The earn-out – Is this the new normal in M&A? (Part two)

Retention arrangements, insolvency risk, creditor issues and dispute resolution

The COVID-19 outbreak, almost overnight, unleashed unparalleled uncertainty, with concerns about a global downturn compounding the impact on the UK, European and worldwide M&A markets. A key factor contributing to the impact on the M&A market is the uncertainty surrounding business valuations and executing deals at the right price. Optimistic sellers will likely argue that a business should be valued on its pre-COVID performance, whereas sceptical buyers will argue that pre-COVID-19 performance indicators may not adequately reflect the pandemic's effects on the market going forward and may request a reduction to the purchase price.

Although the prospect of a COVID-19 vaccine is promising, trends are emerging where buyers and sellers implement commercial and innovative solutions to bridge valuation gaps. One of these trends is an increase in the use of earn-outs. The second paper in this three part series focuses on retention arrangements, insolvency risk and creditor issues in the current environment and ways to deal with those issues and how disputes over earn-outs can be handled.

Retention, insolvency risk and creditor issues

It has become quite clear that certain industries have been very negatively impacted by COVID-19 and the related lockdown measures, such as the airline and travel industries, and that these impacts may not be short-lived. We have seen that the financial covenant strength and cash flow position of certain businesses, including those who only nine months ago had very strong balance sheets, have been compromised. As mentioned in the first paper in this series, sellers should be conscious of this and should consider whether any retention and/or security arrangements (including, for example, taking security over valuable assets) should be put in place to ensure certainty of funding the earn-out. On the other hand, cautious buyers who are aware of liquidity issues in the current climate may wish to resist retention and security arrangements and instead offer comfort by alternative means including parent company guarantees, an option to pay the earn-out in shares (if the buyer is listed), evidence of cash flow projections and available financing facilities. If, however, a motivated seller is insisting on

Key considerations

- Security and retention arrangements should be considered in light of insolvency risk.
- Earn-outs can be the subject of disputes depending on their complexity and performance of the business post-completion.
- Expert determination for earn-outs can be efficient but may not always be suitable. Litigation and arbitration can also be effective options.
- Careful consideration should be given to choosing and leveraging the mechanism for resolving issues relating to earn-outs.

cash-based security, a buyer may wish to consider offering this security in exchange for an early payment earn-out discount.

Where an earn-out is negotiated in the current climate, both buyers and sellers will inevitably have concerns about the payment of an earn-out, including insolvency risk, uncertainty in the market and other relevant factors. Undoubtedly it is in both parties' interest to agree on a position that gives the seller comfort that the earn-out payments will be made. In order to provide the seller with this comfort and conclude the deal, the parties could consider including a provision in the sale contract that permits acceleration of the payment of the outstanding earn-out, or an agreed portion of the outstanding earn-out, in the following circumstances:

1. *Sale of acquired business* – Where the acquired business is sold to another buyer before the end of an earn-out period – this could also assist in making a business more attractive to a future buyer who may otherwise be discouraged from acquiring an encumbered business if the original buyer's obligation to pay the earn-out is passed onto a future buyer.
2. *Insolvency* – Where the buyer is or is likely to become unable to pay its debts (insolvent) or likely to enter a formal insolvency process, such as administration or liquidation – a seller will want this acceleration trigger to apply to 'soft' insolvency events (i.e. before the buyer is actually unable to pay its debts or enters a formal process), however a buyer will typically resist 'soft' insolvency triggers and a compromise will need to be reached between a seller and buyer. Further, even if a soft insolvency event were triggered, the directors of the buyer would have to consider if it was consistent with their duties to act in the interests of all creditors to make a payment at that time.
3. *Upon the occurrence of a specified event.*

With some businesses it may even be possible to structure the earn-out such that it can be satisfied in exchange for an asset type other than cash – for example, transfer of intellectual property or data from the buyer to the seller.

Dispute resolution and expert determination

Earn-out mechanisms, like completion accounts and other consideration adjustment mechanisms, can be the subject of disputes due to their complexity and, to varying degrees, their subjectivity and openness to interpretation. When disputes do arise, it will be important to get an early resolution or determination of the issues so that the payment is unlocked, and the liability is resolved efficiently. It may not always be suitable for such disputes to be referred to courts or arbitration for lengthy proceedings and in those circumstances independent expert determination can be a good dispute resolution mechanism.

Expert determination is a creature of contract and an alternative dispute resolution process that is not as formal as litigation or arbitration. Advantages of appointing an expert, such as an accountant, to determine earn-out disputes include cost and time savings for all parties involved. Another benefit of expert determination is that it can also be well suited for non-legal topics, such as whether the business has met a certain financial performance target within the earn-out period. Due to the flexibility in the expert determination process there is also the possibility of appointing a "legal" expert such as an English law qualified lawyer or an ex-judge to determine narrow legal questions relating to an earn-out.

However, expert determinations, like other forms of dispute resolution, also have their own shortcomings. In the context of earn-outs some of the common issues that can arise with expert determinations are:

1. *The scope of the question to be determined by the expert/s* – This can become a real battleground between the parties because there may be overlapping legal and financial issues that need to be considered. For example, the dispute may not be limited to whether an accounting principle has been correctly applied and may extend to what the meaning of the accounting principles are for the purposes of the earn-out.
2. *Finding an expert that is agreeable to all parties* – Typically, an expert will require their terms of engagement to be signed by all the parties. A non-cooperative party can use this to delay and stall the process. However, this can be mitigated by careful drafting of the earn-out dispute resolution process in the transaction documents by, for example, having obligations requiring parties to act in good faith and to cooperate including an acknowledgement that indemnities will be needed in favour of the expert. This could then be used as a mechanism to unlock progress by seeking remedies from the courts or arbitral tribunals who have the jurisdiction to enforce those sorts of obligations.
3. *Enforcement of the expert decision* – If the losing party is not willing to release payment it can add to time and costs to seek enforcement of the expert's decision. This is often addressed by having interest for late payment payable from the expert's decision.

Whilst expert determination is sometimes classified as the more time effective dispute resolution process, English courts and arbitration rules are becoming more adept at dealing with issues quickly when required – for example, the English courts have a well-developed set of rules and principles that allow a party to seek a judgment on issues

that do not involve a substantial dispute of fact. Alternatively, parties can seek summary judgment without a trial in certain circumstances. Equally, established arbitral institutions like the London Court of International Arbitration (LCIA), International Chamber of Commerce (ICC) and the Singapore International Arbitration Centre (SIAC) have introduced measures that allow for expedited formation of tribunals, emergency relief and summary proceedings to help parties get an early determination of their disputes.

As such, careful consideration should be given to choosing the mechanism for resolving issues relating to earn-outs particularly to ensure that such mechanisms can adequately resolve issues of fact and/or law as applicable. In addition, consideration should be given to the following when negotiating transaction documents so that the drafting of the earn-out provisions is optimised and equally these provisions should be reviewed for their impact as and when a dispute arises:

1. *The format, timing and content* of the completion accounts/earn-out calculations.
2. *The mechanism and timing* for raising disagreements with completion accounts/earn-out calculations.
3. *Access to information for the purposes of the above* – This can be problematic for sellers who on the one hand must provide details of their disagreements but may not have access to the books and records.
4. *The definition of accounting policies* – In the current climate, accounting policies may be adjusted to deal with the extraordinary events, and it is possible these accounting policies will be adjusted as businesses move from crisis mode to rebuild-mode. This could have a dramatic impact on an earn out and, as such, it will be important to define clearly which accounting policies should apply for the calculation of the earn-out and how any changes to accounting standards are dealt with.
5. *Impact of other clauses on the earn-out* – For example, 'No Set-Off', 'Material Adverse Change' and 'Change in Law' clauses. In the current climate where there is a greater degree of legislative intervention, 'Change in Law' clauses can have a material impact on rights and obligations of parties. In addition, where a seller is providing warranties, the buyer may want the ability to set-off any claims on breach of warranties against the earn-out that may be payable to the seller.
6. *Interaction with security and incentivising early resolution* – For example, can amounts held in escrow be unlocked for the undisputed amount of the earn-out.

Given the complexities that are expected to be introduced into valuations and resulting earn-outs, the prospects of post-completion disputes arising should not be underestimated. A risk mitigation strategy can be key to helping parties navigate these issues and should be considered carefully by parties at an early stage of the transaction.

Other papers of interest:
Earn-outs bridging valuation gaps
Payment structures and sector considerations

Kristy Duane
Partner, Corporate
T +44 20 7524 6568
E kristy.duane@cms-cmno.com

Kushal Gandhi
Partner, Finance
T +44 20 7367 2664
E kushal.gandhi@cms-cmno.com

Mariam Azzo
Senior Associate, Corporate
T +44 20 7367 3509
E mariam.azzo@cms-cmno.com

Corinna Lee
Senior Associate, Corporate
T +44 20 7367 2941
E corinna.lee@cms-cmno.com