Baker McKenzie.

M&A Newsletter
June 2022
Luxembourg

M&A Newsletter Series

Part 4: Earn-out clauses

The purpose of this Baker McKenzie M&A Newsletter Series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 4: Earn-out Clauses

This fourth newsletter deals with earn-out clauses that are quite frequently encountered in share sale and purchase agreements. For example, earn-out mechanisms were used in approximately 21% of the European and 27% of the US deals in 2020, with however a lower use in large deals.

"Earn-out clause" can generally be defined as a contractual provision pursuant to which a purchaser undertakes, in a share deal transaction, [1] to pay an additional purchase price (being the earn-out) to the seller in the event that the target achieves one or several agreed financial milestones over a specified period following the closing date. In other words, an earn-out is a contingent additional purchase price (complément de prix) based on specified future financial performances of a target.

Practitioners usually identify two types of earn-out clauses:

(a) the one agreed in connection with the sale of all the shares of a target at once; and
(b) the one agreed in connection with the sale by tranches of all the shares of a target.

AT THE END OF AN AGREED EARN-OUT REFERENCE PERIOD, THE PURCHASER PAYS TO THE SELLER A SECOND PORTION OF THE PURCHASE PRICE, CALCULATED ON THE BASIS OF THE "FUTURE VALUE" OF THE TARGET, TO THE EXTENT, AND ONLY TO THE EXTENT, THAT THE TARGET ACHIEVED SOME AGREED FINANCIAL MILESTONES WITHIN SUCH REFERENCE PERIOD

With the first type of earn-out clauses, the purchaser irrevocably pays to the seller a first portion of the purchase price (the so called base price), calculated on the basis of the "current value" of the target on the closing date.

Then, at the end of an agreed earn-out reference period, the purchaser pays to the seller a second portion of the purchase price, calculated on the basis of the "future value" of the target, to the extent, and only to the extent, that the target achieved some agreed financial milestones within such reference period. This is the most common type of earn-out clauses.

[1] Or sometimes in connection with an agreement relating to the transfer of line of business or of a universality.

With the second type of earn-out clauses, the purchaser acquires progressively all the shares of a target, i.e., by successive tranches. The purchaser pays consequently as many purchase prices as there are successive tranches of shares agreed under the transaction. The purchase price paid for the first tranche of the shares, based on the "current value" of the target, is definitive. Then the payment of the additional purchase prices for each successive tranche of shares is conditioned on the achievement by the target of one or several financial milestones during one or several successive post-closing earn-out reference periods. With this second type of earn-outs, the parties usually agree in addition on a minimum or maximum amount for each of the successive earn-outs in order to prevent excessive variation of the aggregate purchase price. As this is a much less common type due to its intrinsic complexity, it will not be further discussed here.

The key interest of earn-out mechanism lies with the fact that an earn-out can sometimes be used to bridge the gap resulting in a share deal transaction from a typically "prospective" pricing approach of a seller [2] and a typically "retrospective" pricing approach of a purchaser. Indeed, as many practitioners know, a seller and a purchaser usually have naturally different approaches in terms of valuation of a target. The seller usually wants to take into account in determining the value and purchase price of the target the future financial performances of the target or, more generally, its so called development potential. Conversely, the purchaser is usually very reluctant to take into account such future financial performances or alleged development potential, as they are by nature largely uncertain.

This antagonist approach results partially from the asymmetry of information between a seller and a purchaser in any transaction: the seller knows its business to the core, where the purchaser knows this business only through the results of a more or less extended due diligence exercise.

THE USE OF AN EARN-OUT MECHANISM ENABLES, FROM TIME TO TIME, THE SELLER AND THE PURCHASER TO COME OUT OF A DEAD END WITH REGARD TO THE PURCHASE PRICE UNDER THEIR CONTEMPLATED TRANSACTION

Sometimes, the seller and the purchaser manage to bridge such valuation gap bias and agree on a purchase price that takes reasonably into account both their views referred to above. Sometimes, however, they just can't. This is precisely when suggesting the use of an earn-out mechanism enables, from time to time, the seller and the purchaser to come out of a dead end with regard to the purchase price under their contemplated transaction and ultimately save it.

The use of an earn-out presents advantages (and disadvantages) both for the seller and the purchaser.

From a seller's perspective, the use of an earn-out mechanism will obviously grant it the opportunity to continue participating in the economic development of the target after the closing date, thereby enabling it to collect the "fruit of its labor" (if any).

From a purchaser's perspective, the use of an earn-out can also be interesting. Firstly, it will enable the purchaser to pay the seller, on the closing date, the price it deems fundamentally fair with respect to its perception of the financial potential of the target on the signing date; the purchaser would also be able to pay the additional purchase price that the seller was requesting based on the realized financial forecasts. Secondly, it will be an elegant and efficient manner to strongly incentivize a seller any time it would be requested to remain in the management of the target for a handover period. Thirdly, it will enable to spare the cash of the purchaser, unless all or part of the earn-out amount must be set into escrow or guaranteed by the issuance of a bank guarantee at the seller's request. Fourthly, it may enable the purchaser to more smoothly finance the contemplated transaction, as the purchaser may use in due time dividend received from the target to pay the earn-out amount(s).

---

[2] For example, in a deal in which the valuation of the target is based on a discounted cash flow method, a seller is usually very optimistic about the expected future cash flows to be generated by the target according to its business plan, where the purchaser shall rather be more careful. In the same manner, in a deal where the valuation of the target is based on a multiple method, the seller will usually argue that the target EBITDA is fully recurrent, where the purchaser will seek to normalizing it by expunging it from any exceptional items.

Finally, it may be used by the purchaser as a guarantee for the indemnification obligation of the seller in case of breach of the seller's representations and warranties, by agreeing that any sum due under the earn-out clause may be set off against any sum due by the seller under the indemnification clause set out in the share sale and purchase agreement.

The validity of earn-out clauses is not subject to many discussions [3]. Luxembourg legal scholars and case law unanimously agree that earn-outs are valid, subject to three main conditions. Firstly, writers of earn-out clauses should recall that any earn-out amount must be determined or at least be determinable. This is generally not an issue, even if in some instances earn-out clauses have been declared null and void for breaching this rule. Secondly, writers of earn-out clauses should be careful that their earn-out do not qualify as a payment under a condition precedent whose satisfaction depends solely on the will of the debtor (conditions suspensives purement potestatives dans le chef du débiteur), as this would render such earn-out null and void. However, save in exceptional circumstances, risk appears very remote in this respect. Finally, writers of earn-out clauses should, in particular circumstances such as a sale of a target by tranches, carefully consider whether their earn-out clause could not appear as a lion's share provision (clause léonine), which is prohibited.

When drafting or negotiating earn-out clauses, writers and parties will essentially be attentive to the following non-exhaustive key elements:

PARTIES WILL EACH CAREFULLY CONSIDER AND SELECT THE NATURE OF THE FINANCIAL MILESTONE(S), THE ACHIEVEMENT OF WHICH WILL TRIGGER THE PAYMENT OF THE AGREED EARN-OUT AMOUNT

Firstly, the parties will each carefully consider and select the nature of the financial milestone(s), the achievement of which will trigger the payment of the agreed earn-out amount. There is no rule in this respect. The parties are absolutely free to choose their favorite metric. In Europe, the most common metric on which to base an earn-out mechanism remains, without surprise, EBIT / EBITDA [4], particularly in medium size deals. In the US, EBIT/EBIDTA also remains the most common metric used, but only slightly ahead of turnover-based earn-out. However, any other financial metric could alternatively be used.

Secondly, the parties will agree on a reasonable earn-out reference period, taking notably into account the nature of the underlying business of the target and the handover period with the seller (when applicable).

With a typical earn-out reference period currently ranging between:

(a) 18 and 24 months in small and medium-size deals [5]; and
(b) 6 and 24 months in large deals.

A short earn-out reference period shall increase the risk for the parties to see the business of the target affected (positively or negatively) by an exceptional event. It may also incentivize the seller (still involved in the management) to sacrifice the long-term corporate interest to the benefit of its short-term personal interests. A long earn-out reference period usually provides more comfort to the parties that the financial performance achieved during the reference period will be more representative of the target's real development potential.

Finally, the parties should also ask themselves whether or not the occurrence of certain events should accelerate or terminate the right to receive the payment of the earn-out [6].

---

[3] For more legal details in this respect, see mutatis mutandis, for example, JP Smeets, "Point sur les clauses d'earn out en droit belge", R.D.C., 2016/5, p. 449 and subsequent.
[4] In this respect, the parties will carefully define EBIT/EBITDA, as none of these financial metrics is legally defined and may be calculated in different manners.
[5] According to latest M&A studies, approximately 23% of short earn outs (12 months or less) and 21% of long term earn outs (more than 36 months).
[6] For example, in the case of resale of the target by the purchaser at a higher price during the earn out reference period, or in the case the seller who committed to accompany the target for a determined period after the closing date leaves prior to the end of such agreed period.

PARTIES WILL BE VERY CAREFUL WHEN THE TARGET HOLDS SUBSIDIARIES [...] TO DEFINE CLEARLY THE LEGAL AND ACCOUNTING PERIMETER ON THE BASIS OF WHICH THE FINANCIAL METRICS CONDITIONING THE PAYMENT OF THE EARN-OUT SHALL BE CALCULATED

Thirdly, the parties will be very careful when the target holds subsidiaries and affiliated companies to define clearly the legal and accounting perimeter on the basis of which the financial metrics conditioning the payment of the earn-out shall be calculated. They will also agree specifically on the accounting principles that will be applied (post-closing) for establishing the (pro forma) consolidated accounts to be used for calculating these metrics, especially when the seller's and the purchaser's respective groups do not share the same general accounting principles (GAAP vs. IFRS). The seller will also ask for some customary protections (usually in the form of a series of negative covenants) to prevent the purchaser from adversely amending the structure of the target's group or its financial performances during the earn-out reference period (for example by selling some subsidiaries or merging with the target company, thereby affecting directly or indirectly the earn-out metrics). Moreover, the parties will agree on: (a) the process pursuant to which the (consolidated) accounts to be used for determining whether the earn-out's financial milestones were achieved (or not) shall be prepared and then verified by the parties; and (b) how any dispute relating to these (consolidated) accounts, the calculation of these milestones, and/or the calculation of the earn-out amount itself (as applicable) shall be settled. They will use generally in this respect a process very similar to the one used for establishing closing accounts.

Fourthly, the parties shall agree on some principles concerning the management of the target during the earn-out reference period and list some actions that the purchaser shall not be authorized to take, except with the prior consent of the seller.

The first principle is obviously the maintaining of the seller (or seller's representatives) in the management of the target during such period. These principles will usually aim essentially at protecting the seller against potential attempts of the purchaser to influence the earn-out metrics in a manner detrimental to the seller or against some decisions of the purchaser that could potentially indirectly impact in a negative manner the financial performance of the target during the same period.

Fifthly, the parties shall consider the opportunity to agree on a floor and/or a cap affecting the earn-out(s). In this respect, the purchaser shall often try to cap the (aggregate) earn-out amount to a maximum of 10% to 25% of the target estimated value. In the event of a transfer by tranches, the seller shall in its turn usually ask for a floor for its earn-outs.

Sixthly, the seller shall carefully consider any materially adverse interactions that may occur from time to time between the seller's representations and warranties mechanism and the earn-out mechanism to prevent any situation in which the seller would be adversely impacted twice by a same event.

Lastly, the seller will from time to time try to negotiate the delivery by the purchaser of a form of guarantee to secure the payment of the earn-out amount(s), such as a (first demand) bank guarantee, an escrow account mechanism, and a pledge over part the shares of the target. Unfortunately, such a request of the seller could end-up indirectly depriving the earn-out mechanism of all or part of its appealing strengths for the purchaser, thereby sending the parties back — when these discussions cannot be solved in a constructive manner — to their initial dead end.

Jean-Philippe Smeets
Partner

+352 26 18 44 241
jean-philippe.smeets
@bakermckenzie.com