SPEAKMAN LAW

SPAs – Earn Outs and Warranty Caps

Conceptually earn out arrangements are a convenient way of managing price expectations and risk for both sellers and buyers in the context of business and share sale and purchase agreements (**SPAs**). The concept behind them is to link part of the purchase price to actual earnings performance of the business for the agreed earn out period (usually 1 year) post acquisition. Where earnings during the earn out period are above expectations, the seller is compensated; conversely if earnings are below expectations the seller's return is reduced and the buyer is shielded against overpaying for the business.

An earn out arrangement is commonly coupled with a services agreement by which the seller or its senior executives are retained by the buyer for an agreed period post acquisition. This facilitates transition of supply and customer relationships to the buyer.

Both sellers and buyers therefore share some encouragement for an earn out arrangement in negotiating a SPA. But they are a devil to negotiate and this often leads to abandoning the idea and blaming the lawyers for over complicating the deal.

The difficulty in negotiating them lies in the protections that the seller seeks in order to ensure that the earnings of the business during the earn out period are not manipulated by the buyer in any way. Most buyers have no intention of manipulating earnings with the design of prejudicing the seller. But problems arise because buyers do not wish to be constrained in making investment choices for the business.

For example a buyer may, at some time during the earn out period, wish to make capital improvements and these may impact on the earn out amount for the seller. The buyer will not wish to be hamstrung in these respects, hence some carve out will need to be agreed between the buyer and seller that permits the buyer to make the improvements without any prejudice to the seller. But what if the buyer thinks fit to offer existing employees a salary increase? This will, in the short term, decrease the earnings in the business (and reduce the seller's earn out payment). Or, the buyer may think it sensible for the business to reduce its prices for its products/services, in order to meet the market. Again this will reduce earnings in the short term and reduce the seller's earn out payment. Should a buyer not be free to make these sorts of business decisions?

These are just some examples of ordinary business decisions for which a seller will want protection in order to protect the balance of the purchase price payable to it on account of the earn out. The buyer will not wish to be constrained from making these sorts of "normal" business operating decisions. Commonly, this tension causes a breakdown in negotiations around earn outs and the parties return to the idea of a fixed price for the business. One possibility is to base the earn out amount on gross profits. This at least takes away the need for many of the seller's protections, but significantly shifts risk to the buyer. In short, negotiating earn outs is not easy.

Nor is negotiating warranty caps easy. Warranties are in effect another form of protection for the buyer from overpaying for the business. They also force disclosure by the seller of all items that are material to operating the business. Their primary effect is to allocate risk between buyer and seller; the greater the risk in the business, as perceived, by the buyer, the greater level of warranty protection that the buyer will seek.

This also translates to the appropriate caps on warranties. Sellers invariably want a "clean" exit without fear of comeback by the buyer. Buyers on the other hand want shelter against the cost of inheriting a liability that was not of its own making and which the buyer did not know existed. In this context, it is arguable that a buyer should not accept a warranty cap at all. This is not in tune with market practice however. So where should the level of warranty cap be?

There is no right or wrong answer to this question. It is all about the parties' respective viewpoints regarding the risk in the business (or share parcel) that is being transferred. Some points of principle can be stated however:

- Warranty caps are usually set at a fixed sum or a percentage of the purchase price – the larger the deal, the higher they are set.
- There is usually no cap on tax or environmental warranties.
- Often there is no cap on warranties of title to assets.

Time limitations also are relevant in this context. For non-tax warranties the period of time within which a buyer may bring a warranty claim is usually 18 months to 2 years (which ensures the buyer has the benefit of financial accounts for the first year, at least, to identify any cause for a warranty claim). For tax warranties, mostly these are linked to the period within which the IRD may issue an increased assessment – the IRD is ordinarily statute barred from doing so at the end of the fourth income year after the year in which the taxpayer files it tax return. This loosely translates to 5 years.