

An Update on Earnouts in M&A Transactions: *LaPoint v. Amerisource Bergen Corporation*

An earnout is a traditional way of bridging different expectations of value between a buyer and a seller in an M&A transaction. As a contractual mechanism, an “earnout” requires a buyer to pay additional acquisition consideration if the acquired business meets certain performance benchmarks post-close. In a seller-friendly market, earnouts are less common (if a seller is in the driver’s seat they can squeeze full value out of a transaction negotiation, especially if the seller is represented by experienced professionals).



However, as the market adjusts due to economic conditions and credit market changes, buyers are less willing to be as accommodating on valuation. Accordingly, we expect earnouts to become more prevalent in middle market deals.

Given these dynamics, it pays to be reminded of the legal principles of contract interpretation applicable to earnout arrangements. A recent decision issued by the Delaware Court of Chancery in September 2007, *LaPoint v. AmerisourceBergen Corporation*, illustrates the application of these principles in a transactional context.

The Facts and Reasoning of *LaPoint*

In *LaPoint*, the parties agreed to a merger that utilized an earnout, but the parties’ relationship soured as payments came due. The shareholders’ representatives of Bridge Medical, Inc. (Bridge or the Seller), alleged that actions by AmeriSourceBergen Corp. (AmeriSource or the Buyer) and the accounting methods defined in the contract entitled its shareholders to an earnout payment which AmeriSource refused to pay.

By the terms of the merger agreement, the Buyer was required to pay the shareholders of the Seller an earnout if the Bridge business reached certain EBITA targets in 2003 and 2004. Although the parties argue over a number of issues in the case (the Court refers to the transaction, and the relationship between the parties, as a “doomed corporate romance”), the Court applies “common principles of contractual

interpretation” in holding that the language of the merger agreement, and not the intention of the parties (as asserted by AmeriSource), governed the Buyer’s earnout obligation.

First, the court rejected AmeriSource’s argument that EBITA (the basis for the earnout calculations) should be adjusted downwards because the Seller had failed to make appropriate investments in R&D post-closing, as required by the merger agreement. The court held that an EBITA adjustment was not an appropriate remedy (i.e., adjusting the EBITA calculations for earnout purposes because the Seller did not make appropriate R&D investments) because this consequence was not expressly provided in the merger agreement. The court noted that AmeriSource would have “done well to have included in the....merger agreement” an EBITA adjustment provision if the Seller failed to meet R&D spending requirements, but the court declined to draft “any such clause into the agreement *ex post*.”

Next, the court refused AmeriSource’s request to construe the term “average” in a manner other than its “straightforward usage.” Under the merger agreement, sales to certain customers were to be discounted by an “average” discount in determining an adjustment to EBITA for earnout purposes. Specifically, the merger agreement provided that a discount would be determined based on the “[a]verage...[discount] in the last five (5)... contracts executed prior to the execution of the subject contract.” AmeriSource argued that this language required the determination of an “average” discount based on a weighted average (weighted by transaction size), which, not surprisingly, would result in the greatest negative adjustment to EBITA.

The court’s rejection of this position was as follows: “I can see how [the Buyer] might wish that the contract had specified a weighted average, but I cannot understand how the [c]ourt may impose one by fiat.” According to the court, “the most straightforward usage of the term ‘average’ is an arithmetic mean,” thus holding that an arithmetic mean calculation should be used in determining the appropriate EBITA adjustment.

Finally, the court addressed whether generally accepted accounting principles (GAAP) applied in all calculations for determining EBITA (as asserted by the Buyer). While the agreement had a general provision requiring the parties to use GAAP in calculating EBITA, the parties specifically stated that all transactions listed on Annexes to the merger agreement would be adjustments to, and supercede, GAAP. Therefore, because the parties took the time to draft an exhibit to the merger agreement, specifying particular circumstances in which GAAP would not apply, the court would apply those standards.

In total, these changes accounted for an upward adjustment to EBITA of approximately \$6.2 million from the Buyer’s calculations. Given the terms of the earnout provision, this translated into a **\$21 million earnout** award to the Seller’s former shareholders—in a transaction which had a **\$27 million closing payment**.

The Key Lesson from *LaPoint*

In analyzing the terms of the merger agreement, the court latched strongly onto the express language of the contract. Although AmeriSource may have had different intentions when negotiating, the language of the provisions as written did not support the arguments AmeriSource asserted at trial.

LaPoint therefore provides the following important lesson: earnouts can provide a creative way to get a deal closed, but parties must be careful and forward-looking in crafting earnout arrangements - as a court is likely to hold parties precisely to what is written on paper.

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