Earn-Outs: To have or not to have

Introduction

The process of acquisition of a company, by means of shares or assets, is never a simple one. Structuring the transaction assumes paramount significance in either situation. And, there is never a baseline thumb rule because the goal posts of type of acquisition vary and, then, other subtleties apply which are linked with the nature of the business i.e. to say when the target is engaged in manufacturing or services. Frequently, the seller and purchaser have a different perception of the value of the business which eventually impacts the purchase price. Integrating an earn-out as part of the transaction is quite common, notably, when the target is in the information technology industry even though the seller usually is reluctant to accept a contractual earn-out obligation.

This newsletter examines a few issues surrounding the structuring of an earn-out.

1. The Objective

Traditionally, an earn-out is an agreement by the purchaser of a business to pay additional consideration provided the business meets or exceeds certain performance goals. Parties usually agree on a formula which takes into account certain financial or non-financial measurements for this contingent payment. Frequently, in technology companies this can be based on EBITDA (earnings before interest, taxes, depreciation and amortization). In these cases, it is crucial to ensure that the accounting method used to determine the post-closing measurement matches the accounting method used to determine the pre-closing performance baseline. Usually, an earn-out could provide that the purchaser will pay additional consideration equivalent to a multiple of the amount (say, four times) by which EBITDA exceeds a particular baseline amount. However, parties often mutually agree and determine the elements in the calculation of EBITDA so that a fair comparison is made. The earn-out should address:

- applicable performance measures,
- the specific accounting methods and policies to be applied,
- how much control the acquirer will have in driving the policies even if management control remains with the promoters or key management (and if the seller has leverage, this could become an important post-closing obligation/covenant of the acquirer),
- the time frame for the earn-out, and
- issues such as changes in business strategies that could possibly impact the computation.

Usually, the earn-out provisions propose a maximum figure and staggered payments are made after 24 or 36 months and the bulk of the payment is paid in the last year. Some relevant pointers are detailed further below in the section on Structural Suggestions.

2. Pay Heed

(a). RBI Circular

The Reserve Bank of India manages the inflow and outflow of foreign exchange in the country and, in the last dozen years, has slowly eased and liberalized foreign exchange norms. By virtue of A. P. (DIR Series) Circular 63 issued on April 22, 2009, the RBI provided that "*in case of transfer of equity instruments where the non-resident acquirer proposes deferment of payment of the amount of consideration, prior approval of the Reserve Bank would be required, as hitherto*." Earn-out is a form of deferred payment contingent upon attainment of certain contractual parameters. Clearly, the RBI perceived the earn-out to be a deferment of the consideration for the business and so imposed an express bar on making contingent payments without seeking prior approval. In a global business setting if the target is confident of meeting the agreed parameters based on the growth potential of the business, earn-outs are a good arrangement when the contracting parties are unable to come to a price agreement. However, the usefulness of implementing earn-outs is questionable where the payments are to be made in India due to the contingency of the RBI approval. Of course, if the payments are made to key employees who are living overseas then the question of the RBI approval becomes a moot one. But, that is feasible only if/when the transaction is multi-jurisdictional and the buyer has the flexibility to structure earn-outs for those key employees who reside outside India. There is no clear rationale why this approval should be required and RBI needs to assess the efficacy of retaining such a requirement.

(b). Earn-out is "salary?"

There may be several benefits for the acquirer to adopt earn-outs, particularly if the acquisition is to either gain market access to India or even if it is to strengthen and consolidate existing operations. However, for the individuals another critical issue has emerged arising out of recent jurisprudence. In 2009, the Madras High Court passed a judgment whereby the Court said that an earn-out is linked to continued employment and EBITDA of the company. This case emanated from an appeal against an order of the Authority for Advance Ruling. In other words, the position of the tax authority was that an earn-out has a direct nexus with the continued employment and would be characterized as salary under section 17(1)(iv) of the Income Tax Act (**"ITA"**) viz., *any fees, commission, perquisites or profits in lieu of or in addition to any salary or wages* and, thus, taxable under Section 17 of the ITA as salary income.

However, "salary" is paid by an employer to an employee whereas in the case of an acquirer and a target no such relationship exists.

An ancillary question arises whether the person making the payment i.e., the acquirer, is liable to deduct withholding tax. Interestingly, the ITA is silent on this point. If the earn-out payments are considered to be salary, under Indian law, this would involve withholding tax obligations for the person making such payments. The position continues to be ambiguous and it is necessary that the earn-out payments are structured in a fashion so that there is no nexus with an "employment" arrangement.

3. Structural Suggestions

Where earn-outs form a part of a transaction, it would be correct to say that some of the primary causes of post-closing disputes relate to them. Hence, it is crucial to negotiate and structure them in a manner that would minimize the likelihood of such a dispute. How can this be done? At the outset, identify the earn-out targets, which are usually financial or operational or a combination of the two. For the former, the most common include specified thresholds that are based on revenues, net income or EBITDA. Operational targets may include either an increase in customers or the launch of a particular product. The length of the earn-out period has to be weighed very minutely and must be realistic, usually ranging between 1 to 3 years. In rare cases these can go up to 5 years. Upon successful completion of the specified goals, the three most commonly adopted approaches involve payment of a flat fee, *or* percentage of the earn-out target, *or* a multiple of the amount by which the business exceeds the earn-out target. We have often seen that where the overall transaction consideration is determined based on a specific multiple of the business's EBITDA, then it is appropriate to tie the earn-out to EBITDA. The payment can be a multiple of the overall amount by which the business exceeded the specified target. It is also common to specify a cap, notably when the projections can show that the business could exceed the earn-out target. Other matters requiring attention includes determination of:

- the obligation to prepare the initial financial statements and calculations relating to the earn-out and the corresponding accounting principles.
- the time period(s) for review of the calculations and how disputes will ultimately be resolved. At the cost of repetition, in order to avoid disputes it is imperative the parties are precise in describing the **(a)** accounting principles for the earn-out calculations, **(b)** shared costs and expenses, and **(c)** extraordinary items.

The seller will often require the acquirer to operate the target business in accordance with certain post-closing covenants in order to facilitate the business reaching the earn-out targets. These could be maintaining separate books and records for the business with a periodic right to the seller to inspect such records or, additionally, the seller could require that the acquirer maintains commercially reasonable efforts as well in order to assist the seller in reaching the earn-out targets.

Conclusion

There are no fool-proof and secure methods. The level of earn-out disputes have multiplied so much that specialist firms and practices have emerged focusing on delivering solutions when post-closing obligations are unfulfilled thereby leading to disputes when the sums remain unpaid. Parties tend to forget that the reason why earn-outs are inserted in the first place is due to disagreement on the value of the business which, often times, is caused by lack of information. Perhaps, such decisions should be made upfront so that disputes are avoided. If that is not possible, and assuming that the earn-out is the only route available, it is probably best to negotiate smaller payments throughout the earn-out period that leads to a fiscal gain along the way and not a reward in the end only. In addition, parties considering use of an earn-out should consult their external advisers – financial and legal - to discuss all the possible implications of the accounting treatment of the earn-out, the need to secure a regulatory approval and to build in a lead time for that and, finally, how best to minimize exposure so that the acquisition proves to be efficacious for the parties and creates a win-win situation for all.

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