MERGERS AND ACQUISITIONS

Revisiting Earnouts During Coronavirus Pandemic

Given the current economic uncertainty, deals done in this environment are likely to make use of earnouts. The authors look at some of the issues parties, particularly sellers, should consider before negotiating earnouts.

By Marc Mantell and Scott Dunberg

While 2019 was another robust year for mergers and acquisitions, deal-making has sputtered in reaction to the Coronavirus pandemic.[1] The current slowdown is partly due to the need for executives to focus on managing their own companies through the crisis, but it is also a result of the tremendous uncertainty in the extent and duration of the crisis and the inability to value target businesses, not to mention liquidity concerns among potential buyers. Given these obstacles, we expect deals that get done in this environment will make frequent use of earnouts. Already a common feature in many deals, earnouts can be a useful tool in times of uncertainty as they allow parties to bridge a valuation gap at time of closing and also allow buyers to manage liquidity outlay over time, in some cases using profits of a target business to fund purchase price.

We last published an article on earnouts in the February 2014 issue of *Insights*, titled "Using Earnouts to Find an Exit,"[2] which highlighted legal and business considerations, including common drafting pitfalls that parties, particularly sellers, should consider before negotiating earnouts. Given the current deal-making environment, we thought it was a good time to look back on a few key issues to see how they evolved over the last several years.

Marc Mantell *and* **Scott Dunberg** *are attorneys at Mintz, Levin, Cohn, Ferris, Glovsky P.C. The authors would like to thank Troy Nichols, an associate at the firm, who contributed to this article.*

Seller Protections and Buyer Diligence Obligations

In the 2014 article, we discussed the express contractual provisions that govern the effort and resources that a buyer must commit to the acquired business.[3] We reported, based on a survey conducted by the Practical Law Company, that 60.5 percent of earnouts included some provision restricting the buyer's discretion to operate the business following the closing of such transaction.[4] Despite the passage of time, that figure appears to be consistent with current earnout practice. The 2019 ABA Private Target Mergers and Acquisitions Deal Points Study noted that 63 percent of transactions with earnouts contain some express restriction on the buyer's discretion to operate the business following the closing.[5] Notably, there may be an upward trend in covenants requiring buyers to operate the business to "maximize" the earnout payments to sellers. As we noted in the 2014 article, the 2013 ABA Private Target Mergers and Acquisitions Deal Point Study, reported that only 6 percent of deals covered in that study included such a covenant.[6]

However, the 2019 ABA Study reports that 17 percent of deals with earnouts included an express covenant requiring the buyer to run the business to "maximize" the earnout.[7] This is a surprising result, as it appears to reverse the trend reflected in prior studies and could signal a strengthening of sellers' bargaining power.[8] However, based on our independent review of several publicly-filed acquisition agreements, including those in the 2019 ABA Study, many of these provisions invoke a "commercially reasonable efforts" or similar standard to the effect that the buyer's obligation is to use *commercially reasonable efforts* to maximize the earnout payments, or some variation of this language.[9] Buyers and sellers should consider whether provisions drafted in

that manner impose a heightened efforts standard on the buyer or a mere "commercially reasonable efforts" standard, despite using the word "maximize." Accordingly, the authors do not believe this notable spike in the 2019 ABA Study signifies a significant shift in earnout practice or the willingness of buyers to obligate themselves to maximize earnout payments when it is not commercially reasonable to do so.

The Implied Covenant of Good Faith and Fair Dealing

In the 2014 article, we addressed the attention given to the implied covenant of good faith and fair dealing,[10] which some courts had invoked to find a buyer's conduct of an acquired business breached an unwritten obligation of good faith and fair dealing owed to sellers of the business.[11] We concluded that discussion with a brief summary of the Delaware Supreme Court's 2013 decision in *Winshall v. Viacom International, Inc.*,[12] in which the court held that the sellers could not rely on the implied covenant to obligate the buyer to maximize earnout payments. The court stated that the parties could have created such an obligation in their contract, but did not do so and reaffirmed the principal that the implied covenant of good faith "cannot properly be applied to give the plaintiffs contractual protections that 'they failed to secure for themselves at the bargaining table.'"[13]

Since the 2014 article, Delaware courts have continued to emphasize the limited applicability of such implied duty.[14] In 2019, in *Oxbow Carbon & Minerals Holdings v. Crestview-Oxbow Acquisition*, the Delaware Supreme Court stated that the implied covenant of good faith is a "cautious enterprise" that "is 'best understood as a way of implying terms in the agreement,' whether employed to analyze unanticipated developments or to fill gaps in the contract's provisions."[15] "Delaware's implied duty of good faith and fair dealing is not an equitable remedy for rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract."[16] Rather, "the covenant is a limited and extraordinary legal remedy."[17] As such, the implied covenant "does not apply when the contract addresses the conduct at issue,"[18] but only "when the contract is truly silent" concerning the matter at hand.[19] Even where the contract is silent

> [a]n interpreting court cannot use an implied covenant to rewrite the agreement between the parties, and "should be most chary about implying a contractual protection when the contract could easily have been drafted to expressly provide for it."[20]

As we concluded in the 2014 article,[21] recent case law continues to support careful and comprehensive drafting of earnout covenants because courts are reluctant to rewrite contracts to include provisions that the parties could have negotiated themselves.

Set-Off and the Implications of Representation and Warranty Insurance

In the 2014 article, we noted that many buyers retain the right to satisfy indemnification obligations of the seller by reducing any earnout payments owed by the buyer to the seller.[22] These set-off rights often provide additional sources of funds and potential leverage to buyers in the context of settling indemnification claims and post-closing disputes. According to the 2019 ABA Study, 66 percent of earnout deals expressly permit buyers to offset indemnity claims against earnout payments, which is similar to the 68 percent number we reported in our 2014 article.[23] However we believe this figure is either too low or too high, depending on whether the deal utilizes representation and warranty insurance (RWI). In 2014, RWI was evolving and used sparingly, but in the current M&A market RWI has become a common tool,[24] especially in private equity transactions. According to the SRS Acquiom 2019 Buy-Side R&W Insurance Deal Study, of the earnout deals that did *not* utilize RWI, 83 percent expressly permitted offsetting indemnity claims against future

earnout payments, while just 3 percent expressly prohibited such offset rights.[25] On the other hand, when RWI was used, only 59 percent expressly permitted offset, while 27 percent expressly prohibited such offset rights. Accordingly, in uninsured deals, a buyer's right to offset indemnification claims against earnout payments is likely even more common than suggested in the 2019 ABA Study.[26] This is unsurprising, as buyers generally will refuse to pay out funds to shareholders when pursuing an indemnity claim against them, given the difficulty of enforcing clawback liability against a dispersed group of sellers. However, these provisions should be carefully drafted to avoid undermining carefully negotiated caps and other important indemnification procedures.

Conclusion

Though M&A activity will ebb and flow deal-making will continue. Private equity funds have plenty of dry powder and will look for buying opportunities among the more reasonably valued businesses.[27] Strategic buyers also will continue to look for ways to grow their businesses and expand market share. We expect many will use creative structures, such as earnouts, to navigate the current challenges and get these deals done. Understanding market trends and potential consequences of various earnout provisions will be critical to successful outcomes.

Notes

1. *See, e.g.*, Cara Lombardo, "Coronavirus Throws Deal Making Into Disarray," *Wall Street Journal*, 2020, *https://www.wsj.com/articles/coronavirus-throws-deal-making-into-disarray-11585652400* (last visited on April 6, 2020).
2. Marc D. Mantell and Scott Dunberg, "Using Earnouts to Find an Exit," 28 *Insights: The Corp. Sec. Law Advisor* (2014).
3. Mantell, *supra* n.2, at 5-9.
4. Mantell, *supra* n.2, at 5 (*citing* Practical Law Co. Corp. & Sec., Survey of Earn-Outs in Recent Deals, at 1 (2012), *https://1.next.westlaw.com/1-5232344?transitionType=Default&contextData=(sc.Default)&__lrTS=20181022062034959* (last visited on April 6, 2020)).
5. Amer. Bar Assoc.'s Bus. Law Section, "Private Target Mergers & Acquisitions Deal Points Study," at 20 (2019). The 2019 ABA Study found that an additional 7 percent were "indeterminable," meaning the actual percentage of deals limiting buyer's discretion to operate the post-closing business actually may be higher than 63 percent.
6. Mantell, *supra* n.2, at 12 (*citing* Amer. Bar Assoc.'s Bus. Law Section, Private Target Merger & Acquisitions Deal Points Study, at 22 (2013)).
7. Amer. Bar Assoc.'s Bus Law Section, *supra* n.5, at 19.
8. *See*, *e.g.*, Amer. Bar Assoc.'s Bus. Law Section, Private Target Mergers & Acquisitions Deal Points Study, at 16 (2015) (finding that in 2014 no deals (0 percent) contained a covenant to maximize an earnout.
9. *See, e.g.,* MYR Group, Inc., Asset Purchase Agreement (Form 10-Q) (Aug, 1, 2018), *https://www.sec.gov/Archives/edgar/data/700923/000114420418041366/tv498391_ex10-1.htm* (last visited on April 6, 2020)
10. Mantell, *supra* n.2, at 7-9.
11. *See, e.g.,* O'Toole v. Genmar Holdings, Inc., 387 F.3d 1188 (10th Cir. 2004).
12. Mantell, *supra* n.2, at 8-9; Winshall v. Viacom Int'l, Inc., 76 A.3d 808 (Del. 2013).
13. *Winshall*, 76 A.3d at 816 (*quoting* Aspen Advisors LLC v. United Artists Theatre Co., 861 A.2d 1251, 1260 (Del. 2004)).
14. *See*, *e.g.*, Oxbow Carbon & Minerals Holdings, Inc. v. Crestview-Oxbow Acquisition, LLC, 202 A.3d 482 (Del. 2019).
15. *Id*. at 507 (*quoting* Dunlap v. State Farm Fire and Cas. Co., 878 A.2d 434, 441 (Del. 2005).
16. *Id*. (*quoting* Nemec. v. Shrader, 991 A.2d 1120, 1128 (Del. 2010).
17. *Id*. (*quoting Nemec*, 991 A.2d at 1128).
18. *Id*. (*quoting* Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC, 112 A.3d 878, 896 (Del. 2015).
19. *Id*. (*quoting* Allied Capital Corp. v. GC-Sun Holdings, L.P., 910 A.2d 1020, 1033 (Del. Ch. 2006).
20. *Id*. (*quoting Nationwide*, 112 A.3d at 897).
21. Mantell, *supra* n.2, at 2, 9.
22. Mantell, *supra* n.2, at 11.
23. Amer. Bar Assoc.'s Bus Law Section, *supra* n.5, at 21.

24. *See* Sean J. Griffith, Deal Ins.: Representation & Warranty Ins. in M&A Contracting, Harvard Law Sch. Forum on Corporate Governance (July 1, 2019), *https://corpgov.law.harvard.edu/2019/07/01/deal-insurance-representation-warranty-insurance-in-ma-contracting/* (last visited on April 6, 2020) ("The use of RWI has surged dramatically in the United States since 2015. It is now extremely common in deals involving *private* targets, where lawyers estimate that it may now be used in half of all transactions.").
25. SRS Acquiom, 2019 Buy-Side Representations and Warranties Insurance (RWI) Deal Terms Study, at 30 (2019).
26. *Id*.
27. *See* Benjamin Horney, "PE Clients See Opportunity Despite Coronavirus Effects," *Law 360* (March 23, 2020), *https://www.law360.com/articles/1253592/pe-clients-see-opportunity-despite-coronavirus-effects* (last visited on April 6, 2020).