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WHITE PAPER

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Earnout Provisions: When Litigation Arises and How to Avoid It

The use of earnout provisions, which buyers and sellers often use to bridge differing views of value, is on the rise, especially in the private equity and corporate venture capital markets. This *White Paper* examines how courts have addressed such provisions when disputes arise and strategies that buyers and sellers can take to protect themselves.

INTRODUCTION

According to a 2023 analysis of private mergers and acquisitions transactions, the use of so-called "earnout" provisions is on the rise. Between 2018 and 2022, the use of earnout provisions in non-life sciences deals rose from 13% of transactions to 21%.[1] Simply stated, an earnout provision requires the buyer to make a post-closing payment to the seller if certain performance targets are satisfied during specified post-closing periods (generally, between one and five years). The seller "earns" the post-closing payment if the performance of the acquired business exceeds a certain benchmark, most commonly measured in EBITDA or gross revenue.

Buyers and sellers normally use an earnout provision to bridge the gap between their respective expectations of the value of the business, and macro-economic developments (like the recent increasing interest rate environment and consequences of the COVID-19 pandemic), as well as risks specific to the business. An earnout provision shifts some of the risk of weak post-transaction performance from the buyer to the seller, while still preserving future upside gains for the seller.

But as the use of earnout provisions has increased, so have lawsuits between buyers and sellers. Sometimes the parties dispute whether an earnout provision's performance target was satisfied at all, with sellers claiming the buyer has miscalculated the relevant performance target. Other times, the parties agree that certain performance targets were not met, but the seller alleges the buyer failed to put its best foot forward to meet the performance target, or intentionally slowed progress to keep the target out of reach.

In this *White Paper*, we examine how courts have handled the most common types of earnout disputes so that parties (whether buyers or sellers) can best position themselves to avoid earnout litigation in the first place, and to prevail should a litigation dispute arise.

DISPUTES OVER THE PERFORMANCE TARGET

Earnout provisions are structured to require a post-closing payment when a performance target is satisfied. In most cases, the post-closing payment is tied to revenue or earnings targets. Whether certain revenue and earnings targets have been satisfied may seem simple enough—a matter of basic accounting—but complications can arise when the buyer takes control of the business and makes strategic (or opportunistic) changes. The buyer may change accounting practices (e.g., revenue recognition, reserves) or take other steps (change customer mix, pursue a different line of business) that impact earnings. If the acquired company fails to achieve the earnout target, the seller may request the financial records to identify (or manufacture) an error in the accounting and to present its contrary conclusion.

This change of control over the business, as well as the competing incentives between buyer and seller, create an environment ripe for disputes. Some of that risk can be mitigated by careful attention up front to drafting the provisions governing the earnout trigger. For example, clear provisions governing the metrics used to calculate earnings, delineation of the earnout formula, and the scope of a buyer's ability to change pre-closing operational and financial practices will materially reduce the likelihood of a disagreement over the earnout trigger. Even with careful drafting, however, these provisions, by their nature, often lead to claims by a buyer or seller.

Because such disputes involve accounting questions beyond the ken of most courts, parties often agree to engage an accounting expert to resolve them. But what weight is to be given the expert's decision? And is the expert's decision final, or can it be appealed to a court? Acquisition agreements do not always account for these eventualities, resulting in litigation over the import and applicability of the expert's decision.

Arbitrator or Expert?

Usually the parties' agreement includes a provision that governs earnout disputes, including who will act as the expert if there is a disagreement over the performance target, the scope of that person's authority, and the adjudication process that will apply to the dispute. Sometimes that process is described as an "arbitration." Sometimes it's described as an "expert determination," or some other less-official moniker is used. Theoretically, an "arbitration" should be a formal process and should bind the parties in ways that a simple "expert determination" cannot. But that is not always the case. In several jurisdictions, the features that differentiate the two are unclear or unresolved.

This distinction is important because courts scrutinize arbitration decisions less closely than they do expert determinations. In most jurisdictions, arbitration decisions are evaluated under the Federal Arbitration Act ("FAA") or analogous state law, and courts typically accord substantial deference to those awards.[2] On the other hand, courts scrutinize "expert determinations" with more rigor and are more likely to second-guess them. A party unhappy with an expert's decision might take advantage of an ambiguous earnout provision to get a second bite at the apple, leaving the party that thought it bargained for a binding expert decision with the prospect of rearguing the dispute all over again.

The core question is one of intent. *Sapp v. Indus. Action Servs., LLC*, 75 F.4th 205, 212 (3d Cir. 2023). Did the parties intend for the accountant to act as an arbitrator and for her decision to resolve their dispute with appropriate finality, leaving little (if any) room for scrutiny by a second adjudicator? Or did the parties intend for the accountant to act as an expert, thus leaving her decision open to challenge on grounds that would not otherwise apply if her decision was arbitral?

Parties can make the court's job "easy by explicitly defining the role of the third-party decider."[3] Courts "do not require the magic word, 'arbitration,' to find that parties intended to arbitrate,"[4] but if the parties explicitly state that the decider will be acting as an expert and not an arbitrator, it would take an extraordinary dispute resolution provision to render such language ambiguous.[5]

Unfortunately, in many cases the parties do not explicitly identify the role of the accountant. Worse yet, some agreements include conflicting provisions calling the accountant an "expert not arbitrator" while also granting the accountant authority traditionally reserved to an arbitrator.

In these situations, courts look to other language in the contract to gauge what type of proceeding the parties agreed to. Generally, the more arbitration-like language in a contract, the more likely the parties intended to engage in a more formal, arbitral process. As the court explained in *Bus Air,* "even if there is a convention to use the label 'expert not arbitrator' to signal mere expert determination, the convention to include 'arbitration' terms to signal arbitration is plausibly stronger than the convention to include 'expert not arbitrator' to signal mere expert determination."[6]

When looking for such "arbitration terms," courts are likely to give strong weight to language stating the accountant's decision shall "be a final, binding and conclusive resolution," "shall be non-appealable," or when the contract outlines specific procedural rules for the dispute proceeding that mimic the judicial process.[7] Fundamentally, procedural rules that afford each party the opportunity to present its case are viewed as "a defining characteristic of arbitration provisions."[8] More specific judicial elements like scheduled briefing and arguments, evidentiary rules, and limits on *ex parte* communications can go a long way to establishing the process as arbitral.

In the absence of explicit language (or agreement between the parties) regarding intent, the arbitrator-versus-expert question is a difficult one to answer, and the analysis is heavily fact-driven. To avoid relitigating earnout dispute decisions, parties should state their preference for arbitration as clearly as possible in their agreements, including by creating an adjudication process that has the markings of a judicial proceeding.

The parties can also avoid relitigation and unpredictable results in arbitration by carefully defining the scope of the arbitrator's authority and making it clear that the arbitrator or expert does not have the authority to address or decide issues that the parties do not expressly submit for resolution. Under the FAA and similar state statutes, an arbitral award that exceeds the scope of the arbitrator's authority is one of the few grounds for reversal. This kind of limiting provision can ensure that an arbitrator or expert does not freelance, and also provides protection to both parties from a rogue award.

DISPUTES OVER ACHIEVEMENT OF THE PERFORMANCE TARGET

Even if the parties agree that the acquisition agreement's performance triggers were not satisfied, sellers may believe the buyer acted with some sort of negligent or nefarious intent to frustrate achievement of the earnout—and therefore save itself the earnout payment. To protect the seller, earnout provisions universally impose some sort of standard intended to prevent the buyer from intentionally sabotaging earnout payments. But buyers also require discretion in operating the acquired company, and so usually make explicit their authority over all matters relating to the acquired company.[9] In an attempt to balance these competing interests, buyers and sellers have experimented with a variety of standards to govern the buyer's post-closing conduct. Experience teaches that the particular language chosen has enormous ramifications for both parties should litigation ensue.

Burden of Proof and Burden Shifting

At the threshold, the parties must decide whether payment of an earnout is expected unless earnout conditions are not satisfied (i.e., is extinguished by a condition subsequent) or, conversely, whether an earnout payment is required only after certain thresholds have been met (i.e., the earnout is subject to a condition precedent). The distinction matters because it dictates which party will bear the burden of proof in any litigation.

For example, in *S'holder Representative Servs. LLC v. Shire US Holdings, Inc.*,[10] the buyer of an experimental drug was required to make a $45 million payment upon initiation of Phase III clinical trials. Under the terms of the contract, initiation of Phase III clinical trials was automatically deemed to have begun on a certain date.[11] The obligation to pay $45 million was extinguished, however, under a "circumstance in which material safety or efficacy concerns made it impracticable to produce and sell or to obtain regulatory approval" for the drug.[12] Because the contract made clear that Phase III clinical trials were presumed to have begun by a specified date, the buyer bore the burden of demonstrating the condition subsequent at trial, i.e., that "material safety or efficacy concerns" had relieved them of their duty to perform.

The buyer could have avoided this scenario if the agreement stated that the buyer's "performance under the contract [was] not to become due *until* occurrence of an event," in this case initiation of Phase III clinical trials.[13] In such a situation, the seller would have been obliged to show the event transpired triggering the buyer's duty.

The lesson of *Shire* is clear. If the buyer seeks to put the burden of proving a breach of an earnout provision on the seller, then the buyer should ensure its acquisition agreement clearly states that any earnout payment will not be due and owing unless certain performance criteria are satisfied. Conversely, sellers would benefit by drafting an earnout provision that guarantees payment unless certain performance conditions are not satisfied.

Analysis of the Buyer's Discretion, Efforts, and Intent

A buyer assuming control of a business will want to do just that, and may make changes to operations, business focus, capital improvements, and a host of other adjustments. Any of this activity may impact the acquired company's financial performance and, in turn, the ability to hit earnout triggers. Such post-closing changes are fertile ground for disputes and litigation. That risk can be mitigated with careful drafting to address the scope of the buyer's discretion and how post-closing changes will impact the earnout calculation. This helps set expectations upfront and may narrow the field of potential disputes.

Along those lines, the parties must take care when selecting the level of effort imposed on the buyer to facilitate the earnout or to avoid frustration of the earnout. Sometimes the parties settle on "efforts clauses [to] define the level of effort that the [buyer] must deploy to attempt to achieve" the earnout payment.[14] Such clauses require varying levels of effort, from best efforts, to commercially reasonable efforts, to good-faith efforts.[15] More recently, parties often have chosen not to impose an affirmative effort obligation on the buyer, but to prohibit the buyer from taking any action with the intent and purpose (either sole intent and purpose or at least in part) of preventing achievement of an earnout target.

Both types of obligations on buyers raise factual issues that, if sufficiently pled, may survive a motion to dismiss. If a seller alleges facts giving rise to the plausible inference that the defendant failed to put forth the amount of effort required by the contract to reach the necessary benchmarks, it often will survive a motion to dismiss.[16] And where the seller plausibly alleges that the buyer's actions were motivated to avoid an earnout payment, courts have sustained the claims on a motion to dismiss.[17] Of course, pleading subjective intent is often more of a challenge than pleading an objective lack of reasonable efforts, but courts also tend to apply a lesser level of scrutiny to allegations of intent.

Despite the trend toward allowing these claims to survive motions to dismiss, the parties will be more likely to get out of litigation early (or avoid it altogether) if the contract is explicit about what actions the buyer must take to satisfy the efforts clause and what actions the buyer can take without breaching the intent clause. Determining whether something is commercially reasonable is "contextual and necessarily fact intensive,"[18] and parties using such language in their contract will be well served by providing that context and adopting definitions or citing examples in the contract itself of the necessary effort the buyer must exert.

As for intent clauses, buyers can specify in the contract—in addition to a general right to sole discretion in running the business post-closing—express rights to take certain actions post-closing, which then cannot in and of themselves be taken as a basis for establishing intent to frustrate the earnout payment.[19] Additionally, buyers will benefit in litigation from having records of their legitimate business reasons for taking actions that may negatively affect achievement of the earnout targets.

Causation Analysis

Even if the seller can show that the buyer acted with the requisite intent, it still must show that the buyer's actions—and not larger market conditions—caused the failure to satisfy earnout milestones. The buyer's actions must be the actual cause of the acquired company's failure to satisfy earnout milestones. That is, but for the buyer's failure to perform the contract in good faith, the earnout targets would have been reached. In most cases, the causation question is highly fact intensive and will not be easily addressed at the pleading stage, but it can be a useful defense at summary judgment and trial.[20] Thorough recordkeeping of the acquired company's performance prior to and during the earnout period may support arguments that the buyer's actions did or did not cause the company to fall short of the earnout target.

TAKEAWAYS

Parties should take stock of these takeaways—and draft their contracts accordingly—to avoid the pitfalls described in this piece:

- The more a dispute resolution provision adopts requirements associated with arbitration—or, more specifically, an actual judicial proceeding—the more likely a court is to conclude it is an arbitration provision.

- Courts often deny motions to dismiss claims alleging that a buyer breached an agreement by acting with the intent and purpose to frustrate an earnout provision when the seller alleges particular facts, to allow for a reasonable inference that the buyer had such an intent.

- Recognizing that some parties might rationally decide, in light of leverage or other dynamics, that vagueness works in their favor, parties should carefully draft contract provisions with clarity and specificity.

  a. Parties should consult business representatives and attorneys with expertise in the industry to allow for detailed drafting that is business specific.
  b. Parties should engage accountants and other experts to ensure that target measurement metrics and approaches are clear and simple, to avoid confusion, conflict, and manipulation. They should also ensure that future scenarios that could impact the earnout are considered (e.g., excluding earnings from other lines of businesses or future acquisitions from the earnout calculation).
  c. Parties should strongly consider including a contractual "yardstick" when subjecting an earnout payment to vague standards like "commercially reasonable best efforts" or "operating in the ordinary course."
  d. Parties should draft into the contract specific business decisions, judgments, and actions the buyer is permitted or expected to take to maximize an earnout, or that it is not allowed to make without violating any intent requirements.

- Buyers should maintain documentation of business decisions that may impact achievement of earnout targets.

- Buyers should maintain documentation of the impact of business practices on achievement of milestones.

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ENDNOTES

1 American Bar Association, 2023 Private Target Mergers & Acquisitions Deal Points Study.

2 *See Viacom Int'l, Inc. v. Winshall*, 72 A.3d 78, 83–84 (Del. 2013) (holding that arbitral disputes involving calculations related to the earnout provision are reserved for the arbitrator and not the courts).

3 *Sapp*, 75 F.4th at 212.

4 *Bus Air, LLC v. Woods*, No. CV 19-1435-RGA-CJB, 2022 WL 2666001, at *3 (D. Del. July 11, 2022) (cleaned up).

5 *See Penton Bus. Media Holdings, LLC v. Informa PLC*, 252 A.3d 445, 465 (Del. Ch.), judgment entered (Del. Ch. 2018).

6 2022 WL 2666001, at *3.

7 *Viacom* 2012 WL 3249620, at *3; *Stone v. Nationstar Mortg. LLC*, No. CV 2019-0878-KSJM, 2020 WL 4037337, at *8 (Del. Ch. July 6, 2020).

8 *Ray Beyond, Corp. v. Trimaran Fund Mgmt., LLC.*, No. CV 2018-0497-KSJM, 2019 WL 366614, at *7 (Del. Ch. Jan. 29, 2019).

9 *See, e.g.*, *S'holder Representative Servs. LLC v. Albertsons Companies, Inc*, C.A. No. 2020-0710-JSR, 2021 WL 2311455, at *4 (Del. Ch. June 7, 2021).

10 No. CV 2017-0863-KSJM, 2020 WL 6018738 (Del. Ch. Oct. 12, 2020).

11 *Id.* at *19.

12 *Id.*

13 *Id.* at *18 (emphasis added).

14 *Menn v. ConMed Corp.*, No. CV 2017-0137-KSJM, 2022 WL 2387802, at *34 (Del. Ch. June 30, 2022) (cleaned up).

15 *Id.*

16 *Tendyne Hldgs., Inc. v. Abbott Vascular, Inc.*, C.A. No. 18-1070-CFC, 2019 WL 2717857, at *2 (D. Del. June 28, 2019) (granting a motion to dismiss after finding the complaint contained "only conclusory assertions" and claims that the defendant failed to use Commercially Reasonable Efforts were not supported by facts); *Neurvana Med., LLC v. Balt USA, LLC*, No. CV 2019-0034-KSJM, 2020 WL 949917, at *16 (Del. Ch. Feb. 27, 2020) (same).

17 *Albertsons Companies*, 2021 WL 2311455, at *6–8 (holding that the buyer's actions were "motivated at least in part" by an intention not to meet the earnout milestones because it knew this would result from prioritizing brick-and-mortar business over online business); *Chenega Corp. v. Antkowiak*, 1:19-CV-1329, 2020 WL 9520521, at *6–7 (E.D. Va. May 18, 2020) (denying dismissal where the seller has pled specific actions that give rise to an inference that the buyer's primary purpose was consistent with frustration of the earnouts).

18 *Menn*, 2022 WL 2387802, at *29.

19 *See, e.g.*, *Shire*, 2020 WL 6018738, at *19; *Menn*, 2022 WL 2387802, at *25.

20 *See, e.g.*, *Rubin Squared, Inc. v. Cambrex Corp.*, No. 03 CIV. 10138 (PAC), 2007 WL 2428485, at *6, 10 (S.D.N.Y. Aug. 24, 2007), *aff'd*, 321 F. App'x 14 (2d Cir. 2009) (dismissing claims on summary judgment because the acquired company never approached annual earnings required to meet the earnout target, and, further, the plaintiff presented no evidence demonstrating how the acquired company could have done so even if the buyer had kept its promises); *LaPoint v. AmerisourceBergen Corp.*, No. CIV.A. 327-CC, 2007 WL 2565709, at *9–10 (Del. Ch. Sept. 4, 2007), *aff'd*, 956 A.2d 642 (Del. 2008) (finding seller was entitled only to nominal damages because, even if the buyer had acted in complete good faith, the earnout targets would not have been reached).