Earn-out period in a M&A transaction: What happens if the parties have not defined it?

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A two-year earn-out period defined by the courts (by filling a contractual gap).

Judgment of the Federal Supreme Court of 10 June 2022

Case reference : 4A_58/2022

Facts

On November 5, 2012, A (the "Seller") and B (the "Buyer") entered into a sale agreement (the "Agreement"), under which the Seller had sold its "online marketing" activities to the Buyer (asset deal). Under Article 2 of the Agreement, the purchase price consisted of a short-term cash payment and of subsequent payments in the form of sharing of revenues. The short-term cash payment amounted to CHF 25,000, payable by March 31, 2013. The subsequent revenue share payments would be based on the net operating income relating to the sold activities. The amount due to the Seller depended on the amount generated within the first semester of a year, the second semester of a year or the full year. The Agreement did not provide for the duration during which the Buyer would have to pay a share of its revenues to the Seller, but stipulated that the maximum purchase price would be CHF 100,000, after which the revenue share expired.

On March 29, 2019, the Seller filed a claim against the Buyer before the Commercial Court of the Canton of Zurich (the "Commercial Court"), requesting the payment of an amount of CHF 52,059.88 with interests, or, alternatively, that the Buyer be compelled to provide the Seller, *inter alia*, with information on the turnover generated by some clients relating to sold "online marketing" activities since January 1, 2013, so as to allow the Seller to calculate its claim towards the Buyer. The amount claimed corresponded to the difference between CHF 100,000 and the amount that had actually been paid to the Seller.

By partial judgment of December 21, 2021, the Commercial Court held that the purchase price under the Agreement was composed of a fixed portion, in the amount of CHF 25,000, and of a variable portion, which depended on the turnover generated by the sold activities (the "Earn-Out"), knowing that the Parties had not contractually defined the term of the obligation of payment of this variable portion of the purchase price. The Commercial Court consequently held that there was a gap in the Agreement. It filled it by holding that the period during which the obligation of the Buyer to share its revenue was two years after the consummation of the transaction, namely from January 1, 2013 to December 31, 2014 (the "Earn-Out Period"). The Commercial Court thus compelled the Buyer to provide the Seller with information and documents on the turnover generated by the Buyer with the relevant business during the Earn-Out Period only in relation to certain clients.

The Seller filed an appeal before the Federal Supreme Court requesting that the Buyer be compelled to provide information on the turnover generated by the relevant business since January 1, 2013, in relation to all clients. In addition, the Seller did not agree with the findings of the Commercial Court because it considered the purchase price of CHF 100,000.00 to not be variable and was thus due in any event. It further challenged the duration of the Earn-Out Period of two years (as determined by the Commercial Court).

Issue

The Federal Supreme Court had to answer three questions: first, did the Commercial Court correctly qualify the revenue share as a variable portion of the purchase price instead of a payment modality of a fixed purchase price; second, did the Commercial Court correctly hold that the Agreement contained a gap regarding the time limit for the obligation of the Buyer to share its revenue (earn-out) and that such gap had to be filled; third, did the Commercial Court correctly set the

duration of the Earn-Out Period to two years?

Decision

The Federal Supreme Court first confirmed the qualification of the revenue sharing mechanism made by the Commercial Court as constituting a variable portion of the purchase price. The use of "revenue share", in particular by opposition to "cash portion", implies a variable component. Such interpretation is confirmed by the mention of a "maximum" purchase price, set at CHF 100,000. If the parties intended the revenue share to be a modality of payment of a fixed purchase price, they would have drafted the provision so as to provide that "the revenue share amounts to CHF 75,000 and will be paid as follows". Finally, the complexity of the mechanism to calculate the amount due under the revenue share, together with the information rights relating to the calculation thereof, would be unlikely in a situation where the parties had simply agreed on a fixed purchase price of CHF 100,000 and where revenue sharing would only be a payment modality thereof.

The Federal Supreme Court then confirmed the ruling of the Commercial Court which qualified the absence of a time limit for the revenue share as a contractual gap that needed to be filled.

The Federal Supreme Court presented the legal principles applicable to the circumstances at hand. A contractual gap exists if the parties have not, or have not completely, regulated a legal question relating to the content of the contract. Whether such gap needs to be filled must be determined by a subjective (or empirical) interpretation and, if inconclusive, by an objective (or normative) interpretation (ATF 115 II 484, cons. 4a). If a gap must be filled, the court must determine, in the absence of applicable legal provision, what the parties would have agreed in good faith had they considered the unregulated point. In determining this hypothetical intent of the parties, the court must be guided by the thinking and actions of reasonable and honest contracting parties, as well as by the nature and purpose of the contract (ATF 133 III 421, cons. 4.1). The result of this normative activity is reviewed by the Federal Supreme Court freely, but with a certain restraint (ATF 127 III 300, cons. 6b), since filling a gap in a contract is generally within the discretion of the cantonal courts (ATF 129 III 380, cons. 2).

Applying these legal principles, the Federal Supreme Court held that a variable purchase price component presupposes a limitation in time of the Earn-Out Period. The Commercial Court correctly stated that the influence of the Seller on the success of the business would diminish over time and, conversely, the Buyer would not be inclined to share with the Seller earnings that are attributable to its own successful management of the business for an unlimited period of time.

On this basis, the Federal Supreme Court held that the Commercial Court rightfully limited the Earn-Out Period to a duration of two years. The Commercial Court defined the duration of two years for the Earn-Out Period by referencing various provisions of the Agreement: first, the non-compete undertaking binding the Seller had a duration of two years; second, the Buyer was authorized to use an identification name owned by the Seller for a duration of two years. The Federal Supreme Court then confirmed that the duration set by the Commercial Court was within the usual earn-out duration mentioned by Swiss legal scholars. Given that the Seller did not make any convincing arguments in order to justify that the Earn-Out Period should be longer than the two years duration set by the Commercial Court, the Federal Supreme Court confirmed the ruling of the lower court.

On this basis, the Federal Supreme Court rejected the appeal filed by the Seller.

Key takeaway

Why did the parties end up in front of the court? Because they had not specified the period during which the earn-out was to be calculated in the Agreement.

The key takeaway of this ruling is the importance for parties to set, in the transactional documentation, the key terms of the earn-out and, more specifically, the earn-out period. Agreeing upfront on the terms of the earn-out and reflecting them clearly in the contract is essential in M&A transactions where an earn-out mechanism is use, as this will allow the parties to reduce post-completion litigation risks and avoid uncertainties deriving from the perilous exercise of gap filling by the courts.

In addition, this ruling gives some useful insight on how the Federal Supreme Court approaches contract interpretation and supplementation of contractual gaps. While another high court may have kept a certain distance with regards to the contract and remained on a high level of legal debate, the Federal Supreme Court took a pragmatic and "hands-on" approach to determine the hypothetical intent of the parties much like the Commercial Court. In particular, the Federal Supreme Court ruled out the qualification of the Earn-Out as a simple modality of payment of a fixed purchase price on the

basis that the parties would have expressly provided for this in the Agreement had they desired such a purchase price structure. In this context, the Federal Supreme Court even suggested how such clause may have been drafted ("*the participation to the turnover amounts to CHF 75,000 and shall be paid as follows:*").

Comments

On paper, earn-outs are pricing mechanisms that are generally beneficial to both parties: a portion of the purchase price is contingent on the future success of the target and the payment thereof thus deferred in time. For the buyer, an earn-out is a way to partially reduce the risk and uncertainty inherent to valuation exercises, and to partially finance the purchase price through future profits of the business. For the seller, an earn-out is a way to (potentially) obtain a higher price than what the buyer would (or simply could) have paid upfront (Rudolf Tschäni/Hans-Jakob Diem/Matthias Wolf, M&A-Transaktionen, Zurich (Schulthess) 2021, pp.172-173; see also Urs Schenker, Unternehmenskauf, Bern (Stämpfli) 2016, p. 250-251).

However, do these theoretical benefits pass the test of reality? The answer is (unsurprisingly) one a lawyer would have: it depends.

For example, when a transaction involves a drug development company, it is standard to tie the payment of a portion of the purchase price to the achievement of future regulatory or commercial events. In this context, milestone payments can typically be triggered by the start of a clinical trial, the obtaining of marketing approval from regulatory authorities (US Food and Drug Administration or the European Medicines Agency), and the first sale of a product in a given market. In the drug development industry, an earn-out is generally mutually beneficial as it enables the parties to reduce the negative impact on valuation deriving from the uncertainty inherent to the drug development process.

That being said, there is one principle that is generally acknowledged by practitioners: earn-outs tend to end up in court or arbitration proceedings (Tschäni/Diem/Wolf, p. 173; Schenker, p. 250). First, because the parties cannot foresee the future and anticipate all potential issues in the contract. When an unforeseen event happens after completion, two parties with interests that are not necessarily aligned will have different views. Second, because as from completion, the buyer is in charge of the target and may have a strategy that diverges from that of the seller's. For example, whereas the seller may have had a conservative investment strategy, the buyer may wish to invest heavily in business growth, thus reducing the profit it generates. In other situations, the seller would have only considered the profitability of the target, while the buyer may decide to optimize the profit at group level, which may adversely affect the profitability of the target (Schenker, pp. 250-251). Third, because the parties, often having diverging interests after completion, may simply not agree on how the contractual provisions relating to the earn-out are to be interpreted. For example, in 4A_56/2017, the parties did not agree on the manner in which the earn-out was to be calculated, as well as which financial elements relating to the target were to be taken into account to determine the amount of the earn-out.

This empirical findings seem to be corroborated by the case at hand, although the litigation related to the existence of an earn-out (which is generally not debated) and its duration, rather than whether the buyer prevented the earn-out from becoming due (which is often disputed) or how the earn-out must be calculated (which was debated in 4A_56/2017).

There is one point to take away from this finding and the case at hand: if the parties to an M&A transaction decide, for whatever reason, that the purchase price will be variable and depend on future events, they must aim to draft a contractual provision that is as complete as possible and, if possible, include an example of how the earn-out will be calculated. This will reduce post-completion litigation risks and help avoid uncertainties deriving from the perilous exercise of gap filling by the courts. In the end, it's better to be safe than sorry: anticipate, discuss and clearly express the agreement (even if it may be obvious). These elements are key to a successful transaction.

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