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Navigating Earn-Out Disputes: Key Considerations for Private Funds

The Capital Commitment on **May 27, 2025**

Times of economic volatility often increase disparities between a seller's valuation and the buyer's valuation of the same company. Earn-out provisions are one tool frequently used to address such disparities. An earn-out provision requires the buyer to make one or more post-closing payments (the "earn-out consideration") to the seller if the company being sold (the "earn-out entity") meets certain milestones during a defined post-closing period (the "earn-out period," which is usually between one to five years). These milestones may include EBITDA, gross revenue, net income, the expansion of the business into defined geographic or product areas, or other metrics.

Earn-out provisions can be fertile grounds for post-closing disputes between the seller and buyer. Specifically, earn-out provisions often lead to disputes as to whether the identified milestones were satisfied during the earn-out period, and if so, the amount of earn-out consideration that the buyer is obligated to pay. First, the seller and buyer approach earn-out provisions with competing incentives. The seller is motivated by the opportunity to receive further consideration for the transaction. Meanwhile, the buyer may be incentivized to argue that the identified milestones have not been met, and thus the seller is not entitled to any additional consideration. The seller may respond to such arguments by arguing that the buyer failed to make appropriate efforts to manage the earn-out entity in a manner to meet those milestones.

As earn-out provisions are often used in private equity merger and acquisition transactions involving portfolio companies, the management team is often left with the task of interpreting the earn-out provision and applying it to the performance of the portfolio company. While it is impossible to eliminate the risk of a dispute related to an earn-out provision, there are steps that can be taken to mitigate that risk, both pre- and post-closing.

One category of disputes that can result from an earn-out provision are disputes related to the milestone(s) identified in the earn-out provision. Earn-out milestones often rely upon metrics such as EBITDA, gross revenue or net income. When drafting the earn-out provision, the parties may believe that determining whether such well-recognized accounting metrics have been achieved will be straightforward. However, once control of the earn-out entity passes to the buyer, it may alter the company’s accounting practices or make other operational decisions that impact the company’s financial performance. Meanwhile, earn-out provisions often require the buyer to produce post-closing financial documents to the seller so it may analyze whether the milestones have been met. The seller’s review of those financial documents can fuel arguments that accounting practices or other vehicles have been used to prevent the milestones from being met.

The best way to mitigate this particular risk is for the parties to focus on the precise language in the earn-out provision related to the milestones. They should consider whether to include any limitations on the buyer’s power to alter accounting practices, such as the use of inter-company debt to finance the earn-out entity, and the company’s operations. The buyer and seller should consider including examples of how the milestones will be calculated and what specific documents the buyer will need to provide to the seller to review those post-closing calculations.

In two recent cases, *Fortis Advisors LLC v. Johnson & Johnson* (“*Johnson & Johnson*”) and *Shareholder Representative Services LLC v. Alexion Pharmaceuticals* (“*Alexion*”), the Delaware Court of Chancery has emphasized the use of “bespoke” earn-out provisions to mitigate this category of risk. The court noted that earn-out provisions must be tailored to the specifics of the company involved in the transaction and its products and emphasized the importance of counsel and their clients working closely together to craft language that addresses the details of how the company’s operations impact the milestones.

Another category of risk lies in the seller's argument that the buyer purposely or negligently impacted the earn-out entity's performance to preclude it from meeting the identified milestones, and thus avoiding the payment of some or all of the earn-out consideration. Earn-out provisions frequently require the buyer to use "commercially reasonable efforts," "good faith efforts," "best efforts" or some similar variation in their operation of the earn-out entity. In *Johnson & Johnson*, the court noted that "there is no agreement in case law over whether [these phrases] create different standards" and Delaware courts have viewed some of these provisions, especially those that include the term "reasonable," as "largely interchangeable."

The threshold issue related to this particular risk is to identify whether the earn-out consideration is expected ***unless*** the earn-out milestones are not satisfied, or whether the earn-out consideration is required ***only after*** the milestones have been met. The difference in approach impacts which party has the burden of proof in any litigation.

In addition, the risk related to "best efforts" provisions or similar terms can be mitigated by including explicit language about what the buyer needs to due to satisfy the "best efforts" clause. Obviously, the analysis of whether certain actions satisfy a "best efforts" clause is factually dependent, and the more detail the parties can agree to include in the earn-out provision, the less risk they will have a dispute whether the buyer has satisfied such a provision. Another alternative is to avoid such terms completely and instead include language that prevents the buyer from taking actions with the intent or purpose to prevent the earn-out entity from meeting the milestones.

In sum, the use of an earn-out provision usually comes with increased risks of a post-closing dispute. The best way to mitigate that risk is to invest time in the discussions and drafting of the earn-out provision and to ensure that the provision is specifically tailored to the earn-out entity and its products.

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