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Negotiating Earnout Provisions in Acquisition Pacts

So-called “earnout” provisions are a common feature of business acquisition agreements. Under an earnout provision, the purchase price for the acquired business is increased if the business meets certain financial performance targets over a specified period following the purchase.

A recent North Carolina decision highlights the importance of thoughtful planning and careful drafting in incorporating such a provision in an acquisition agreement.

‘Avesair Inc. v. InPhonic’

*Avesair Inc. v. InPhonic Inc.*¹ concerned a transaction in which the defendant, InPhonic, a distributor of mobile phones and provider of wireless services to consumers, purchased the business and assets of the plaintiff, Avesair, a company that had developed technology for delivering targeted marketing messages to mobile devices.

The purchase price, payable in the form of shares of buyer’s stock, was \$7 million, subject to possible increase under an earnout provision. The terms of the earnout were that buyer would issue up to an additional \$4 million of its shares to seller if buyer’s gross revenues from the acquired business exceeded \$2 million during a 12-month period ending after the closing. The actual number of additional shares to be issued was to be computed on a sliding scale, based on how far such gross revenues exceeded the \$2 million threshold during the earnout period.

In addition to those rather unremarkable earnout terms, however, the purchase agreement also included a more unusual, default-type provision. The agreement provided that, regardless of whether the \$2 million gross revenue threshold was attained during the earnout period, seller would be entitled to the maximum possible earnout amount (\$4 million in shares), if buyer either (1) failed to use “commercially reasonable efforts” during the earnout period to sell products or services derived from seller’s intellectual property, or (2) terminated certain of seller’s employees whom buyer hired at the closing or (3) failed to provide “outside audited financial information” at the end of the earnout period.

It was this default provision that was the subject of the lawsuit in *Avesair*, in which seller sued buyer for payment of the entire earnout amount. Seller claimed that it was entitled to the entire \$4 million



additional payment on the grounds: first, that the buyer had not used the required commercially reasonable efforts to sell the products and services and, second, that buyer had not provided seller with the required audited financial information.²

The decision in *Avesair* was a ruling by the trial court on summary judgment motions by the parties solely on the issue of whether seller was entitled to the full earnout amount under the default provision because of buyer’s alleged failure to provide the post-closing financial information contemplated by the purchase agreement.

Applying Delaware law, the court ruled in favor of seller and awarded seller the full \$4 million additional amount it sought. In reaching that result, the court addressed two major issues, one a question of contract construction and the other a question of the enforceability of a supposed liquidated damages clause. Both issues could have been anticipated—and perhaps avoided—by more careful contract drafting.

First Issue

• The first issue the court addressed was whether buyer had provided seller with the “outside audited financial information” referred to in the contract. The contract was unclear, however, as to just what kind of financial information that was supposed to be. The section of the agreement most immediately at issue in the dispute simply said that seller would be entitled to the additional \$4 million “if outside audited financial information is not provided” at the end of the earnout period, without specifying exactly what kind of financial information buyer was supposed to provide or even what was meant by an “outside audit.”

Further confusing matters, the next section of the agreement provided that “[f]or purposes of determining whether Seller is entitled” to the additional \$4 million payment (either under the earnout section or the alternative, default provision described above) buyer was required at the end of the earnout period to deliver to seller a statement “signed by an officer of Buyer setting forth the actual amount of the gross revenues and the basis for such calculation.” The agreement did not, however, require that this revenue statement be audited.

As to the question of what kind of financial information the phrase “outside audited financial information” was meant to refer, one might reasonably suppose that it was the dollar amount of buyer’s gross revenues from the sale of seller’s products and services. This is both because the earnout formula in the agreement referred only to those gross revenues and because buyer’s post-closing revenue report was only required to report gross revenues. That is not, however, what the court concluded.

Instead, the court found the phrase “outside audited financial information” to be ambiguous, permitting it to consider extrinsic evidence as to what the parties intended by that phrase. The court also noted that the agreement had been drafted by the buyer’s lawyers and cited the well-established principle of contract construction that ambiguities in a contract are to be construed against the drafter (in this case, buyer and its counsel).

The court then quoted at length, as extrinsic evidence of the parties’ supposed intention, an affidavit from one of seller’s directors. In the affidavit, the director said that the default provision was “designed to avoid litigation over the earnout agreement” and claimed that buyer’s revenues would exceed the \$2 million threshold and trigger an earnout only if buyer used “commercially reasonable efforts.”

From this, the court agreed with seller that the purpose of the provision calling for “outside audited financial information” was to provide seller with the kind of information the court said seller “would need” not simply to verify the amount of gross sales but also the reasonableness of buyer’s commercial efforts in achieving those sales.

The failure of buyer and its counsel to include in the agreement a clear description of what kind of financial information buyer was expected to provide thus invited the court to accept uncritically seller’s claim that a fundamental purpose of the provision was to allow seller to determine the reasonableness

