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Using earnouts and CVRs in M&A transactions

The value of a business is typically based on its expected future financial performance. However, buyers and sellers negotiating mergers and acquisitions (M&As) often have dramatically different views on the target company's prospects and, therefore, its value. Earnouts can help bridge the valuation gap. But there's a downside: Earnouts raise complex accounting and tax issues.

Accounting issues

An earnout is a contractual arrangement under which part of the purchase price is contingent on the target's achievement of certain financial benchmarks (such as a specified level of earnings or profits) or operational milestones (such as issuance of a patent or FDA approval of a drug). An earnout allows the seller to be compensated if the business meets expectations, while preventing the buyer from overpaying if the company underperforms.

Under U.S. Generally Accepted Accounting Principles, a buyer must record the portion of the purchase price contingent on future events at its acquisition-date fair value. Fair value is based on:

- The amount of contingent consideration,
- The probability that the earnings target or other milestone will be achieved, and
- The discount rate used to determine its present value.

Similar to call options, CVRs require the buyer to pay additional consideration if certain payment triggers occur.

Suppose a buyer agrees to pay additional consideration of $2 million if the acquired business meets certain earnings targets for three years after the deal closes. If the probability the business will hit those targets for three years is 50%, the fair (present) value of the earnout would be approximately $864,000, using a 5% discount rate.

The seller doesn't generally recognize contingent consideration until the contingency is resolved. But, in some cases, it may be appropriate for the seller to recognize its fair value on the acquisition date.

Tax concerns

Earnout payments are often conditioned on the seller or key employees continuing to work for the company for a certain amount of time. Should these payments be characterized for tax purposes

as compensation or part of the purchase price?

From the buyer's perspective, classifying earnout payments as compensation is advantageous because it's deductible when paid. Conversely, sellers prefer to classify the payments as part of the purchase price. This creates a capital expenditure subject to the tax rules for capital gains and losses. By comparison, compensation is treated as ordinary income, which is taxed at higher rates than capital gains.

Another tax concern for sellers is whether they're required to use the installment method to report earnout payments. If the seller can demonstrate that future earnout payments are highly uncertain, it's *not* required to recognize any gain until it has recovered its basis in the business. Otherwise, the IRS may require the use of the installment method. Under that method, each payment includes a combination of capital gain, interest and tax-free return of basis. Alternatively, sellers can elect to include the present value of contingent earnout payments in the purchase price in the year of sale.

Creative alternative

In some M&A transactions, typically those involving public companies, the seller issues contingent value rights (CVRs), which provide similar benefits to earnouts. CVRs are securities — similar to call options — that require the buyer to pay additional consideration if certain payment triggers occur.

Examples of triggering events include a decline in the price of the buyer's stock used as consideration or the achievement of a financial benchmark. CVRs raise a variety of accounting, tax and securities law issues that require input from an experienced tax professional.

Bridging the gap

A carefully designed earnout or CVR can be an effective tool for getting a buyer and seller on the same page. To avoid surprises when planning these arrangements, it's important to consider potential effects on both parties' financial statements and tax obligations. ■

Handle structured attorneys' fees with care

For years, attorneys who work on a contingent fee basis have had the option of receiving fees in installments paid — and taxed – over a period of years. This can be advantageous because it avoids sizable lump sum payments in a single tax year, which can potentially push the attorney (or law firm) into a higher tax bracket.

The U.S. Tax Court and the U.S. Court of Appeals for the 11th Circuit approved structured attorneys' fee arrangements that meet certain requirements in a 1994 case (*Childs v. Commissioner*). Over the next three decades, the IRS generally hasn't challenged them, except for certain abusive arrangements.

However, in a recent generic legal advice memorandum, the IRS Chief Counsel's office opined that a hypothetical structured attorneys' fee arrangement wouldn't work, requiring deferred payments to be immediately taxable. The memorandum outlines several legal arguments in support of the IRS's position. It doesn't explicitly call for *Childs* to be overturned, and there are significant differences between the facts in *Childs* and the hypothetical arrangement addressed by the memorandum. Also, generic legal advice doesn't constitute binding authority or necessarily represent the official position of the IRS.

Nonetheless, the IRS could use the arguments set forth in the recent memorandum to challenge structured attorneys' fee arrangements that diverge from the *Childs* model. So, it's important to design and implement these arrangements with the IRS-approved model in mind.

How to communicate statistical evidence to jurors

Statistical evidence can be pivotal in many types of commercial litigation related to liability and economic damages. But this type of evidence can cause jurors' eyes to glaze over with boredom, lack of comprehension or skepticism — unless it's presented just right.

Recognizing biases and distrust

Statistics can be difficult to present, and not only because many people are suspicious of numbers. These days, advertising, politicians, social media and news outlets create skepticism about statistics in general. Often, jurors feel more comfortable relying on their own instincts or experiences to assess the likelihood of an event. Jurors tend to believe the popular interpretation of the principle known as Occam's Razor — that the best explanation for an occurrence is the simplest explanation — despite statistical evidence to the contrary.

The dynamics of a courtroom can pose obstacles, too. Jurors typically place greater credence in evidence that supports their beliefs about the appropriate outcome, while discounting evidence that contradicts those beliefs. They also tend to give more credit to studies and related statistics that have been formulated independently of the case at hand, opposed to those conducted specifically for litigation purposes. And when experts present conflicting statistical evidence, jurors are likely to disregard both. By and large, jurors hesitate to render decisions on liability based solely on statistical evidence.

Overcoming hurdles

Qualified experts take several steps to overcome these obstacles. First, they ensure information is being communicated clearly — translating their field's numerical vocabulary into plain English. They also simplify and condense multiple layers of statistical details into comprehensible bottom lines. For example, they might synthesize reams of income and profit statements for dozens of product lines into a single, comprehensive summary.

Additionally, the use of visual aids can help engage jurors and reinforce verbal testimony. Many people are visual learners, so oral testimony alone may not be enough to enable them to understand complex statistical analyses. Experts who supplement their analyses with pictures are likely to leave a lasting impression. But it's important not to overload jurors with too many pictures — or too much information on one chart, graph or table.

Generally, experts should limit themselves to no more than five images per case, and each image should present no more than two key points. During trial, attorneys should ask experts to explain each graphic in detail, rather than leaving jurors to interpret the visuals themselves.

Jurors have other needs as well. Perhaps foremost, they want to go home with a clean conscience regarding their final verdict. That generally means they prefer not to deny the claim of an injured plaintiff in the absence of another cause. Depending on

which side they serve, experts may use statistics to support or eliminate alternative causation.

Supporting everyday statistics

Effective experts also act as advocates for statistics. That is, they build the overall reliability of statistics, showing jurors how they depend on statistics to help them with everyday decision-making. Experts accomplish this by providing examples of the everyday use of statistics, such as in sports analysis or weather forecasts.

From there, experts build up the reliability of the party's statistics, illustrating how large or small a figure is in real life using points of reference to which jurors can easily relate. They then wield the same criteria to fortify their own statistics — and, conversely, to undermine the opposing party's statistics by showing how the latter fall short of meeting those criteria for reliability.

Choosing a qualified expert

Does your expert understand how to use jurors' pre-existing tendencies to successfully relay statistical evidence to them? When selecting experts to testify on statistical evidence, look for more than impressive resumés. While good credentials are certainly important, soft skills — such as being able to write and speak effectively and persuasively — can mean the difference between winning or losing a case. ■

Ramcell, Inc. v. Alltel Corporation

Court's DCF analysis nearly quadruples stock valuation

In a recent appraisal action, the Delaware Chancery Court determined that the fair value of the petitioner's stock was $11,464 per share using the discounted cash flow (DCF) method. This was nearly four times the consideration received in connection with a short-form merger under Delaware law. Here's a summary of the court's ruling.

Petitioner squeezed out

The respondent, a Delaware corporation and Verizon subsidiary, owned 90% of the common stock of Jackson Cellular Telephone (Jackson), also a Delaware corporation. Jackson was a Verizon-operated and -branded provider of cell phone products and services in Mississippi. In April 2019, Jackson merged into the respondent. The common stock owned by the petitioner, a minority shareholder, was canceled in exchange for cash consideration of $2,963 per share. The petitioner, which hadn't consented to the merger, filed an appraisal petition.

At trial, the parties' valuation experts both relied exclusively on the DCF method, but they arrived at dramatically different conclusions. The respondent's expert valued the stock at $5,690.92 per share on the merger date, while the petitioner's expert valued it at $36,016 per share.

Projections were unpersuasive

The parties agreed to use the DCF method to value the stock, but their inputs to the model differed. The court found both parties' financial projections to be flawed and applied its own blended approach to arrive at fair value.

To estimate future cash flow, the respondent's expert relied on projections prepared by management in anticipation of a merger. These projections were

based in part on the NPA-NXX system, under which service revenue is allocated to a provider based on the area code and first three digits of a subscriber's phone number. The NPA-NXX system was accurate at one time. But the petitioner's expert argued, and the court agreed, that it had become unreliable in an era of phone number portability. In other words, it didn't allocate revenue properly for customers who move without changing their phone numbers.

The petitioner's expert created projections based on the assumption that Jackson's market performance was on par with Verizon's overall national performance. The expert claimed there was no plausible explanation for the company's underperformance relative to that benchmark. The court disagreed, noting that the respondent's expert had provided several plausible explanations for Jackson's underperformance.

Court blends DCF models

The court created a blended share price, finding that a weighted average of the two experts' models "better reflects Jackson's future revenue than either of the experts' models alone." The model used by the respondent's expert was based on the "concrete, but inaccurate" NPA-NXX system. The model used by the petitioner's expert attempted to adjust for "inaccuracies in the outdated NPA-NXX system,"

but it went "too far" by assuming Jackson's market penetration rate should be the same as Verizon's nationwide rate.

The court assigned weights of 70% to the respondent's model and 30% to the petitioner's model. The former was more credible, the court said, because it was based on management projections and was tied to a metric that was accurate at one time. The court also used a blended approach to determine the discount rate.

Assumptions are everything

Cash flow projections and other assumptions on which a DCF analysis is based can have a major impact on an expert's conclusion. By successfully challenging the company's appraisal, the petitioner in *Ramcell* was able to increase its consideration by more than $1.3 million. ■

Consultants vs. expert witnesses: It pays to hire both

Outside professionals can play a critical role in litigation — particularly in cases involving complex financial or accounting issues. But it's important to understand that experts can serve two distinct roles as 1) consultants and 2) expert witnesses. And the two should generally be kept separate.

Consultants as advocates

Consultants' opinions and communications — as well as the facts or data they rely on — are generally protected against discovery except under extraordinary circumstances. This gives you the freedom to share information with consultants and

seek their opinions on sensitive issues without fear of revealing your strategies to opponents.

Thus, consultants may be well suited to:

- Evaluate the strengths and weaknesses of your case,
- Assess the potential impact of "bad facts,"
- Advise on areas where a testifying expert's opinions or methods are susceptible to challenge by opposing attorneys or their experts,
- Assist in developing strategies and lines of questioning for deposing or cross-examining the opposing experts or other witnesses, and
- Investigate multiple avenues of attack and help your testifying expert focus on the most relevant issues and evidence.

Consultants who won't be designated as expert witnesses can be valuable members of a litigation team. To ensure that consultants' work and communications are protected, an engagement letter should spell out their roles and responsibilities carefully.

> ***There may be significant advantages to keeping the roles of consulting and testifying expert separate.***

Independent experts

In contrast, expert witnesses explain complex issues and concepts to the judge or jury if the case ultimately goes to trial. Once an expert is designated an expert witness, much of this person's work product and communications — as well as information the expert considers or relies on in forming an opinion — becomes discoverable by other parties. Some protection may be offered by the attorney-client privilege or the attorney work-product doctrine. But an expert witness designation can expose certain communications or materials to discovery that would otherwise be privileged.

For example, Federal Rules of Civil Procedure (FRCP) Rule 26(b)(4)(C) protects communications between attorneys and testifying experts — except to the extent they "identify facts or data that the party's attorney provided and that the expert considered in forming the opinions to be expressed" or "identify assumptions that the party's attorney provided and that the expert relied on in forming the opinions to be expressed."

Key distinction

Sometimes litigants will initially engage experts as nontestifying consultants. Later, they may designate the same experts as testifying witnesses if their opinions, communication skills and credibility are satisfactory. However, there may be significant advantages to engaging one expert as a consultant to act as a behind-the-scenes *advocate* while a different *independent* expert testifies at trial. ■

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