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Earn-out, locked box and retention Q&A: Singapore

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This Q&A provides country-specific commentary on *Practice note, Earn-out, locked box and retention: Cross-border*, and forms part of *Cross-border private company acquisitions*.

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Earn-out, locked box and retention

1. Is it possible/common to provide for payments of consideration to be deferred and payable by reference to the future performance of the target (a so-called earn-out)?

Yes, it is possible to defer consideration by way of an earn-out in Singapore, though earn-outs are not appropriate in every transaction. Earn-outs are most common where:

- The value of the target company is difficult to accurately measure or predict, for example:
  - where the main asset of the target company is an untested commodity;
  - where the target has not been in business long enough to have a track record of reliable financial information; or
  - where the price is based largely or in part on a future net profit or other financial number of the company which cannot be determined at the point of signing of the sale and purchase agreement.
- The sellers are also key employees or managers of the target company who will be staying on after the sale, and the buyer wants to incentivise the sellers in their capacity as employees or managers to run the target business profitably.
- The buyer wants to limit consideration paid up front, for example where the buyer does not have enough cash or financing ahead of the transaction.

Earn-outs are not typically used where the buyer and the seller want a clean break after the acquisition is complete. Whether an earn-out is used will also depend on the relative bargaining strength of the parties and the parties' desire to do the deal. If the seller is in the stronger bargaining position, it may insist on full payment at completion. However, the parties may look to an earn-out to bridge a consideration gap between the parties if both parties are committed to getting the deal done.

2. How long do earn-out periods usually last?

Earn-out periods typically last for two to three audit cycles after completion. Earn-out payments may be staged over the course of the earn-out period. Both parties will want the earn-out period to last sufficiently long enough to accurately measure the subsequent financial performance of the target. However, the buyer will not want an overly long earn-out period so the buyer can start to reap the full financial benefits of the target's performance.

3. What are the accounting principles used for drawing up the reference accounts in an earn-out mechanism?

It is up to the parties to agree what accounting principles should be used for drawing up Reference Accounts in an earn-out mechanism, but the parties will typically refer to internationally recognised principles. It is sensible to use the accounting principles that the target already uses to prepare its audited accounts (if the target does prepare audited accounts).

In Singapore, most companies must prepare audited accounts in accordance with Singapore Financial Reporting Standards (SFRS), so the parties may agree to use SFRS in the preparation of Reference Accounts (see the definition of "Reference Accounts" in *Standard clause, Earn-out: Cross-border: Schedule: paragraph 1 (Definitions)*). SFRS are similar to, but not identical to, International Financial Reporting Standards (IFRS), which many UK-based parties will be familiar with.

However, from 1 January 2018, Singapore-incorporated companies that have issued (or are in the process of issuing) equity or debt instruments for trading on the Singapore Exchange Securities Trading Limited (SGX-ST) must apply a new financial reporting framework, identical to IFRS. The requirement was previously announced by the Singapore Accounting Standards Council (ASC) on 29 May 2014. The ASC has also clarified that other Singapore-incorporated companies (that is, companies not listed on the SGX-ST) may continue to apply the existing financial framework reporting frameworks, including the SFRS, or they may elect to apply the new IFRS-identical framework.

4. Would the seller normally ask for a security or indemnity from the buyer with respect to the earn-out payments?

The parties are free to agree security from the buyer for earn-out payments. However, this is not typical and the buyer will likely strongly resist any proposals for earn-out payment security. Since the obligation to pay the earn-out is tied to the future financial performance of the target, the buyer may well be counting on using future dividends from the target in order to make any earn-out payment. The buyer may therefore not have any funds or assets available to be earmarked for earn-out payments.

If the parties do want to agree security for an earn-out, their options include:

- A bank guarantee provided by the buyer's bank.
- A charge or other security over some of the buyer's assets.
- A guarantee from the buyer's parent company.
- A charge over some or all of the target shares.

5. What is the procedure that the parties will commonly follow if they fail to resolve a dispute relating to the calculation of an earn-out payment? Will they refer it to an expert? How would the expert be selected and appointed?

In the event that there is a dispute in relation to the calculation of an earn-out payment, the share purchase agreement will typically provide for resolution of this dispute by expert determination by an independent accountant (see *Standard clause, Earn-out: Cross-border: Schedule: paragraph 4 (Expert Determination)*). As provided for in paragraphs 4.1 and 4.2, the parties will look to appoint an expert jointly by agreement. The parties typically have a set period (for example, ten – 30 business days) during which to appoint the expert , if they fail to do so, the share purchase agreement will typically provide that the President of the Institute of Singapore Chartered Accountants will appoint the expert.

6. On which grounds may an expert determination regarding any dispute relating to the calculation of an earn-out payment be challenged by the parties to a share purchase agreement?

The purpose of appointing an expert to determine a dispute relating to the calculation of an earn-out payment is to ensure a fair, objective assessment of the parties' disagreement. The parties would expect the expert to leave aside any subjective consideration of the facts.

On this basis, the grounds for challenging an expert determination are usually very limited, especially in comparison with other forms of dispute resolution. In the context of an earn-out calculation dispute, the expert's determination will usually be final and binding except in cases of fraud or manifest error (see *Standard clause, Earn-out: Cross-border: Schedule: paragraph 4.9*). So that the parties may rely on the expert's determination with certainty, any challenges to the expert's determination should be limited to a set period after the expert's determination is delivered.

7. How common is it (if allowed) for cash payments under an earn-out mechanism to be carried out from the buyer's lawyers to the seller's lawyers? Would this be a valid mechanism to discharge the buyer's obligations under the earn-out mechanism?

It is not common for lawyers to make or receive earn-out payments on behalf of their clients. Earn-out payments are usually made directly from the buyer to the seller. As the earn-out period runs long after completion (often for several years), the buyer's and seller's transaction lawyers will not typically be involved for the duration of the earn-out period. Lawyers in Singapore are subject to the Legal Profession (Solicitors' Accounts) Rules (the Rules), which govern the holding and paying of client money. Although lawyers in Singapore may hold client money, the Rules contain restrictions on how the money can be dealt with. For example, the Rules stipulate that any sum over SGD30,000 can only be drawn from a client account by a cheque signed by two solicitors where a bookkeeper has been engaged (*Rule 8*), but parties will typically expect bank transfers for these payments.

It is possible to use an escrow account to carry out an earn-out payment (see *Question 12*). However, the buyer may not have earn-out funds available on completion, and there is little added value or reason to set up an escrow arrangement just before an earn-out payment is to be made.

8. Would the buyer usually negotiate a contractual right to set off any payment it may owe the seller according to an earn-out clause against any amounts owed to it by the seller in connection with any warranty, indemnity or tax covenant claim under the share purchase agreement? Would any mandatory provision limit the buyer's right to set off payments?

The buyer will usually request a right to set off amounts the seller owes in respect of a warranty, indemnity or tax covenant claim against any amounts the buyer may owe for earn-out payments.

A key negotiation point here will be when the buyer's right to set off is triggered. The seller will argue that the buyer should only be entitled to withhold earn-out payments when a claim is finally settled or determined (see *Standard clause, Earn-out: Cross-border: Schedule: paragraph 2.4*).

However, if the buyer is in the stronger bargaining position, it may insist on the right to withhold earn-out payments simply when a claim is notified to the seller according to the provisions of the share purchase agreement.

The buyer's right to set off is a contractual matter and is not limited by Singapore law.

9. Should the earn-out clause include an undertaking from the buyer not to take any action in bad faith with the sole purpose of avoiding or reducing any earn-out payment or will this not be necessary (for example, because the buyer will be subject to a general duty to act in good faith)? Which other seller protection mechanisms are usually built-in in earn-out arrangements?

An earn-out usually looks to align the incentives of the buyer and seller during the earn-out period. Depending to some extent on how the earn-out is structured, both parties will generally be interested in maximising the profitability of the target, the buyer as shareholder of the target and the seller as recipient of the earn-out.

Any positive and negative covenants imposed on the buyer regarding the conduct of business of the target in the earn-out period would be for commercial negotiation between the parties.

10. Is it possible/common to provide for a "locked box" mechanism as a method to determine the purchase price?

Yes, a locked box mechanism is a common method in Singapore for determining the purchase price (as distinct from the completion accounts mechanism).

The locked box provides a mechanism for agreeing the value of the target on the signing of the share purchase agreement by reference to a set of historical reference accounts (typically the most recent audited accounts or half yearly management accounts). The value of the target will be "locked in" at the date of the reference accounts, and the seller will give a "no leakage" covenant. The no leakage covenant prevents the seller from taking cash out of the target, unless specifically contractually permitted.

The covenant against leakage will be effective from the date of the reference accounts up to completion. This means that the economic risk and benefit in the target effectively passes from the seller to the buyer at the date of the reference accounts, which offers a level of certainty that may be attractive to both parties. Sellers, and private equity sellers in particular, may prefer the locked box as there is no purchase price adjustment after completion (other than leakage, which the seller should have control over).

11. Is it possible/common to provide for part of the purchase price to be retained by the buyer?

The buyer may seek to retain part of the purchase price as security for potential breaches of warranties or indemnities. The buyer will be especially interested in doing so where the seller gives an indemnity for a specific issue the buyer has identified in due diligence. Whether the buyer and seller agree that the buyer will retain part of the purchase price is a matter of commercial agreement – a stronger buyer may be able to insist on retention.

12. If so, is it common to put the consideration (or a portion of it) in a joint bank account or any other arrangement (for example, escrow agreement)?

If the buyer does retain part of the consideration, the seller will want reassurance that the retained consideration is ring-fenced from the buyer's other assets, and is subject to restrictions such that the buyer cannot deal with the retained consideration freely. The parties may use a joint bank account (where for example both parties must sign off on any withdrawal) but the most common mechanism in Singapore is for the parties to set up an escrow arrangement (see *Question 13*).

13. In case an escrow account is set out, who is usually instructed to act as escrow agent(s)? Are the parties' lawyers allowed, or commonly entrusted, to act as escrow agents or do the parties usually appoint a financial institution or third party service providers to perform this role?

Although it is possible for lawyers to hold client money under the Legal Profession (Solicitors' Accounts) Rules, it is not common for the parties' lawyers to act as escrow agents in a transaction (see *Question 7*), including in respect of retained consideration. The parties will typically want an independent third party to act as escrow agent. A bank with an escrow services department will have the appropriate infrastructure and expertise and will be best placed to act as escrow agent.

14. Are letters of instruction from the escrow agent(s) to the escrow bank drafted on the basis of standard forms provided by the escrow bank?

Escrow agents and escrow banks in Singapore and Southeast Asia will differ widely on what they can accept for escrow documentation, but escrow agents will typically have their own standard form escrow agreements and escrow instruction letters. The parties' lawyers will then amend these documents to suit the facts and circumstances of the transaction.

Escrow documentation should be as mechanical as possible to suit the interests of all parties. The buyer and seller will want to ensure that the escrow agent can only (and must) act on the basis of their specific instructions. Equally, the escrow agent will want to be extremely clear on its obligations under the escrow documentation and what triggers those obligations as a part of the escrow agent's efforts to minimise its liability (see *Question 15*).

Substantive changes to the escrow agent's standard form documentation often need to be escalated and approved internally at the escrow bank. Parties often look to limit their changes to the escrow agent's standard form documentation as much as possible, to avoid time consuming discussions with the escrow agent. The escrow agent will be especially concerned with amendments to their standard limitations of liability (see *Question 15*).

15. Can the escrow agent(s) liability be limited so that it only arises in case of their wilful misconduct or gross negligence?

Yes. As with the general escrow documentation, escrow agents will typically have standard language they require on limitation of liability (see *Standard document, Escrow letter: Cross-border: paragraph 6.1*). Escrow agents will generally look to limit their liability as much as possible. In some cases this will extend beyond limitation for wilful misconduct or gross negligence, to exclude all liability except for fraud and personal injury or death.

From the escrow agent's perspective, this is reasonable – the escrow agent's view is that it is acting only as a service provider on the basis of the parties' joint instructions. The escrow agent will not want to take any risk or exercise any judgment in operating the escrow account. The escrow agent will often look to limit its liability for specific issues (for example, signatures on instructions being forged) by explicitly stating that it is entitled to rely (without enquiry) on instructions given by the parties, as long as the instructions are in the appropriate form (see *Standard document, Escrow letter: Cross-border: paragraph 6.2*).

As part of its liability package, the escrow agent will likely require that the buyer and seller indemnify the escrow agent against all costs and liabilities arising in connection with the escrow agent's appointment (see *Standard document, Escrow letter: Cross-border: paragraph 6.3*).

16. In the event all or part of the consideration is paid in a form other than cash (for example, shares or loan notes) what mechanisms may the buyer consider to secure the seller's obligations (for example, taking a charge over the non-cash consideration)?

Retention by way of an escrow arrangement can work for certain types of non-cash consideration, including shares. Escrow banks may open specialised escrow accounts that hold certain shares, bonds and other equities in dematerialised (that is, electronic) form, rather than using share certificates or other paper evidence of the asset. If the buyer is providing shares in itself (or in another company) as consideration, the parties may open an escrow account on joint instructions in largely the same way as the parties would operate a cash escrow account.

If the non-cash consideration asset already exists, the parties can also use traditional security arrangements, such as a charge over shares. In this situation, the parties would need to consider whether either:

- The asset would be handed over to the seller on completion and charged back to the buyer, with the buyer able to exercise the security if, for example, the seller fails to pay amounts due for breach of warranty.
- The asset would be retained by the buyer and charged to the seller, with the seller able to exercise the security if the buyer fails to hand over the asset on expiration of any claims period.

Neither of these options puts the parties in the position of giving a true third party (such as an escrow agent) control over the non-cash consideration. There are other, more complex mechanisms for structuring security around non-cash consideration, although these other mechanisms are not commonly used in Singapore.

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