M&A Series 2:

Earn-Out: Price Adjustment Method in Share Purchase Agreements

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Purchase price is invariably among the most contentious points during the negotiation phase of an M&A transaction. Especially in cross-border transactions, the buyer may wish to minimise risks by opting for alternative payment methods. One is these methods is "earn-out," where a part of purchase price will be calculated by reference to the future financial performance of the target company. Statistics pertaining to the year of 2020, indicate that earn-out clauses were used in around 27% of the acquisitions concluded in the United States. Also, earn-out clauses are frequently being used in share purchase agreements concluded in Europe. This is especially the case in deals involving start-up companies, where the uncertainty increases on the factors of target company's future performance and the buyer does not have any in-depth market experience.

What is 'Earn-Out' Payment?

Earn-out is a purchase price adjustment mechanism in the share purchase agreement under which part of purchase price will be paid in the future upon the fulfillment of certain conditions set out in the agreement. Accordingly, the purchase price is divided into two parts: (i) a fixed amount to be paid at the time of the transfer of the shares, (i.e., at the closing), and (ii) a variable amount to be paid after the closing based on the expectations of future income of the target company. Therefore, the remaining portion of the purchase price is paid to the seller only if the parameters set forth under the share purchase agreement are met. Otherwise, the buyer is not obliged to pay an earn-out payment in addition to the fixed amount. The earn-out amount to be paid in the future would often range from 20% to 30% of the total purchase price. In addition, larger or lower percentages can be arranged on a case-by-case basis.

Earn-Out Parameters

Earn-out clauses should be designed in a way to avoid a conflict of interest and to reach a balance between the parties. Thus, the starting point for triggering a fair earn-out claim is the calculation of target company's objective financial data. Objective financial data related to the target company's financial status can comprise of budget targets, such as cash flow, balance sheet income, gross or distributable profit, annual turnover, EBIT (earnings before interest and taxes), and EBITDA (earnings before

interest, taxes, depreciation, and amortization). However, such calculation formulas may not reflect the actual financial position of the target company, thus buyers prefer to agree on achieving certain turnover targets instead of using foregoing target values. EBITDA is one of the most preferred parameters since the buyer has less possibility to manipulate the costs.

Non-financial parameters can also be decided upon to determine the future payment of the purchase price. In general, non-financial events are being used as a basis while acquiring start-ups and companies operating in regulated sectors, such as condition of seller's remaining their role in the company management post-closing or obtaining necessary official permissions. For example, in the acquisition of a start-up company where the future performance of the target company is tied to the seller's management, the parties may negotiate on the seller's executive role in the target's management for an earnout time period. Henceforth, the seller is entitled to receive the remaining purchase price only at the end of such time period. Similarly, for a target company operating in pharmaceutical industry, acquiring official permissions or a patent can be envisaged under the share purchase agreement as a condition for earn-out payment. In this respect, the seller will only be able to receive the remainder of the purchase price after obtaining the official permission or patent.

On the other hand, parties may also agree on both financial and non-financial parameters at the same time under the share purchase agreement.

Why Earn-Out?

Earn-out offers a fair value to both the buyer and the seller. Generally, seller will be paid with the fixed price at the closing, and the remainder of the purchase price is dependent upon the occurrence of certain parameters agreed on between the parties. That being said, for the parties this has the advantage that the buyer only pays a portion of the purchase price upfront and eliminates uncertainties regarding the future performance of the target, and the seller is to receive additional compensation in the future if the business achieves financial or non-financial goals which they envisage.

Earn-out arrangements are effective ways of holding the seller responsible for the information they provide about the expectation of target company's future state. Furthermore, an earn-out clause can also be attractive for the seller, as it gives them the possibility of benefiting from a longer-term successful transaction beyond the purchase price.

As a result, the interests of buyer who may suffer from the uncertainties and risks regarding target company's future financial performance can be insured by providing an earn-out protection. For this reason, use of earn-out clauses are increasing drastically in due course particularly in acquisitions of start-up companies, and such arrangements become more attractive for both buyer and seller in case the parameters are formulated correctly.

Earn-out Mechanism under Turkish Law

Earn-out is not specifically regulated in Turkish law. However, Turkish law allows parties to agree on a purchase price payable upon the fulfilment of certain conditions, thus it does not prevent the implementation of earn-out mechanism. Moreover, price determination based on the fulfilment of certain condition in the future refers to the existence of retarding condition [*geciktirici koşul*]. To be precise, terms and conditions of the share purchase agreement subject to the earn-out payment can be referred as a retarding condition within the scope of Article 170 of the Turkish Code of Obligation Law No. 6098 ["**TCO**"].

As mentioned above, such retarding condition can be determined based on the future financial expectations or the occurrence of the non-financial events. In this respect, the seller will not be entitled to receive the relevant portion of the purchase price until the condition is fulfilled. That part of the purchase price will be due and payable to the seller only after the delaying condition is fulfilled.

Article 175 of the TCO is worth mentioning here. Pursuant to this provision, if the buyer assuming control following the share transfer prevents the fulfilment of conditions set out in the share purchase agreement in order to avoid the obligation to make the earn-out payment, the relevant condition could arguably be interpreted as being met, and the seller becomes to be entitled

to the earn-out payment due to the buyer's actions in bad faith. Again, depending on the characteristics of the earn-out agreement, the TCO's provisions on sale and mandate contracts may be applied by analogy.1

Earn-out-Related Disputes

An earn-out agreement is attractive for both the seller and the buyer: while the seller is entitled to a higher purchase price upon the success of the company, the buyer will pay a part of the purchase price instead of total purchase price only if the conditions are fulfilled. However, earn-outs are one of the main grounds of disputes between the parties. For instance, buyer's strategy in long-term investment plans, or transferring a large percentage of the company's assets, or investing in other companies would highly likely affect seller's future earn-out receivable, thus cause a dispute between the parties.

Hence, not only the value and calculation of the purchase price to be paid in the future, but also the factors which would affect the amount of the earn-out payment should be considered during the negotiations. At first, restrictive covenants can be envisaged in the agreement so as the seller to retain a level of control over the operations of the target or to prevent the buyer from making significant changes that may lead to decrease in the earn-out amount. Also, in cases where buyer's decisions affects the target's economic activity, and therefore cause loss in the company, the earn-out payment can be calculated as if no loss has been occurred.

[1] For more information on the earn-out clauses in Turkish law and applicable provisions of the TCO, please see Atamer Y.M. / Altunbaş Sancak Z., Earn-Out Clauses in Share Purchase Agreements- A Comperatibe Overview, BATIDER 2019, Issue 3, pp.97-136.