

# Earn-Outs in Private M&A Transactions

*Presented by Clint Rancher and Michael Mazidi*

# Presenter Bios



## Clint Rancher – Corporate

Partner | Houston  
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Clint Rancher represents public and private businesses in a broad range of corporate and securities matters. He represents clients in IPOs, public offerings and private placements of equity and debt securities, liability management transactions, mergers and acquisitions and general corporate concerns, including Exchange Act reporting and corporate governance. He has substantial experience representing upstream, midstream and oilfield services companies in the energy industry.

In 2023, Mr. Rancher was recognized for his legal work and for his dedication to clients. The Legal 500 U.S. included him in its rankings for U.S. M&A: large deals (\$1bn+), Chambers USA listed him in the Energy: Oil & Gas Transactional category, and BTI named him a "Client Service All-Star." Prior to joining Baker Botts, Mr. Rancher worked in the assurance practice of PricewaterhouseCoopers L.L.P.

### Education / Honors

J.D., Georgetown University Law Center 2008  
*magna cum laude*  
Order of the Coif

M.P.A., The University of Texas 2002  
Sommerfeld Scholar  
Dean's Award

B.B.A., Accounting, The University of Texas 2002  
*with highest honors*

### Select M&A Experience:

- Cabot Oil & Gas Corporation—\$17 billion merger of equals with Cimarex Energy Co. to form Coterra Energy Inc.
- CenterPoint Energy, Inc.—formation of midstream joint venture with OGE Energy Corp. and ArcLight Capital Partners with assets over \$11 billion
- Schlumberger Limited—\$11 billion acquisition of Smith International, Inc.
- CenterPoint Energy, Inc.—\$7.2 billion acquisition of Enable Midstream Partners, LP by Energy Transfer LP
- Encore Acquisition Company—\$4.5 billion acquisition for cash and stock by Denbury Resources Inc.
- Chesapeake Energy Corporation—\$4 billion acquisition of WildHorse Resource Development Corporation
- John Wood Group PLC—\$2.8 billion sale of well support division
- CenterPoint Energy, Inc.—\$2.15 billion sale of Arkansas and Oklahoma natural gas LDC businesses
- John Wood Group PLC—formation of joint venture with Siemens AG with assets over \$1 billion
- Seadrill Limited—\$960 million acquisition of Aquadrill LLC
- John Wood Group PLC—\$300 million aggregate acquisitions
- Petroleum Geo-Services ASA—\$210 million sale of onshore seismic business to Geokinetics Inc.
- Patterson-UTI Energy, Inc.—multiple acquisitions of pressure pumping assets

# Presenter Bios



## Michael Mazidi – Corporate

Associate | Houston  
michael.mazidi@bakerbotts.com

Michael Mazidi represents public and private companies in mergers and acquisitions, securities offerings and general corporate matters. Michael also advises clients on securities compliance issues, including Exchange Act reporting.

### Education / Honors

J.D., The University of Texas School of Law 2020  
Research Editor, *Texas Review of Litigation*  
Research Assistant for Professor Henry T.C. Hu

B.A., Philosophy, The University of Texas 2014

### Select M&A Experience:

- Cabot Oil & Gas Corporation's \$17 billion merger of equals with Cimarex Energy Co. to form Coterra Energy Inc.
- Noble Corporation's \$292 million divestment of four jackup rigs
- Crestwood Equity Partners LP's \$1.8 billion merger with Oasis Midstream Partners LP
- Composite Advanced Technologies, Inc in its acquisition by Apollo Funds (transaction value undisclosed)
- Hi-Crush Inc. in its \$450 million acquisition by Atlas Energy Solutions Inc. (mix consideration between shares, cash and seller note)
- Edgewater Midstream LLC's \$235 million acquisition of certain pipeline and terminal assets from Shell USA, Inc.
- Sayona Mining Limited's pending \$650 million merger of equals with Piedmont Lithium Inc.
- Vitesse Energy, Inc.'s \$220 million acquisition of Lucero Energy Corp.
- Transocean Ltd. in formation of \$200 million joint venture with affiliates of Lime Rock Management L.P. and Perestroika A.S.
- Halliburton in formation of joint venture with Siguler Guff for emissions management software (transaction value undisclosed)
- Transocean Ltd. in buyout of joint venture interests of Hayfin Capital Management LLP (mixed consideration share issuance and senior notes)
- Transocean Ltd. in buyout of joint venture interests of Lime Rock Management L.P. and Perestroika A.S. (consideration of share issuance)

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# 1. What is an Earn-Out?

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A contingent portion of purchase price that becomes payable post-closing only if the target company or specified asset or business line satisfies agreed performance targets (financial or operational) during a defined measurement period.

**An earnout is an agreement to litigate later.**

- ***Situations Where Earn-Outs Are Common***
  - Highly volatile industries or times of macro-uncertainty (e.g., pandemic)
  - Turn-around stories following temporary earnings dip
  - Little operating history; targets with new technology or unproven products
  - Early-stage companies with limited operating history
  - Difficulty obtaining upfront financing
  - **Common denominator: Use when bridging a valuation gap**

# 1. What is an Earn-Out?

## Sample provision

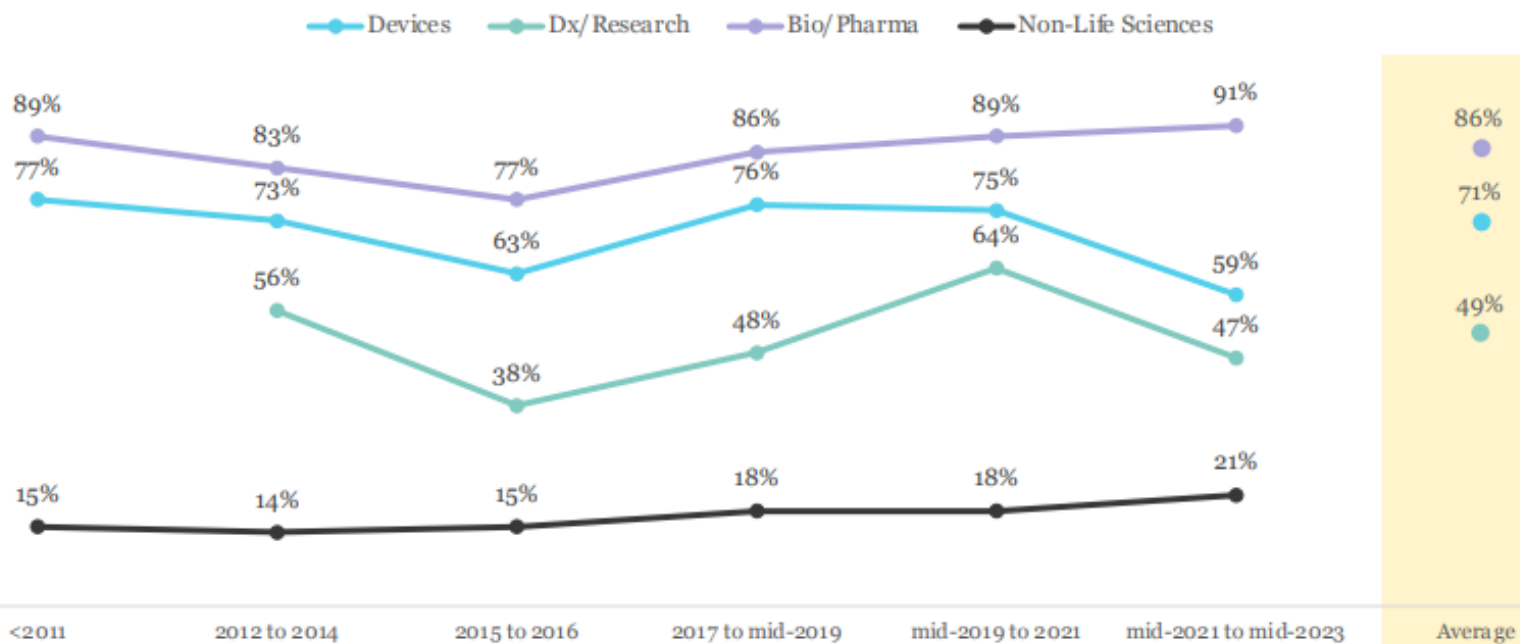
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*“As additional consideration for the Purchased Assets, at such times as provided in Section 2.3(d), Buyer shall pay to Stockholder Representative with respect to each Calculation Period within the Earn-Out Period an amount, if any (each, an “Earn-Out Payment”), equal to the product of (i) an amount equal to (A) the Adjusted EBITDA for such Calculation Period, minus (B) the EBITDA Threshold for such Calculation Period; multiplied by (ii) the Earn-Out Multiple; provided, that in no event shall Buyer be obligated to pay Stockholder Representative more than \$[NUMBER] [for any Calculation Period/in the aggregate for all Calculation Periods during the Earn-Out Period]. If the Adjusted EBITDA for a particular Calculation Period does not exceed the applicable EBITDA Threshold, no Earn-Out Payment shall be due for such Calculation Period.”*

# 1. What is an Earn-Out?

- *Prevalence of Earn-Outs*

Percent of deals with an earnout – Life Sciences sectors and other industries



# 1. What is an Earn-Out?

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- ***Buyer Perspective***

- Bridge valuation gap, protect downside
- Pay for actual post-closing performance, mitigates over-payment risk
- Defers cash when financing is tight (*i.e.*, an interest-free seller loan)
- Shares future risk with seller; aligns incentives of retained management
- Allows aggressive headline number in competitive bid without full cash commitment

- ***Seller Perspective***

- Bridge valuation gap, preserve upside
- Potential to benefit from buyer synergies
- May obtain higher headline price in an auction

## 2. Major Components of an Earn-Out

### *Performance Metrics*

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- ***Common Performance Metrics***

- Financial Metrics – revenue, EBITDA, net income
- Operational Metrics – number of new customers, units sold, clinical trial phases, regulatory approvals
- Hybrid Metrics – combination or tiered approach (*e.g.*, revenue year 1, EBITDA year 2)

- ***Non-Financial (Milestone) Performance Metrics***

- Regulatory approval (FDA, CE mark)
- Patent issuance
- Launch of specific product features
- Award of government contract
- Benefits: objective binary triggers; less susceptible to accounting manipulation

# 2. Major Components of an Earn-Out

## Performance Metrics

Common Financial Metric	Pro	Con
Revenue	Easier to measure, less accounting judgment	Ignores cost control
EBITDA	Aligns with enterprise value, factors in costs	Susceptible to allocation disputes
Net income	Comprehensive	Heavily influenced by accounting policies

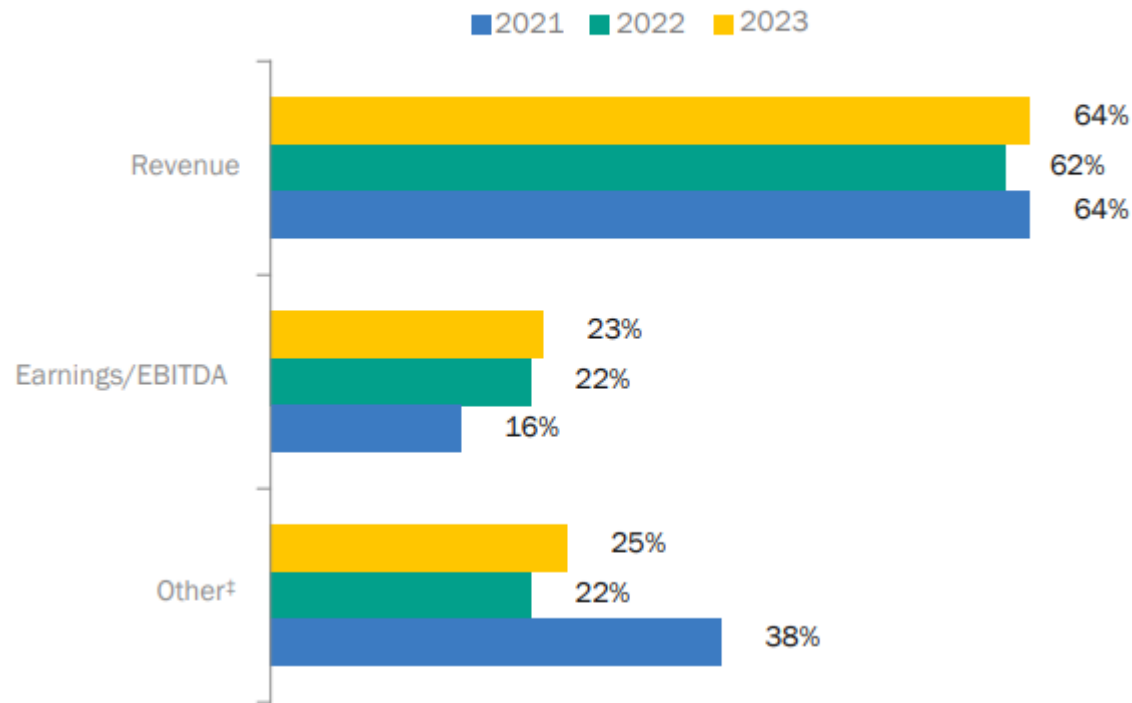


*"Let me get this, but keep in mind that you'll pay for it in other, more subtle ways later on."*

# 2. Major Components of an Earn-Out

## Performance Metrics

### EARNOUT METRICS†



† Earnouts can include more than one metric, such as a combination of revenue and earnings.

‡ Examples: unit sales, product launches, divestiture of assets.

## 2. Major Components of an Earn-Out

### Measurement Period and Mechanics

- Typical length: 1-3 years (outliers 4-5 years in life-sciences)
- Single “bullet” payment vs. annual or quarterly instalments
- Seller bias toward shorter periods; buyer may prefer longer to avoid short-termism and to smooth ASC 805 fair-value accounting swings

#### Accounting Matters

- Tax Treatment
- Accounting Treatment
- Payment currency



**“Everything was fine until you insisted on transparent accounting!”**

## 2. Major Components of an Earn-Out

### Payment Formula

- Fixed dollar tiers (e.g., \$5MM if EBITDA  $\geq$  \$20MM)
- Sliding scale / percentage of metric (e.g., 10% of EBITDA above \$18MM)
- Multiples of excess performance
- Caps and collars to limit exposure; floors to ensure minimum

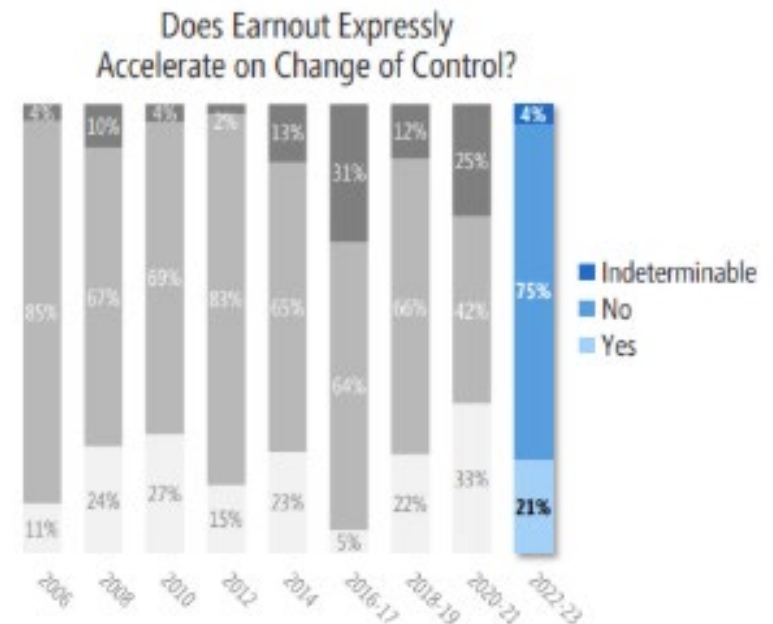


*"It's all there, but my life is such a mess right now I didn't have time to organize it."*

## 2. Major Components of an Earn-Out

### Miscellaneous Provisions

- Security
  - Cash escrow (rare; capital inefficient for buyer)
  - Parent guaranty (typical if acquisition vehicle is thin)
  - Security interest in target equity/assets
  - Subordination/standstill issues if lenders require
- Acceleration
- Buyout Option
- Right of Offset



# 3. Post-Closing Covenants

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- **Seller seeks:**
  - Obligation to operate “consistent with past practice,” per agreed budget or to achieve earn-out targets
  - Minimum working capital / dedicated personnel
  - Prohibition on diverting business, charging affiliate overhead, or selling assets
- **Buyer resists**, seeking maximum flexibility to run the business

**“Even the most carefully drafted agreement will harbor residual nooks and crannies for the implied covenant to fill.”**

*ASB Allegiance v. Scion Breckenridge (Del. Ch. 2012).*

# 3. Post-Closing Covenants

- **Efforts Standards – Hierarchy & Drafting**
  - “Best Efforts” – highest, near-fiduciary; rare
  - “Commercially Reasonable Efforts” – objective standard, majority Delaware usage
  - Explicit disclaimer: Buyer owes no duty to maximize earn-out absent express language (e.g., *Collab9 v. En Pointe*, 2019 WL 4454412 (September 17, 2019))
    - Delaware courts have held that the implied duty of good faith and fair dealing requires that the buyer not take any affirmative action *for the purpose* of frustrating the achievement of an earnout target

**Best practice:** Define efforts standard and, if possible, list required actions/exclusions. Because Delaware courts tend to emphasize contract language and facts and circumstances, more is often more when drafting an earn-out provision.



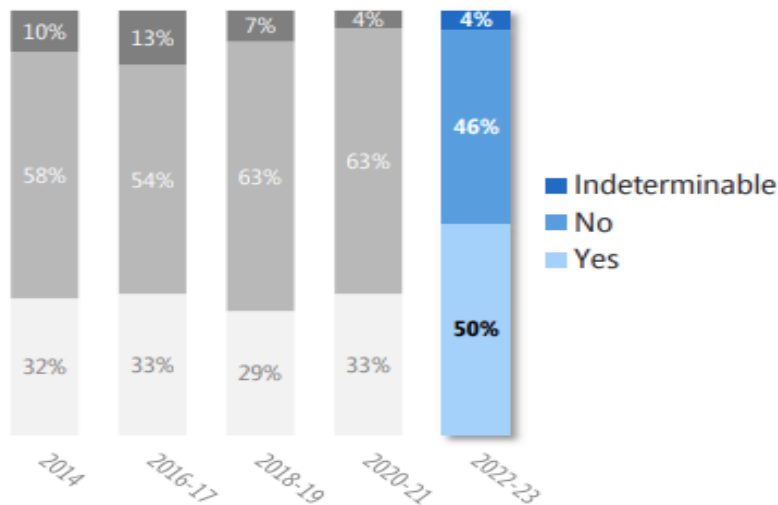
*“We’ve decided that it will be better for his later development if we speak to him only in legalese.”*

# 4. Delaware Case Law Landscape

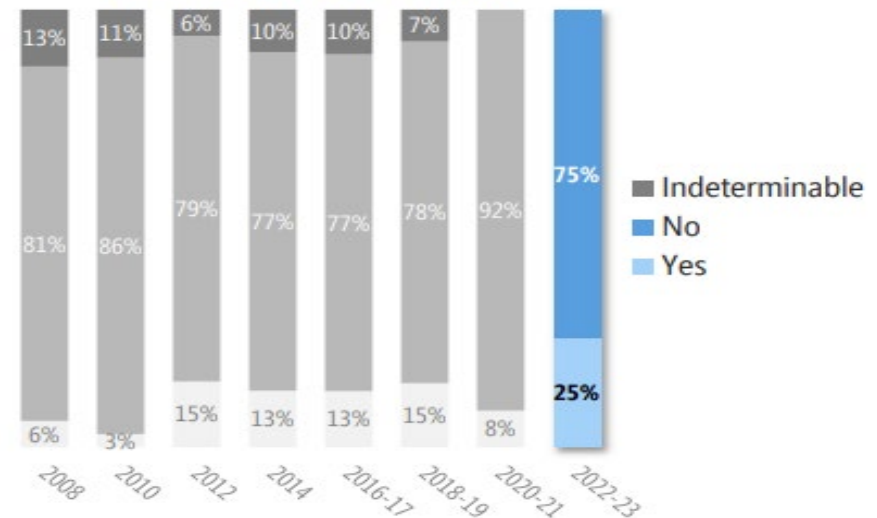
- Traditional tilt toward buyers; recent trend is more seller-friendly (6 of 7 major 2021-23 opinions favored sellers)
- High chance of litigation if targets not met

**Most earn-out litigation focuses on whether the buyer has breached its general efforts obligations or specific covenants with respect to post-closing business operations.**

Includes Right of Buyer to Operate Post-Closing in Buyer's Discretion?



Includes Express Disclaimer of Fiduciary Relationship?



# 4. Delaware Case Law Landscape

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- ***Shareholder Representative Services v. Albertson's (Del. Ch. 2021)***
  - Buyer shifts focus of the acquired business model from e-commerce operations to in-store sales
  - **Key buyer covenant:** Buyer has exclusive right to make all post-closing business and operational decisions in its sole and absolute discretion and no obligation to maximize earnout
  - **Key buyer covenant:** May not take any action “with the intent” of avoiding earn-out payments
  - Seller prevails at motion to dismiss, with court holding that buyer may have schemed to conceal its true intentions
- ***Shareholder Representative Services v. Shire US (Del. Ch. 2020)***
  - Buyer fails to make milestone payment based on delayed development of an experimental drug
  - Buyer was permitted to omit payment if, among other things, the FDA halted or delayed clinical trials for the drug
  - **Key buyer covenant:** Buyer has sole and absolute discretion over post-closing development of the drug
  - In holding for Seller, court finds that FDA delay had to be the *only* reason for the delay in clinical trials and that routine drug development delays were a contributing factor

# 4. Delaware Case Law Landscape

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- ***Menn v. ConMed (Del. Ch. 2022)***
  - Buyer discontinued product citing safety; contract allowed if issues were “known” pre-closing
  - **Key buyer covenant:** Use best efforts to maximize the earnout payment
    - However, Buyer had express contractual right to terminate the product based on safety concern
  - Of note, Buyer had made two of three milestone payment
  - Court found buyer acted within rights; no earn-out owed
- ***FLMS LLC v. Integris BioServices (Del. Ch. 2023)***
  - Seller alleged buyer delayed hiring scientists to miss revenue target
  - **Key buyer covenant:** Use commercially reasonable efforts to ensure the Earnout Business will have access to funding, personnel, compensation for employees, and support as is reasonably necessary to operate the Earnout Business reasonably consistent with past practice
  - **Key buyer covenant:** Omit actions in bad faith that would have the purpose or effect of avoiding or reducing any Earnout Payment
  - Court, at motion to dismiss, found plausible “bad-faith” claim under covenants to use commercially reasonable efforts

# 5. Drafting Pitfalls & Litigation Drivers



*"The language in this contract is wordy and indirect, and uses unnecessary technical words and phrases. I'm very impressed."*

- Ambiguous metric definitions (e.g., "indication," "commercially reasonable")
- Inadequate accounting principles & reference statements
- Failure to address integration, shared services, or cost allocations
- No explicit dispute-resolution roadmap
- Ignoring tax/ASC 805 fair-value volatility

# 5. Drafting Pitfalls & Litigation Drivers

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- ***Negotiation Best Practices***

- **Confirm earn-out genuinely bridges a valuation gap you cannot close today—otherwise avoid**
- Align metric with how business is actually run and what parties can measure objectively
- Draft metric definitions, GAAP application, and add-backs with accountant input from the beginning
- Expressly state buyer's efforts standard and any seller cooperation or stand-still obligations
- Provide clear, short dispute-resolution timetable
- Consider floors/caps, interim releases, acceleration or buy-out rights to reduce future conflict

## 6. Q&A



"BEHIND EVERY GREAT BUSINESS DEAL IS A COMPANY LAWYER ADVISING AGAINST IT."

AUSTIN

BRUSSELS

DALLAS

DUBAI

HOUSTON

LONDON

NEW YORK

PALO ALTO

RIYADH

SAN FRANCISCO

SINGAPORE

WASHINGTON

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