments, and (2) whether the earnout payments will be subordinated to the rights of the buyer's lenders.

No Fiduciary Duties. The buyer may negotiate for a clause expressly disclaiming any fiduciary duties owed by the buyer to the seller regarding the earnout. This may occur specifically in relation to the earnout or in a broader provision relating to the relationship of the parties.

Courts have been reluctant to impose fiduciary duties on the buyer in favour of the seller in connection with an earnout, instead instructing that sellers should rely on their contractual rights.

Set-Off Rights. Set-off rights expressly permit the buyer to reduce its earnout payments by the amount of any claim by the buyer against the sellers under the acquisition agreement, e.g., an indemnity claim for breached seller representations and warranties. A disadvantage of set-off rights is that the intertwining of an earnout dispute with another dispute may make it more difficult to resolve any one of the disputes individually. Set-off rights may also incentivize a buyer to make borderline indemnity claims.

Part 5: Dispute Resolution Clauses and Mechanics

M&A agreements can provide for the resolution of earnout disputes in one of two ways. First, and as is almost always the case, any earnout dispute (or a subset of earnout disputes, e.g., accounting disputes) can be subject to a bespoke dispute resolution mechanism. A common way this is done is by crafting a dispute resolution procedure for any earnout dispute that is akin to the post-closing purchase price adjustment for closing working capital. Second, and much less often, any earnout dispute can simply be left for the purchase agreement's general dispute resolution clause, e.g., attornment to the courts of a specified jurisdiction or arbitration under agreed arbitration rules.

In either case, the parties typically first specify a procedure for the preparation and sharing of earnout results, and once again this procedure is often similar to the procedure for resolving post-closing working capital adjustments. For example, where the earnout trigger is based on a financial metric, the parties may agree that (1) the buyer prepares the associated financial statements and calculates the amount of the earnout payment, if any, within a specified number of days following the end of the applicable earnout period, and (2) seller has a specified number of days to review the buyer's materials and either accept the buyer's determination or submit a notice of dispute. The parties may also go into additional detail. This many include (A) granting the seller additional information rights, and (B) limiting the grounds upon which the seller can contest the buyer's position to factual, numerical or calculation mistakes or inconsistencies with an example earnout statement included in the purchase agreement. Where the earnout trigger is based on a milestone, the procedure may be less complex as the buyer may only need to prepare documentation evidencing that the milestone either has or has not been met.

The parties will typically subject any earnout dispute over financial metrics or calculations to an independent third party expert (e.g., an accountant) in a manner similar to the procedure for resolving post-closing working capital adjustments.

Where the parties agree to a tailored dispute resolution mechanism (e.g., in connection with an earnout trigger based on a financial metric), the most common approach is submission of the dispute to an independent third-party expert, typically an accountant. Issues that can be addressed in an expert dispute resolution clause include:

- How the expert is selected and the expert's expertise
- The types of disputes that the expert has the authority to resolve
- That the expert is being appointed as an expert and not as an arbitrator
- The procedure for the parties' submissions and any limitations on those submissions
- Whether the expert can consider issues beyond those identified or contested by the parties
- Whether the expert can perform a *de novo* calculation to reach their own result or must agree with either the submissions of the buyer or of the seller
- Whether the expert's decision will be final and binding or whether the parties are entitled to appeal the expert's conclusions
- The allocation of the expert's costs (e.g. shared equally or entirely for the account of the party whose position most differed from the expert's decision)

Whether the third party is appointed as an expert or arbitrator can have important consequences depending on the governing law. For example, an arbitrator's authority may be analogous to a court's and include the authority to interpret contracts, determine liability, and award damages. Appointment of the third party as an arbitrator may also automatically attract the governing law's rules regarding the parties' rights of appeal, which are typically relatively limited under arbitration legislation.

Lastly, the parties should be mindful of the express scope of authority of the third party under the dispute resolution mechanism. As discussed elsewhere,[15] several earnout disputes have involved disagreement as to whether the third party has the authority, or has exceeded their authority, to resolve a dispute, such as by considering allegations of buyer misconduct related to the earnout in connection with deciding the correct earnout calculation. The third party's authority should be set out precisely (e.g. the purchase agreement should state whether the third party has the authority to resolve "all disputes" related to the earn out, including matters of contractual interpretation, or only disputes related to "calculations" and/or the proper application of the relevant accounting standards and principles). Disputes that are outside the third party's authority will be determined in accordance with the purchase agreement's general dispute resolution clause.

15 See Part 6: Learning From Past Earnout Disputes.

Part 6: Learning from Past Earnout Disputes

Evidence suggests earnouts may give rise to post-closing disputes more frequently than some other common private M&A terms. This observation is supported by a series of earnout rulings issued by Delaware courts since early 2024. Delaware courts have also at times taken a cynical stance towards earnouts, cautioning they can prove to be only a "dispute delayed".[16]

Our review of more than 50 earnout rulings issued over the last 20 years suggests that many earnout disputes fall within three categories:

- Whether the buyer erred in its earnout calculations or in deciding that an earnout trigger had not been met
- Whether the buyer complied with its earnout obligations, including whether the buyer acted in good faith and/or satisfied its associated efforts undertakings
- Whether a third party expert (e.g. an accountant) made an error or exceeded their authority[17]

Earnout disputes exemplify the importance of clear and purposeful drafting in M&A. They also warn of the dangers of ambiguity and inconsistency.

Overall, earnout disputes highlight (1) the complexity of drafting for future events, (2) the value of careful and considered clauses over drafting of a lesser standard, and (3) that the choices made in crafting earnouts can materially impact the likelihood of a dispute and/or the complexity of the dispute should potential litigation arise. To assist, we've summarized an illustrative array of examples.

16 See *Airborne Health v. Squid Soap*, 984 A.2d 126 (Del. Ch. 2009): "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 inherently debateable and the cause of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome."

17 Note that such issues are not necessarily specific to earnout disputes but to "expert determination" clauses generally.

Earnout Calculations and Milestones

Examples of rulings arising from earnout calculation and milestone disputes include:

- While the buyer's EBITDA calculations complied with GAAP, certain adjustments conflicted with (and thus were in breach of) the parties' accounting specifications in the purchase agreement.
- The buyer incorrectly treated target employee bonuses tied to the acquisition as an operating expense rather than as one time, non-recurring expenses, as they did not reasonably represent future similar costs.
- The approval of a drug treatment only for a specific subset of leukemia patients, rather than approval as a wider treatment for leukemia, did not meet the applicable milestone.
- An amendment to an existing client contract, even with material new terms, did not satisfy a milestone requiring a "new" contract with the client on the basis an amended contract continues to exist while a new contract isn't contingent on an existing one.
- In deciding whether a new and lucrative client contract should be counted toward the earnout, the court relied heavily on the fact the buyer had previously included similar (although lower value) contracts toward the earnout.

Guidance from the courts: notwithstanding a post-closing change of circumstances that creates a disconnect between an earnout milestone and the new business reality, the earnout will continue to apply as drafted.

Good Faith, Intent and Primary Purpose

Examples arising from earnout disputes alleging a lack of good faith or improper purpose include:

- Buyer conduct which the courts have held may be indicative of bad faith (or an absence of good faith) includes (1) redirecting clients, revenue and resources from the target to other buyer companies, (2) shifting costs from one of the buyer's other businesses to the target or shifting future target costs into the earnout period, (3) failing to allocate sufficient resources to the target or expend sufficient funds toward the development of the target products, (4) prioritizing target products that do not contribute to the earnout or substituting other buyer products for target products, and (5) entering into a joint venture with a competitor of the target.
- It is not uncommon for a buyer to agree not to take any action with the "intent" or the "primary purpose" of decreasing or avoiding the earnout payments. Regarding the former, the courts have held that the seller bears the burden of establishing the buyer's actions were specifically motivated by a desire to frustrate the earnout. Regarding the latter, the courts have characterized this as a "buyer-friendly standard" that permits the buyer to act in ways intended to defeat the earnout so long as defeating the earnout was not the primary purpose. These disputes have also underscored the challenges a seller can face in presenting evidence of buyer intent.

Guidance from the courts: a decision by directors to prioritize the target's long-term value over short-term profits may not be indicative of bad faith or an intent to undermine an earnout, including in light of the directors' duty of loyalty to the company.

Bespoke Buyer Obligations

Examples of rulings arising from bespoke buyer obligations include:

- In some cases earnouts have required the buyer to conduct business as would a reasonable company of a "similar size" with "similar revenues" pursuing a "similar objective". This has been called the standard of a hypothetical and objective similarly-situated company. Such cases have demonstrated the challenges a seller may face in establishing how such a hypothetical company would have acted. This standard has also led to buyer breaches for conduct the court deemed overly "idiosyncratic", i.e., motivated by special buyer goals not shared by the buyer's competitors or peers (e.g. the pursuit of merger synergies after the target and buyer were later acquired by another purchaser).
- An earnout required the buyer to use the commercially reasonable efforts of a company with substantially the same resources and expertise as the buyer, with due regard for the costs of pursuing the relevant objective. However, the buyer was also given complete discretion over the target's development activities. The court held the result of these somewhat conflicting guidelines was a hybrid objective/subjective standard whereby the buyer could conduct a reasonable cost/benefit analysis amid the buyer's particular circumstances. This standard was not breached by the buyer abandoning further development of a pharmaceutical drug after it was approved for half of its intended treatment but three successive proposals for the other half of its intended treatment were rejected by regulators.
- Other earnout standards have been set by reference to the buyer's other operations. One example involved the buyer agreeing to dedicate the same level of resources to the target product as the buyer typically devotes to products of similar market potential at a similar stage of development. In another example the buyer agreed to dedicate the same level of efforts to the development of the target product that the buyer gives to its highest priority products. In the former case, the court faulted the buyer for notable delays both in submitting its initial request for regulatory approval as well as in its reapplication for regulatory approval. In the latter case, the court faulted the buyer for causing the target first to compete internally with, and later combine with, one of the buyer's competitor products.

Guidance from the courts: requiring the buyer to conduct the target business as would a hypothetical, objective company may impede the buyer from pursuing more "idiosyncratic" goals not shared by the buyer's competitors or peers.

Caselaw also demonstrates that, even where the seller establishes a breach of the buyer's earnout obligations (e.g. a failure to use commercially reasonable efforts to meet the earnout triggers), the seller will still be required to prove damages (i.e., that the trigger would have been met had the breach not occurred).[18]

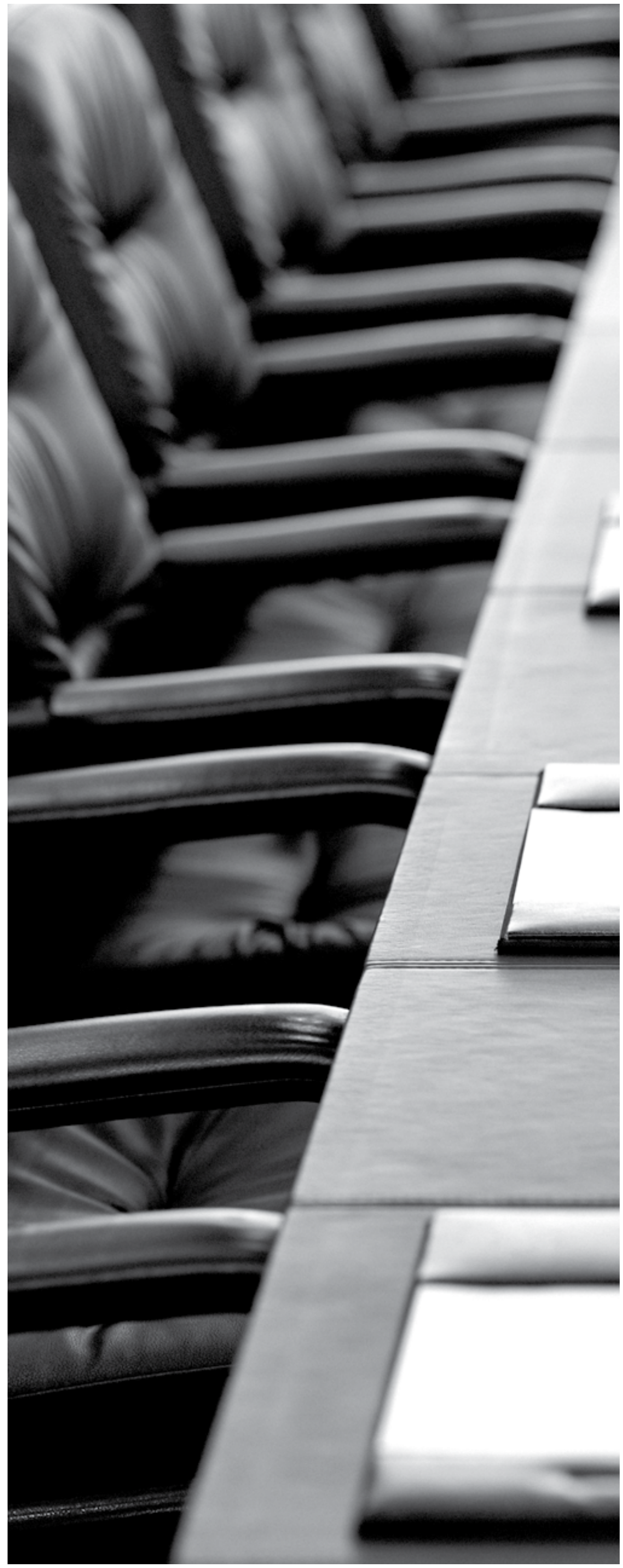
18 This often leads a court to a "loss of chance" analysis whereby it first determines the probability the earnout trigger would have been met had the buyer satisfied its efforts undertaking (e.g. a 50% chance), and then discounts the damages payable accordingly.

Dispute Resolution Issues

Examples of rulings arising from dispute resolution provisions applicable to earnouts include:

- The parties disputed the accountant's scope of authority under the earnout's dispute resolution clause. The court held the accountant's power was limited to deciding the buyer's compliance with the applicable accounting standards in calculating the earnout and did not include the ability to decide allegations of buyer business misconduct, breach of contract or breach of good faith, even if such conduct would impact the earnings informing the earnout calculations.
- The parties disputed what constitutes a "manifest error" by the expert, which was one of the sole grounds for contesting the expert's decision. The court declined to conduct its own accountant-level review, and deferred to the accountant's weighing of the merits of the parties' respective submissions. The court also held it was not inappropriate for the expert to give greater weight to the seller's submissions given the buyer had failed to maintain separate books and records in connection with the earnout as required by the purchase agreement.
- The parties disputed whether the buyer could contest the accuracy of its earnout calculations (in which an earnout trigger was deemed met) after it had submitted them to the seller. The buyer had later come to doubt the accuracy of the calculations and to believe they had been prepared in bad faith by a rollover employee who stood to benefit from the earnout payment. However, as the earnout clause expressly provided that, once prepared by the buyer and accepted by the seller, the earnout calculation was final and binding, the buyer's claim failed.

Guidance from the courts: the scope of an expert's authority under a dispute resolution clause is critical in deciding whether an earnout dispute falls entirely within that authority or may involve legal issues outside that scope.



Part 7: Key Differences Between Canada and Delaware

Canadian and Delaware contract law applicable to M&A agreements are more similar than dissimilar. That said, several exceptions relevant to earnouts warrant highlighting.

Different Efforts Undertakings

As discussed,[19] efforts undertakings in Canada benefit from a relatively clear hierarchy among three commonly used formulations, being “best efforts”, “reasonable efforts” and “reasonable commercial efforts”. Things are different in Delaware, where efforts undertakings suffer from somewhat of a disconnect. On the one hand, U.S. M&A lawyers understand a hierarchy among different efforts undertakings ranging from more onerous to less onerous standards depending on the formulation.[20] On the other hand, Delaware courts often dissolve any distinctions among the different formulations to effectively treat them interchangeably and as simply imposing an obligation to take reasonable steps in pursuit of the objective.[21] The result is that, in Canada, M&A parties benefit from greater certainty regarding the standard attached to each of the three most common efforts undertakings they may choose among in connection with an earnout.

19 See Part 3: Structuring Earnouts – Essential Terms; Efforts Undertakings in Canada.

20 See also ABA Business Law Section Mergers & Acquisitions Committee, *Model Stock Purchase Agreement with Commentary*, 2nd ed. (Chicago: American Bar Association, 2010) vol. 1 at 213: “Although practitioners may believe there are differences between the various efforts standards, courts have been inconsistent both in interpreting these clauses and in perceiving distinctions between them.”

21 See *Williams Companies, Inc. v. Energy Transfer Equity, L.P.*, 2016 WL 3576682 at *16 (Del. Ch. June 24, 2016), *aff’d* 159 A.3d 264 (Del. 2017). See also *Channel Medsystems, Inc. v. Boston Scientific Corp.*, 2019 Del. Ch. LEXIS 1394 at *95 n. 410 (Del. Ch. Dec. 18, 2019): “Although the Agreement here refers to the use of ‘commercially reasonable efforts’ while the provision in *Akorn* referred to the use of ‘reasonable best efforts,’ Delaware ‘case law [contains] little support for … distinctions’ between these two clauses.” See also *Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.*, 2021 Del. Ch. LEXIS 84 at *86 (Del. Ch. April 30, 2021).

Good Faith Always Applies in Canada

In Canada good faith applies to every contract, including a duty of honest performance and a duty to exercise contractual discretionary rights in good faith. Nor can these duties be contracted out of, even by sophisticated parties. By contrast, in Delaware, the implied duty of good faith and fair dealing primarily plays a "gap filling" role. Where the contract is silent on a point, the duty will apply.[22] But if the contract addresses the point, or if the evidence shows the parties considered addressing the point, but ultimately decided not to, the duty will not apply.[23] The result in Canada is that, even where the parties have expressly applied an efforts undertaking to the buyer's pursuit of the earnout triggers, duties of good faith will still apply. In Delaware, by contrast, applying a specific efforts undertaking to an earnout may preclude claims of good faith relating to the earnout.

Duties of good faith and honest performance will still apply to an earnout in Canada even where the parties have applied a specific efforts standard to the earnout.

The "Factual Matrix" vs the "Four Corners"

Delaware generally seeks to resolve contractual interpretation issues strictly within the "four corners" of the M&A contract.[24] However, should an ambiguity in the contract's meaning persist, Delaware courts have wide latitude to consider extrinsic evidence to resolve the ambiguity, including evidence of the parties' negotiations and prior drafts of the M&A agreement,[25] and may even apply such principles as the "forthright negotiator".[26] In Canada, the courts will generally consider the "factual matrix" in every contractual interpretation dispute, looking not only at the contract's terms but also at its surrounding circumstances, and whether or not an ambiguity exists. However, in Canada, evidence of the parties' negotiations and prior drafts is not permitted, even where there is an ambiguity. The result is that, where an earnout dispute in Canada involves an ambiguous term, while the court can seek insight from the factual matrix, it will not have access to the full scope of extrinsic evidence that might assist a Delaware court.

That Canada does not allow access to the same depth of extrinsic evidence in the event of an ambiguity in an earnout clause as does Delaware underscores the importance of ensuring the earnout accurately reflects the parties' intentions.

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22 See *Shareholder Representative Services v. Valeant Pharmaceuticals,* 2017 Del. Ch. LEXIS 886 (Del. Ch. Mar. 13, 2017).

23 See *Winshall v. Viacom International Inc.*, 2012 WL 3249620 (Del. Ch. Aug. 9, 2012), *aff'd* 76 A.3d 808 (Del. 2013). See also *Edinburgh Holdings, Inc. v. Education Affiliates, Inc.*, 2018 WL 2727542 (Del. Ch. June 6, 2018).

24 See *AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC,* 2020 Del. Ch. LEXIS 353 (Del. Ch. Nov. 30, 2020): "Absent ambiguity, the court "will give priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions."

25 See *Fortis Advisors, LLC v. Dematic Corp.,* C.A. No. N18C-12-104 AML CCLD (Del. Superior Ct. Dec. 29, 2022).

26 See *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007). The "forthright negotiator" principle provides that, where one party becomes aware during negotiations that the other party has a materially different understanding of a contractual term than the first party and the first party fails to raise their conflicting understanding with the other party, the first party may be precluded from relying on their interpretation of the clause in a subsequent dispute.

Excluding Liability for Extra-Contractual Statements

In Delaware, M&A parties can, through a robust entire agreement clause (often called an "integration" clause by U.S. lawyers) with express "anti-reliance" language, exclude liability for misrepresentations (whether intentional or unintentional) occurring anywhere except within the M&A contract's "four corners".[27] Indeed, if sufficiently robust, such clauses can effectively bar fraud claims based on statements made outside the contract's "four corners".[28] Canadian law gives effect to "entire agreement" clauses to guard against statements made outside the contract forming part of the parties' bargain. However, Canadian law also provides that "fraud vitiates all" and that public policy prohibits contractually excluding liability for fraud.[29] As a buyer will often make extra-contractual statements to the sellers regarding how the buyer intends to operate the target post-closing in pursuit of achieving the earnout triggers, this difference between Delaware and Canada is noteworthy.

27 See *Trifecta Multimedia Holdings, Inc. v. WCG Clinical Services LLC*, 318 A.3d 450 (Del. Ch. 2024).

28 See *Fortis Advisors LLC v. Johnson & Johnson*, 2024 WL 4048060 (Del. Ch. Sept. 4, 2024).

29 See *Scheuerman v. Scheuerman*, 1916 CanLII 42 (SCC), 52 SCR 625.

Part 8: Tax Considerations

Earnouts and reverse earnouts are complex concepts from a tax perspective and must be carefully structured to avoid adverse tax consequences. Earnouts and reverse earnouts also present some uncertainty from a tax perspective such that hard bargaining between buyers and sellers can result.

While a detailed discussion of the tax considerations applicable to earnouts and reverse earnouts is outside the scope of this guide, M&A lawyers should, inter alia, generally limit earnout periods to five years or less and tie earnout payments to the value of the underlying goodwill of the target business when negotiating the earnout's terms. Other situations which should be approached with particular care include where earnout payments would be made to non-resident vendors or in the context of an asset sale.

From a tax perspective, earnouts and reverse earnouts present multiple considerations, and some uncertainty, depending on the circumstances.

Part 9: Potential Earnout Alternatives

As mentioned, (1) the most common reason M&A parties use an earnout is to bridge a "valuation gap" between the buyer and seller over the value of the target, and (2) another reason M&A parties sometimes employ earnouts is that the buyer is cash-constrained and seeks to reduce the amount of the purchase price payable on closing. In either case, the parties can consider whether a potential alternative approach may offer an effective and more desirable resolution of the issue, and these include the following:

- **Holdback or Escrow Arrangements**. In a holdback a portion of the purchase price is held back and only paid to the sellers upon the achievement of specific milestones or the resolution of certain contingencies. Typically, a buyer does not need to set aside or segregate funds before a holdback trigger is met. Escrow arrangements are typically less appealing to the buyer as a portion of the purchase price is held in escrow with a third party and released to the sellers once milestones are met or contingencies resolved. This provides security to the sellers that funds are at hand and not subject to the credit risk of the buyer.
- **Seller Financing**. In a seller financing, often described as "vendor take-back" or VTB, the sellers provide a loan to the buyer to finance a portion of the purchase price, typically subordinated to the buyer's senior lender in a private equity purchase transaction. This can help the buyer manage cash flow and reduce the upfront payment, while the seller benefits from interest payments and a higher overall valuation. A common means of effecting a VTB is by the buyer issuing to the seller(s) one or more promissory notes as part of the purchase price.

- **Equity Rollovers**. Most private equity M&A transactions will already involve an equity rollover. In this case, the sellers retain a minority equity stake in the target or the buyer post-closing. An equity rollover allows the sellers to participate in the future growth and success of the business, aligning their interests with the buyer and potentially achieving a higher overall valuation. From the buyer's perspective, in addition to helping align the interests of the sellers to the business post-closing, an equity rollover enables the buyer to reduce the cash purchase paid on closing. By increasing the size of the equity rollover, the closing cash purchase price can be further reduced, thereby increasingly narrowing the valuation gap.
- **Contingent Value Rights**. CVRs involve the sellers being granted certain rights to additional future payments if certain milestones or performance targets are met post-closing. These can align the interests of both parties and provide a mechanism for the sellers to realize additional value based on the future success of the business. This alternative is a close cousin to an earnout but is often less challenging to negotiate and draft.

While an earnout can be a win for both the buyer and seller, the parties can consider whether a potential alternative approach may offer an effective resolution of the valuation gap or limitations on buyer financing impeding negotiations.

Part 10: Key Practical and Strategic Takeaways

In conclusion, our key practical and strategic takeaways include:

- While a carefully constructed earnout can be a win for both the buyer and seller, the parties can consider whether potential alternatives are available for bridging a valuation gap or limited buyer financing that is impeding deal negotiations, e.g., a holdback, seller financing, or contingent value rights.
- Sellers and Buyers often have different preferences regarding financial earnout triggers:
  - Buyers generally prefer net income triggers given they account for expenses and thus incentivize cost-efficient operations.
  - Sellers generally prefer revenue-based triggers given they are less affected by expenses and thus carry less risk of buyer manipulation.
  - A mutually compelling financial metric may be one based on the valuation method that informed the closing purchase price (e.g., EBITDA if the buyer valued the target on a multiple of EBITDA).
- A flat (i.e., "all or nothing") earnout payment can demotivate key personnel that will remain with the target post-closing if it becomes apparent the earnout trigger will not be met.
  - By contrast, a graduated formula (e.g., a percentage) may carry less demotivation risk.
  - This risk can also be mitigated by allowing for some portion of the earnout to be carried forward into future earnout periods.
- Another potential advantage of a graduated formula is that it may reduce the likelihood of a post-closing dispute given that, as opposed to a flat payment, the buyer may be less incentivized to orchestrate a narrow miss of the earnout trigger.
- As with a graduated formula, caps and floors may also reduce the amount of discrepancy that is subject to dispute and thus also reduce the potential for any formal dispute.

- Regardless of what type of earnout trigger is chosen, the parties should seek to ensure, as far as reasonably possible, the triggers are: (1) clearly defined, (2) objectively measurable, and (3) aligned with both the target's and the buyer's business.
    - Input should be sought by businesspeople, legal counsel, accountants and others with close familiarity with the target, its operations, and its industry.
    - Applicable accounting principles, assumptions, and adjustments should be addressed.
    - Illustrative examples should be scheduled to the purchase agreement including, if applicable, regarding formulas, caps, floors, carry-forwards and carry-backs.
- Regarding the desirable length of any earnout period:
    - The buyer should weigh how long it is willing to be subject to its earnout obligations and their associated positive and negative covenants, as applicable; and
    - The seller should weigh how long it is prepared (1) to be subject to the buyer's credit risk, (2) for the target's performance to be subject to general industry or market conditions, and (3) to wait to be paid part of the purchase price for the business being sold.
- Reverse earnouts employ conditional promissory notes for the maximum potential earnout payout and can be more attractive to sellers for tax reasons.
- The parties should choose carefully among the different efforts standards available for application to an earnout and try to avoid hybrid or overly complicated formulations.
    - Regardless of the efforts standard chosen, duties of good faith will continue to apply. By contrast, fiduciary duties are very unlikely to apply.
- Specific positive and/or negative covenants of the buyer may be particularly valuable to the seller(s) where they (e.g., the founder(s)) are not retained by the target and thus have no post-closing influence over the target business or the pursuit of the earnout.
    - Whether or not eventually included, raising specific positive and/or negative covenants during negotiations can assist the seller(s) in "feeling out" a prospective buyer as relates to a potential earnout.
    - If included, it may be easier for a disappointed seller to claim for breach of a positive or negative covenant post-closing than to claim on an efforts undertaking, including as the latter will inevitably be more vague in substance.
- Post-closing, the buyer should maintain a reasonably detailed record of its business decisions relevant to the earnout, particularly where the buyer has made an efforts undertaking and/or has agreed not to take any action with the "intent" or "purpose" of undermining the earnout.
- The scope of an expert's authority under a dispute resolution clause is critical in deciding whether an earnout dispute falls entirely within that authority or may involve legal issues outside that scope.

Earnouts are a valuable but complex potential tool in private M&A. Whether the buyer or seller, an informed negotiation strategy and careful drafting are key to success.

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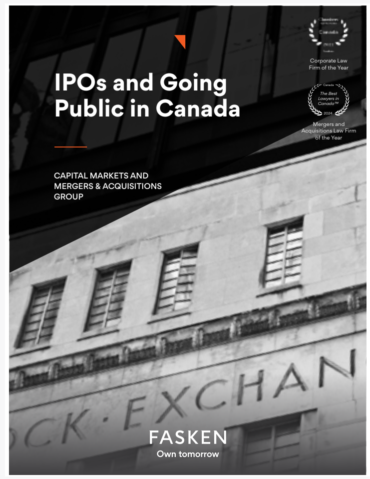

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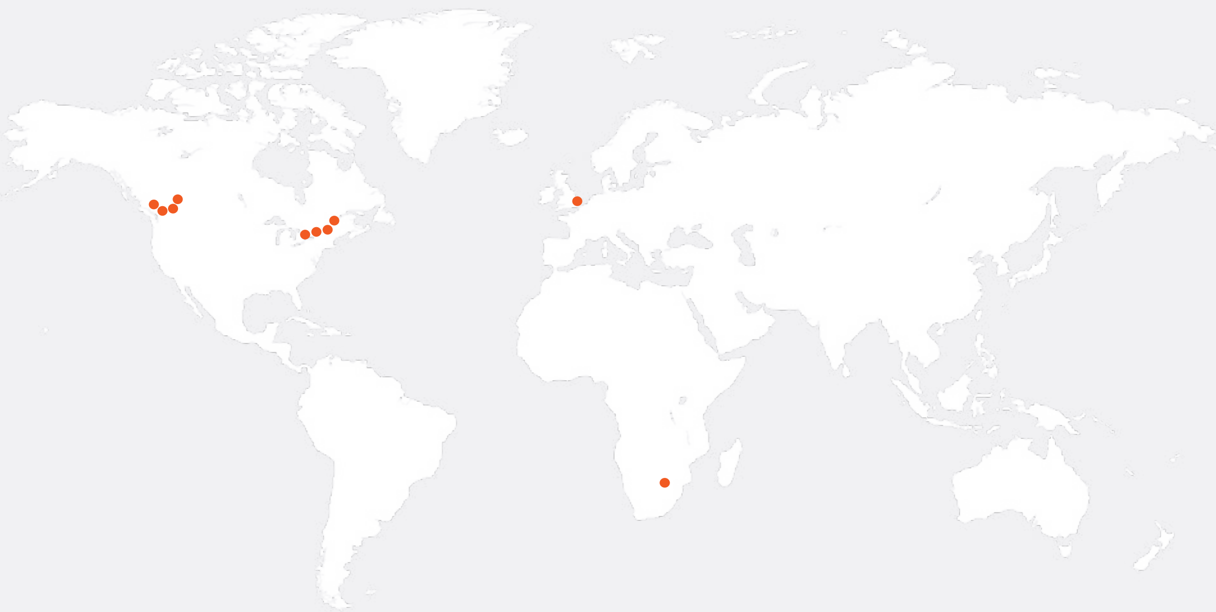

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