Corporate Finance/M&A - France

Earn-Out Clauses: A User's Guide

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Following an increase in M&A transactions over the past 15 years, Anglo-Saxon concepts have been pursued in French law in response to demands caused by the increasingly international nature of these transactions. One of these concepts, the earn-out clause, has appeared in business acquisitions.

The earn-out clause indexes a portion of the acquisition price to the future performance of the target company. Thus, the seller, which may assist the buyer in managing the company for a certain period after the sale, will benefit from an additional sale price if certain objectives conventionally agreed upon with the buyer are met.

At first glance these clauses appear to be particularly appealing when the target company has a high potential for growth. Thus, it seems questionable whether such clauses are worthwhile in this period of financial crisis, when losses are more likely to occur than profits. However, earn-out clauses can also provide a means to facilitate share transfers in these times.

Sellers do not want the expected disappointing performance to constitute the principal element in the determination of the sale price. However, buyers do not want to evaluate the price based on past performance, which could differ greatly from future performance.

In this situation the earn-out clause is a means for the seller to sell in the hope of benefiting from an improvement in operating conditions; and for the buyer a way to avoid paying an excessive acquisition price when future gains are unascertainable. Earn-out clauses are therefore in the interest of both the buyer and the seller.

These clauses are nevertheless relatively unstable and can present legal risks if they are not drafted with precision and stringency.

Litigation on the determination of the transfer price has arisen over the past several years.

Article 1591 of the Civil Code sets out the principle that "the sale price must be determined and designated by the parties". Therefore, the setting of a purchase price is a decision to be made by both parties and, as a result, shall not be at the discretion of one of the parties. It follows that if a price is not determined in the sale, the contract is rendered void due to the lack of an essential element (ie, the price).

This principle was nevertheless relaxed by case law, which considers that if the price is not determined, it must be determinable. The application of this law is nonetheless rather difficult in the face of the development of certain commercial practices such as the earn-out clause.

Upon completion of the share transfer, the amount of the earn-out is not known by the parties as it is most often subject to the company's future profits or revenues. The financial statements referenced for this earn-out payment will be established not on the day the agreement is signed, but at some time after this date.

However, case law has accepted this type of clause and, in particular, has allowed that the price may be fixed based on a future financial statement.(1) Nevertheless, the validity of this clause is not unconditional. Case law has stated that if the financial statements referenced are not reliable,(2) there are no valid criteria for determining the price.(3)

In addition, the preparation of the financial statement or the components chosen by the parties to determine the amount of the earn-out must not depend exclusively on the will of one party since, under French law, a condition which depends unilaterally on the will of one of the parties to a contract is deemed to be 'potestative' (Article 1170 of the Civil Code), and any obligation contracted to subject to such a condition on the part of the contractee is void.

Faced with an earn-out clause, the buyer could attempt to reduce the profitability of the company in order to avoid having to pay the earn-out. Payment of the earn-out would thus be subject to its own will. However, the valuation of the company usually hinges upon pre-identified external elements. As such, the Court of Cassation validated a transfer in which the price corresponded to a percentage of the future revenue as "the contingency of the activity" was not subject to the sole decision of one party.(4)

When the seller retains certain duties within the company during the transition period between the share transfer and payment of the earn-out, the seller retains a certain amount of control over the management. Therefore, it is important that the functions and powers of the seller be clearly outlined within the sale contract in order to avoid any dispute as to the seller's implication in the earn-out process.

Case law considers that the price formula must not require a new agreement between the parties. The Court of Cassation has judged that a share transfer was void because the determination of the final price required the conflicting preparation of a balance sheet just before the transfer was settled, without the parties having set out solutions in case of disagreement - as they are solely capable of doing. The court therefore concluded that the agreement as drafted required a new agreement between the parties to agree on the final price and consequently that there was no determinable price.(5)

Great care should therefore be given to the drafting of an earn-out clause. It must:

- be detailed;
- highlight the underlying calculation methods so that the price may be distinctly and independently established;
- set the duration period of the clause; and
- where appropriate, define the role of the seller within the company following its sale.

The parties should make the sale price as clear as possible upon closing.

As a precaution, parties should insert a clause into the contract by which they have recourse to a third-party expert to determine the value of the shares sold. The Civil Code offers the possibility to have recourse to an 'expert' in the context of a sale contract (Article 1592),(6) and provides that if the expert is unwilling or unable to make an estimate, there is no sale since the price is not determined or determinable.

Consequently, in the absence of any agreement between the parties regarding the elements taken into consideration to calculate the earn-out and if no expert has been appointed by the parties to fix the price, the price is not determined or determinable. Accordingly, the whole transaction is void and should be unwound.

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Endnotes

(1) Cass Com, June 18 1996, RD bancaire 1996, p 178, obs Germain and Frison-Roche.

(2) The judge considered that the financial statements referenced were not reliable since (i) the approval of the annual accounts was not mentioned in the shareholders' meeting register, and (ii) the situation according to which the company was unable to pay debts which fell due with its available assets was hidden by suspect entries.

(3) Cass Com, May 19 1992: Bull Joly 1992, p 747; Cass 2ème Civ, April 8 1999, JCP1999, II, No 10618, Viandier.

(4) Cass Com, June 28 1988, D 1989.121.

(5) Cass Com, December 14 1999, *Bulletin civ 1999 IV No 234* p 196.

(6) In certain circumstances, the appointment of an expert is legally required (Article 1843-4 of the code).

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