Mitigating The Risk Of Post-Closing M&A Earnout Disputes

By **Chad Barton and Claire Lydiard** (February 21, 2024, 4:18 PM EST)

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Merger and acquisitions practitioners harbor cautious optimism that deal volumes will tick up in 2024.[1] However, it remains unclear whether, or to what extent, the factors that suppressed deal activity in 2022 and 2023 have actually abated.[2]

Therefore, transacting parties are likely to continue to use contingent payment mechanisms, such as earnouts, to bridge discordant views of a target's enterprise value and mitigate uncertainty.

Yet the disconnect between increasing volume and lingering uncertainty suggests that transactions that close in 2024 will harbor an increased risk of post-closing disputes.[3]

This article identifies factors driving this concern and suggests steps that transacting parties can take to mitigate the risk of such disputes occurring.

A Rosy Outlook, Complete with Thorns

Last month, lawyers, acquirers and transaction insurance brokers and underwriters convened in Miami for insurance broker Aon PLC's 2024 M&A and Transaction Solutions Symposium.

During a session titled "The 2024 M&A Forecast: Strategies and Insights for a Dynamic Market," Matthew Wiener, co-practice leader of Aon's M&A and Transaction Solutions Group, conducted an informal poll of attendees' expectations of 2024 deal volumes.

A vast majority of participants indicated that they expected a moderate increase relative to 2023 — rather than down, neutral or significantly up. "Based on deal flow through January 2024, we saw an increase in transaction volume by approximately 25% year-over-year, and our pipeline of new deals expected to transact in Q1 2024 signals a strong start to M&A for the year," Wiener reported in discussions regarding this article.

This optimism is driven by a number of factors, including year-over-year fourth-quarter transaction volume improvements,[4] the expectation that interest rates will decline moderately, speculation that private equity buyers must come off the sideline to deploy **capital reserves**,[5] and growing confidence that the U.S. economy will achieve a so-called soft landing.

Nevertheless, the factors that have held deal flow from returning to 2021 highs persist, including interest rates well above 10-year averages,[6] a persistent valuation gulf between buyers and sellers, and, to cap it all off, political uncertainty and increasing geopolitical conflict. In this context, parties' heavy reliance on earnouts to bridge valuation gaps will continue,[7] and likely increase.

A well-crafted earnout is an excellent way for parties to accomplish a desired transaction, which could not otherwise occur. However, earnouts can present an increased risk of post-closing disputes.

Parties that could not agree on a target's enterprise value at closing will find that their ultimate enterprise value determination will continue to evolve as data aggregates — often upon the completion of a full post-closing audit cycle — and hindsight sets in.

Many valuation gulfs will widen, as buyers absorb unknown losses or sellers watch benefits accrue that are not reflected in the negotiated earnout-triggering metrics. Where swings are considerable, so is the likelihood of dispute.

A recent second installment of professional services firm Grant Thornton's 2023 M&A Dispute Survey — aptly titled "With Rising Deal Volumes Expect an Increase in M&A Disputes"[8] — indicated that "[w]hile the proportion of deals resulting in disputes appears to have decreased since the firm's previous [2020] survey, dispute activity has increased with the increase in overall deal volumes."

If M&A volumes do increase and the increased use of earnouts in 2024 M&A deals does pose an increased risk of dispute, a rebound in proportional disputes paired with a further increase in deal volume will produce a leap in total dispute volume.

A Closer Review of Earnouts — and Why Parties Use Them

In deals incorporating an earnout, buyers and sellers agree that a base purchase price will be paid at the closing, while sellers have the opportunity to "earn" additional amounts based on the sold business's future financial performance or achievement of certain defined milestones.

From 2018 to 2022, the use of earnouts grew at a steady clip. According to SRS Acquiom's 2023 M&A Deal Terms Study, the percentage of transactions, including earnouts, grew from 13% in 2018 to 21% in 2022.[9]

Further, the portion of purchase price represented by earnouts is significant. The median earnout consideration in deals analyzed in 2018 and 2022 represented almost one-third of total achievable purchase price — or 30% and 31%, respectively.[10]

For this reason alone, counsel for sellers should focus on carefully crafting earnout provisions to ensure predictable calculation of underlying metrics.

Of course, not all transacting parties utilize earnouts for the same purpose or in the same manner. Consider three ways in which earnouts can enable parties to accomplish a transaction where a commercial agreement may not have otherwise been achievable:

1. Earnouts as Buyer Financing Alternatives

Earnouts are usually a poor substitute for a well-negotiated seller note. Nevertheless, parties occasionally craft earnout provisions where the triggers are almost certain to be achieved.

This might be because a buyer cannot fully finance a deal by traditional methods or, for one reason or another, cannot book the amount as debt at closing. Further, the high likelihood that earnouts will be achieved may be clear from the outset of letter of intent negotiations or could become apparent to one or both parties during the course of a transaction.

Either way, the earnout ceases to function solely as a risk-sharing mechanism and becomes

a means of allowing buyers to pay a portion of the purchase price post-closing. In such circumstances, sellers can gauge their negotiating leverage by reference to the cost of buyers' financing alternatives.

Buyers enjoy informational asymmetry here — but have a firm understanding of their alternatives and can transact accordingly.

2. Earnouts That Address Specific Known Risks

Earnouts can be an excellent tool for parties who are seeking to address a specific contingency that could have a meaningful impact on the target's enterprise value. An archetypical example would be a large contract to be awarded to one of two bidders — the seller and a competitor.

If the seller prevails, the target's enterprise value soars. Here, rather than wait out future third-party action, transacting parties need only to reduce the contingency to discernible outcomes with formulaic consequences. Of course, triggers are not always binary — but a range of outcomes can give way to a range of earnout payments.

3. Earnouts as Present Valuation Bridges

Here, parties avoid an impassable gulf in their view of a target's present enterprise value by selecting key performance metrics — e.g., revenue; gross profit; earnings before interest, taxes, depreciation and amortization, or EBITDA; or adjusted EBITDA —[11] that, if achieved, will trigger additional post-closing payments, effectively delaying the enterprise value determination.

These payment typically do not trigger until a minimum performance floor is satisfied — which reflects the performance required by buyer to justify the purchase price paid at closing. Accordingly, in these earnouts, particularly percentage-based earnouts, the calculation of post-closing performance matters.

Unsurprisingly, this third category of earnouts is the most likely to result in disputes. Transacting parties who determine that reducing purchase price to an amount certain at closing is less efficient than deploying an earnout may also be inclined to preserve optionality by avoiding defining or addressing specific nuances in the application of such earnout.[12]

This approach allows parties to deploy judgment in calculating post-closing amounts. In lower enterprise value transactions, parties' incentive to limit transaction costs heightens this temptation. Either way, this approach is fraught with peril, as judgment-based calculations carry a high risk of triggering post-closing disputes.

A reoccurring theme in the 2023 Grant Thornton Dispute Survey is that deal-makers' best hope of avoiding disputes is to limit opportunities to exercise judgment post-closing.

"Generally speaking, you have more risk for a dispute when you have more areas that require judgment," says Charles Blank, Grant Thornton's M&A dispute services leader and managing director of forensic advisory services.

"The more detailed and process-driven you are, and the less judgment is present in your policies and procedures, the better your chances of success," Blank emphasized in the report.[13]

Drafting Earnout Provisions to Mitigate or Avoid Disputes — Bridging Gaps

A mentor once shared a lawyering parable that we consider frequently:

The general counsel of a seller has negotiated a sale of a majority stake in a meaningful business unit to a foreign conglomerate. The documents are final and the seller celebrates the GC's securing favorable terms, which will produce a windfall several years down the line — let's assume an earnout. At the in-person closing, the transaction teams meet in person for the first time. The GC's team is buoyant, sharing congratulations. The GC greets his counterparty. They have exchanged countless emails and had many congenial and productive calls. However, in person, the GC is surprised at the counterparty's solemnity. The counterparty offers a curt bow and cuts the pleasantries short, ushering the GC directly to the buyer's CEO. The CEO is also solemn when he asks a question in his native language, which the counterparty translates "Are you confident in the terms you have negotiated?"

Surprised, the GC responds "Yes! This is a great outcome for our stakeholders and we have enjoyed working with your team. Your GC is a credit to your organization."

"I am aware. But, are you satisfied with the amount we are required to pay you under this agreement?"

"Yes," the GC answers, discomfort mounting.

"Because, I will never pay you a single cent more than this document contractually requires. Do you understand? We cannot sign unless you fully understand."

Suddenly, the GC's own CEO appears, beaming, pen in hand. "Are we ready?"

Business teams are responsible for building assumption-based models, and making informed business decisions driven by their acumen, as well as for the insights such models reveal. Here, the seller's business case predicts that the transaction will be successful based on its modeling — but the seller has also assumed that in the future the buyer will interpret the contract in a manner that is compatible with its model.

The GC was tasked with ensuring, to the best of their ability, that the contract requires the buyer to calculate amounts owed in manner that is consistent with the model. If the contract allows the buyer to alter critical aspects of the seller's model to produce buyer-favorable outcomes, the seller's assumptions may prove correct without producing the intended financial benefit. In this instance, the GC will have failed.

On the other hand, in order to succeed, the GC must have an understanding of the assumptions inherent in the seller's model, the means in which the buyer could supplant those assumptions to the determent of seller, and ensured that contract addressed each.

In negotiating an earnout structure, it is especially important not to lose sight of a fundamental component of all transactions — transacting parties have different cultures, which drive behavior and shape expectations.

These differences extend to problem-solving approaches and methods of measuring metrics, each of which provides fertile ground for post-closing disagreements.

To force a metaphor, while parties might agree to speak the same language when

evaluating key earnout metrics — i.e., generally accepted accounting principles, or GAAP — they almost certainly use different dialects in interpreting GAAP.

Carefully Select Earnout Metrics and Negotiate Accordingly

Different earnout metrics produce different degrees of risk that post-closing disputes will occur. Relatively simple revenue-based metrics result in fewer disputes than EBITDA-based metrics.

However, the 2023 Grant Thornton Dispute Survey found that deal-makers prefer EBITDA-based metrics — including both EBITDA and adjusted EBITDA-based metrics — and EBITDA-based metrics lead revenue-based metrics by a 39% point margin, or 59% to 20% respectively.[14]

Unsurprisingly, the risk of post-closing disputes is preferable to the risk of post-closing performance manipulation. After all, perverse incentives have the potential to lead a business team to juice revenue at the expense of profit.

Nevertheless, while 26% of 2022 deals that include earnout mechanics result in post-closing disputes, nearly a third of earnouts based on adjusted EBITDA, 28%, and gross profits, 32%, result in disputes.

Accordingly, transacting parties utilizing EBITDA and profit-based earnout metrics should address this dispute risk head-on, ensuring earnout components are capable of being calculated in accordance with a standard documented in the purchase agreement.

For example, Max Mitchell, Grant Thornton's purchase agreement advisory leader, states in the report that parties utilizing adjusted EBITDA as an earnout metric often contract for adjustments by simple reference to "extraordinary, nonrecurring or exceptional items" while noting that there is no GAAP standard to dictate post-closing calculations based on this concept.

The Financial Accounting Standards Board eliminated the concept of extraordinary items back in 2015.[15] Accordingly, parties, in close collaboration with their legal, accounting and tax advisors, should work to ensure earnout metrics can be calculated in accordance with discernible guidelines.

Particularly in the case of adjusted EBITDA-based metrics, parties would do well to schedule specific add-backs or adjustments that drive earnout calculations.

Further, certain income statement areas pose heightened dispute risk. Respondents in the 2023 Grant Thornton Dispute Survey were asked to select income statement areas most likely to produce disputes.

They identified each of net profit and operating expense with greater than 20% response rates, followed by net revenue and gross revenue, at 15% and 13% respectively.[16]

With this in mind, deal-makers, who will likely have identified points of perceived weakness or concern in the financial diligence process, should take care to schedule carefully crafted accounting policies that address how income statements will factor identified areas of concern.

After all, it is easier to reach consensus in the context of pre-closing negotiations involving

hypothetical dollars than it is post-closing, with real dollars in dispute. Further, parties in the midst of negotiations have the opportunity to trade for preferred treatment of known issues relating to earnout calculations.

A unique opportunity is present where sellers' management team (1) owns the business being sold and (2) will continue to manage the target post close.

Parties can craft a revenue-based earnout with sellers on one hand that is in balance with an EBITDA, or other profit or customer retention, -based employment bonus. In such case, management is incentivized to maximize both revenue and profits, while the purchase agreement can utilize a simplified revenue-focused earnout metric.

Of course, in this context, sellers forgo favorable capital tax treatment with respect to the portion paid as an employment bonus.

Further, this concept is ill-suited in circumstances where management owes duties to many third-party equity-holders participating in the sale. Circumstances will ultimately be deal-specific, but thoughtful, prospective problem-solving will always benefit parties who can afford the expense.

Adopting Accounting Hierarchies

A high percentage of practitioners surveyed in the 2023 Grant Thornton Dispute Survey cited the use of an accounting hierarchy as a successful means of mitigating post-closing disputes, with 50% increasing their reliance on such hierarchy's in recent years.

A simplified example of a common hierarchy would require that, in the event of an inconsistent or uncertain application of GAAP, specific accounting policies reduced to a negotiated schedule will prevail over GAAP, as applied in a specified set of financial statements, which in turn will prevail over GAAP — generally.

Here, parties have invested the resources to chart a road map for calculating earnout payments, and limiting post-closing disputes. According to page 11 of the 2023 Grant Thornton Dispute Survey:

GAAP can be open to subjective interpretation and consistency cannot predict the future. Neither fully addresses the intricacies of the closing balance sheet or the earn-out calculation. (Indeed GAAP may offer specific guidance on year-end and interim financial statement preparation, but not to M&A output).

The hierarchy, on the other hand, provides a dynamic capable of adapting to the parties' unforeseen needs.

In Conclusion — Don't Gloss Over the Seemingly Minor Details

In the course of a thorough earnout negotiation, deal-makers will encounter details that may, at the time, seem minor or ancillary. However, these items can have an outsize impact on the likelihood of a post-closing dispute arising or the pain such a dispute imposes.

For example, buyers and sellers can reduce the likelihood of experiencing an arbitrary dispute by ensuring that sellers have reasonable access to materials used to calculate post-closing earnout metrics.

Such sellers will not be compelled to initiate a formal dispute process as the sole means of checking the buyer's math. Buyers will want to avoid disrupting operations or providing costly access outside of normal working hours, but these concerns can be addressed in drafting — and are largely mitigated by the increasingly digital nature of the process, excepting perhaps a rare physical inventory audit.

Ultimately, parties who force careful, nuanced consideration of earnout mechanics during — and preferably early in — the course of negotiations will incur additional time and expense, and likely endure greater friction, in the course of drafting and negotiation. After all, parties who do not agree on enterprise value at closing will likely not find total harmony in their view of underlying value drivers.

However, by negotiating — and yes, compromising — to a middle ground in advance of closing, parties can avoid or mitigate expensive and disruptive post-closing disputes.

Sellers are less inclined to dispute a failed earnout achievement if they had a meaningful say in crafting the underlying calculation methodology. Buyers are more likely to align with sellers on less advantageous GAAP applications when they contractually obligated themselves to do so.

Fortunately, the benefit of fewer and smoother disputes extends beyond the subject transaction alone.

Parties earn unexpected dividends where buyers and sellers continue to collaborate post-closing, whether as colleagues, co-litigants in a third-party dispute, or referral partners — particularly where acquisitive buyers seek endorsements and referrals from past sellers.

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[1] Jade Martinez-Pogue, PE Market Poised To 'Unclog' In 2024, Hopeful Attorneys Say, Law360, Jan. 1, 2024, https://www.law360.com/articles/1773992/pe-market-poised-to-unclog-in-2024-hopeful-attorneys-say.

While a challenging market has defined the better part of the past two years, there remains ample opportunity for buyers and sellers to transact in 2024, given the dry powder and fundamental strength of companies in rising industries.

[2] Jade Martinez-Pogue, Asset Buyers Have Upper Hand Amid PE Market Lull, Law360, June 30, 2023, https://www.law360.com/articles/1693047/asset-buyers-have-upper-hand-amid-pe-market-lull.

[3] See Berkeley Research Group, Mid-Year M&A Disputes Report 2023, https://media.thinkbrg.com/wp-content/uploads/2023/07/13045113/BRG-Mid-Year-MA-Disputes-Report-2023-1.pdf ("Economic uncertainty and higher interest rates are leading many companies and investors to take a closer look at their existing portfolio with a reduced appetite for risk, especially since valuations tend to decrease as rates increase",

said BRG Managing Director Mustafa Hadi. "While IPO exits and new investments certainly are responsible for disputes, exits from investments made over the past five years also seem to be one of the major factors fueling disputes this year—investors are looking for a way out".).

[4] See Emily Rouleau, ANALYSIS: Despite Q4 Boost, 2023 M&A Deal Volumes Disappoint, Bloomberg Law, Jan. 9, 2024, https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-despite-q4-boost-2023-m-a-deal-volumes-disappoint ("Quarterly deal counts were cause for meager optimism. Global M&A deals and controlling-stake M&A deals saw increases in deal counts from Q3 2023 to Q4 2023, which didn't happen for either category of M&A deals in 2022.").

[5] Jade Martinez-Pogue, PE Market Poised To 'Unclog' In 2024, Hopeful Attorneys Say, Law360, Jan. 1, 2024, https://www.law360.com/articles/1773992/pe-market-poised-to-unclog-in-2024-hopeful-attorneys-say.

[6] Federal Reserve Bank of St. Louis, FRED Economic Data, Bank Prime Loan Rate Changes: Historical Dates of Changes and Rates, https://fred.stlouisfed.org/series/PRIME.

[7] SRS Acquiom, 2023 M&A Deal Terms Study, 24, https://info.srsacquiom.com/2023-srs-acquiom-deal-terms-study.

[8] The 2023 Grant Thornton Dispute Survey is available for download at: https://www.grantthornton.com/services/advisory-services/transaction-advisory/m-and-a-dispute-survey-2023.

[9] SRS Acquiom, 2023 M&A Deal Terms Study, 24, https://info.srsacquiom.com/2023-srs-acquiom-deal-terms-study.

[10] https://info.srsacquiom.com/2023-srs-acquiom-deal-terms-study pg. 25.

[11] Grant Thornton, How to guard against rising M&A disputes, https://www.grantthornton.com/content/dam/grantthornton/website/assets/content-page-files/advisory/pdfs/2023/2020-manda-dispute-survey-report.pdf.

[12] Grant Thornton, How to guard against rising M&A disputes, 6, https://www.grantthornton.com/content/dam/grantthornton/website/assets/content-page-files/advisory/pdfs/2023/2020-manda-dispute-survey-report.pdf ("Interviewees indicated that vague language is not uncommon because the parties are looking to get the deal done, and the working capital or earn-out provisions are often some of the last to be drafted.").

[13] https://www.grantthornton.com/content/dam/grantthornton/website/assets/content-page-files/advisory/pdfs/2023/2020-manda-dispute-survey-report.pdf.

[13] https://www.grantthornton.com/content/dam/grantthornton/website/assets/content-page-files/advisory/pdfs/2023/2020-manda-dispute-survey-report.pdf.

[14] See Grant Thornton LLP, With rising deal volumes, expect an increase in M&A disputes, 9, available for download at https://www.grantthornton.com/services/advisory-services/transaction-advisory/m-and-a-dispute-survey-2023; but see SRS Acquiom, 2023 M&A Deal Terms Study, 24, available for download at https://www.srsacquiom.com/our-insights/deal-terms/ (finding that 61% of evaluated transactions utilized revenue as an

earnout triggering event, though 42% of the deals incorporating earnouts were reported to include multiple trigger events).

[15] See the 2023 Grant Thornton Dispute Survey, page 9 (available for download at: https://www.grantthornton.com/services/advisory-services/transaction-advisory/m-and-a-dispute-survey-2023).

[16] https://www.grantthornton.com/content/dam/grantthornton/website/assets/content-page-files/advisory/pdfs/2023/2020-manda-dispute-survey-report.pdf at 31.