



WING TIPS

Earn Outs

Earn outs in M&A transactions – where the purchase price is split between a payment at closing and one or more contingent payments dependent on certain targets being met – are an important tool for both buyers and sellers as they enable the price to be fixed retrospectively. Indeed, in today's market, it would be rare not to see some form of earn out where an unquoted technology or services company is being purchased.

Why use an Earn Out?

Earn outs have a definite appeal to a buyer as they:-

- *Valuation.* Focus a seller's attention on valuation issues.
- *Incentive.* Act as a management retention and incentive tool.
- *Exposure.* Reduce its exposure to variations in performance post-acquisition.
- *Recovery.* Reduce the price if certain assumptions are incorrect.
- *Cash flow.* Allow it to reduce the up front consideration.

For a seller, an earn out:-

- *Realisation of Perceived Value.* Provides a mechanism to enable sellers to recover potential profit value.
- *Access to Buyer's Resources and Networks.* Gives the target company an opportunity to unlock value by being part of a larger group.

Although there can be a ratchet upwards that leads to substantial subsequent payment, a seller should only rely on the initial payment with any certainty and explore other routes – such as waiting until the buyer's concerns are shown not to exist - before agreeing to an earn out.

Structuring the Earn Out

Earn outs can be as flexible as the parties wish, but the sale agreement should be clear and unequivocal on the structure of the earn out and the mechanism for resolving disputes.

The time frame for an earn out can vary significantly depending on what the objective is. Typically an earn out for the purchase of an unquoted technology or services company is in the range of 18 months to 3 years, and rarely 5 years. Buyers frequently resist very short earn outs as they encourage very opportunistic short-term behaviour.

Protecting the seller

A seller will be exposed to activities of the buyer in reducing the value of the earn out even where the business interests of the parties are clearly aligned. As a result, a seller will seek to contractually secure a number of protective provisions. Some of the provisions that may be required by sellers managing the business post acquisition include:

- The right to manage the business.
- A general provision that nothing will be done with the intention of reducing the amount of the earn out.
- An acceleration or modification of the earn out if the company's business or assets are sold or changed in a way which would adversely affect the earn out or its calculation.
- Specific commitments as to provision of financial or other resources and access to sales channels, often set out in the business plan.

Sellers often also seek some form of security in relation to payment of the earn out. A buyer is likely to negotiate these protective provisions to ensure that they are tailored to areas of particular risk for the sellers and give the buyer the right to preserve its economic interest in the business. Buyers should note that too protective provisions may prevent the benefits of the acquisition from being fully realised during the earn out period. Sellers should note that whatever contractual protections are in place, the reality is that post acquisition they will lose a considerable degree of control. It is most important that there is trust and 'cultural fit'.

Tax Issues

An earn out raises a host of tax issues and, frequently, these issues drive the structure of the earn out as they have a significant financial impact. These include:-

- *Capital Gains Tax (CGT).*
 - The value of an earn out will be allowed for in calculating a seller's liability to CGT on the sale of its shares even where the value of the earn out is unascertainable, but this can (subject to various conditions) be delayed if the earn out is satisfied in shares or loan notes until true value is realised.
 - Individuals who are sellers can, subject to certain conditions being satisfied, have the benefit of taper relief on a sale of their shares and therefore are likely to want to roll over any gain into shares or loan notes where this is possible.
- *Income Tax Treatment*
 - Individuals who are sellers will look for the earn out to be subject to capital gains tax rather than income tax and national insurance..
 - If a seller is the employee of the acquiring company or a subsidiary (e.g. the target) post-acquisition, there is a risk that the earn out will be regarded as employee remuneration. For the seller to avoid possible employee tax liabilities the earn out should only operate to cover further proceeds of sale, with no element of remuneration.

Summary

In theory, earn outs are flexible, provide a mechanism for dealing with valuation disagreements and foster co-operation in developing and building a business. In practice, they can become extremely complex, leave both sides exposed and lead to disputes. It is therefore essential that the earn out be structured carefully, both in terms of the targets, operational issues and in terms of what is to happen in the event of disagreement or if the earn out targets are not being met.

If you have any questions or would like to discuss anything in this article in more detail, please contact Charles Claisse at Kemp Little LLP on 020 7600 8080 or email charles.claisse@kemplittle.com