DRAFTING AND USING EARN-OUT PROVISIONS IN M&A TRANSACTIONS

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BIOGRAPHICAL INFORMATION

EDUCATION

- Admitted to bar, 1978, Texas.
- University of Texas (J.D., 1978). Order of the Coif; First Place Team - Kemp, Smith Mock Trial.
- Oklahoma State University (B.A., English, 1975). Outstanding Graduate in College of Arts and Science 1975; Blue Key; Omicron Delta Kappa; Phi Eta Sigma; Student Senate.

PROFESSIONAL ACTIVITIES

Member: Austin Bar Association (Business, Corporate and Tax Section); American Bar Association (Business Law Section); State Bar of Texas Business Law Section, Chair of Business Entities and Forms Committee, Vice-Chair Legal Opinions Committee.

UT Law Continuing Legal Education, LLC's, LP's and Partnerships; Planning Committee Co-Chair, since 2014.

SELECTED HONORS, PUBLICATIONS AND PRESENTATIONS

- *The Best Lawyers in America*®, Banking and Finance Law Corporate Law; Mergers & Acquisition Law; Securities/Capital Markets Law (2010-2025)
- *"Lawyer of the Year" by Best Lawyers*®, Banking and Finance Law, Austin (2018 & 2024), Securities/Capital Markets Law, Austin (2017, 2019, 2025), Mergers and Acquisitions Law, Austin (2014, 2016, 2025)
- AV® Preeminent™ Peer Review Rating, Martindale.com
- Editor and Author, *Texas Limited Liability Companies Under the Business Organizations Code Forms and Practice Manual* – published by Data Trace Publishing Company
- *Model Company Agreements for Closely Held LLCs*, Tex. Bar Essentials of Business (March 2024, March 2025); UT LLCs, LPs and Partnerships Seminar (July 2015; July 2016, July 2018, July 2019, July 2022)
- *Death and Divorce in Closely Held Entities*, Tex. Bar Choice, Governance & Acquisition of Entities (May 2025)
- *Capital Call Provisions in LLC and Partnership Agreements*, UT LLCs, LPs and Partnerships Seminar (July 2023)
- *LLCs and Veil Piercing*, UT LLCs, LPs and Partnerships Seminar (July 2021)
- *Acquisition and Disposition of LLC's in Texas and Delaware*, Tex. Bar Choice, Governance & Acquisition of Entities (May 2019)
- *Using the Concept of Units in Operating Agreements for LLCs and Limited Partnerships* – UT LLCs, LPs and Partnerships Seminar (July 2018)
- *Reorganizing a Failing Business* – Tex. Bar Advanced Business Law (November 2017)
- *Divisive Mergers: How to Divide an Entity into Two or More Entities Under a Merger Authorized by the Texas Business Organizations Code*, Tex. Bar Choice, Governance & Acquisitions (May 2016, May 2017); Tex. Bar Advanced Business Law (November 2016)
- *Acquisitions of Professional Firms* – Tex. Bar Choice & Acquisition of Entities (May 2014)

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- Northern Illinois University, B.S. 1976
- Certified Public Accountant, Texas 1994; Illinois 1977

COURT ADMISSIONS

- Admitted to Texas and Illinois Bar
- U.S. Tax Court
- U.S. District Court for the Western District of Texas

HONORS AND RECOGNITIONS

- Board Certified, Tax Law, Texas Board of Legal Specialization
- "Lawyer of the Year" by Best Lawyers®, Tax Law (2020)
- Austin Monthly, Austin's Top Attorneys, Tax Law (2020)
- The Best Lawyers in America®, Tax Law (2009-2026)

COMMUNITY AND PROFESSIONAL ACTIVITIES

- American Bar Association: Taxation, Business Law Section
- Texas Board of Legal Specialization: Tax Law Advisory and Exam Commission (Vice Chairman 2001-2003)
- Texas Society of Public Accountants
- Austin Bar Association Corporation and Tax Section (Chairman 2005-2007; Board of Directors 2005-2007)
- Greater Austin Chamber of Commerce Economic Development Council (Board of Directors 2005-2013)
- Austin Chapter of TSCPAs: Tax Section (Chairman and Committee Chair 1990-1991)
- Ronald McDonald House (past Board of Directors, Treasurer 1998 -2001)
- Young Men's Business League (past Board of Directors)
- Johnson Creek Neighborhood Association (President 1988-1992)
- Boy Scouts of America: Bee Cave District (Finance Chairman)

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I. INTRODUCTION.

A. The Valuation Gap Problem in M&A.

Every M&A transaction involves a fundamental tension: the seller believes the business is worth more than the buyer is willing to pay. This valuation gap is not simply the product of greed or bad faith; it reflects genuine differences in how each party assesses the future. Sellers are intimately familiar with their business, believe in its trajectory, and have often devoted years—or decades—to building it. Buyers, dealing with insufficient or unreliable information and bearing the financial risk of the acquisition, discount uncertain future earnings and apply conservative multiples.

Where the gap is wide, transactions fail. Potential deals that might otherwise create value for both parties collapse because the parties cannot agree on price. The earn-out provision exists, in large part, to bridge this divide. By linking a portion of the purchase price to the post-closing performance of the acquired business, an earn-out allows the parties to share risk, defer the resolution of valuation disputes into the future, and—when structured properly—align the incentives of seller and buyer during the critical post-closing integration period.

B. Earn-Outs as a Bridge Between Buyer and Seller Expectations.

An earn-out is a contractual mechanism in which a portion of the purchase consideration in a merger or acquisition is contingent upon the acquired business achieving specified performance targets after the closing.[1] In its simplest form, the buyer pays a fixed amount at closing and agrees to pay additional consideration—the "earn-out"—if the target meets agreed milestones over a defined post-closing period.

The elegance of the earn-out is theoretical. In practice, the mechanism carries significant risks and has generated a remarkable volume of post-closing litigation. Earn-outs are among the most frequently disputed provisions in M&A transactions, and the disputes are often bitter, expensive, and protracted. Sophisticated parties who execute what appears to be a well-crafted agreement frequently find themselves in arbitration or litigation within months of closing, arguing over the proper accounting treatment of a single line item or whether the buyer breached a covenant to operate the business in the ordinary course.

This paper examines earn-outs from the perspective of the lawyers involved in the transaction. It addresses the strategic considerations that should inform the decision to use an earn-out, the structural choices that shape how the earn-out provisions work, the drafting principles that determine whether it will function as intended, and the litigation patterns that reveal where even carefully drafted provisions break down. The paper also addresses accounting and tax issues that deal counsel must understand and provides practical guidance for negotiating and drafting earn-out provisions in a variety of transaction contexts.

C. Prevalence and Trends in Earn-Out Usage.

Earn-outs are a standard feature of the M&A landscape, but their prevalence varies significantly by deal type, industry, and macroeconomic conditions. According to surveys conducted by the American Bar Association and various deal analytics firms, earn-outs appear in roughly 20 to 30 percent of private M&A transactions.[2] Their use increases during periods of economic uncertainty, when buyers and sellers are most likely to diverge on valuation, and in sectors characterized by rapid growth, high uncertainty, or significant dependence on intellectual property or key personnel.

Life sciences and technology transactions historically account for the highest concentration of earn-out provisions, reflecting the inherent difficulty of valuing businesses whose principal assets are developmental-stage products or unproven technologies. Earn-outs are also common in founder-led businesses, where the seller's continued involvement and motivation are critical to the realization of the purchase price.

The Covid-19 pandemic and its aftermath accelerated earn-out usage across industries. With traditional valuation benchmarks disrupted and forward-looking projections rendered unreliable, parties increasingly turned to earn-outs as a mechanism to acknowledge uncertainty while still getting deals done.[3] That trend has moderated somewhat as markets

[1] The term "earn-out" does not have a single universally accepted legal definition. For purposes of this paper, "earn-out" means any contract provisions in the purchase or merger agreement in which a portion of the consideration payable in the covered transaction is conditioned on the post-closing performance of the acquired business, whether measured by financial metrics, milestone achievement, or other criteria.

[2] American Bar Association Business Law Section, PRIVATE TARGET MERGERS & ACQUISITIONS DEAL POINTS STUDY (2025) at 18. The ABA's deal points studies survey completed private M&A transactions and report on the frequency and structure of earn-out provisions and related deal terms. Annual editions of the study have consistently found earn-outs present in approximately 20–30% of surveyed transactions.

[3] *See, e.g.*, SRS Acquiom, 2026 M&A DEAL TERMS STUDY (2026) available at https://www.srsacquiom.com/our-insights/deal-terms-study/, reporting increased earn-out

have stabilized, but earn-outs remain a prominent feature of middle-market and lower-middle-market M&A transactions.

D. Overview.

This paper proceeds in nine additional parts. Part II examines the strategic context in which earn-outs arise and the advantages and disadvantages they present to each party. Part III surveys the principal structural choices in earn-out design. Part IV addresses the critical drafting issues that determine whether an earn-out provision will perform as intended. Part V covers accounting and tax considerations that must be integrated into the deal structure. Part VI surveys litigation trends and the judicial treatment of common earn-out disputes. Part VII provides negotiation strategies and practical guidance for deal counsel representing buyers and sellers. Part VIII addresses special topics, including earn-outs in private equity, cross-border, and distressed transactions, and the growing use of ESG and non-financial milestones. Part IX offers a comprehensive drafting checklist. Part X concludes with overarching observations for practitioners.

II. THE STRATEGIC ROLE OF EARN-OUTS.

A. When Earn-Outs Are Most Appropriate.

The decision to use an earn-out should be deliberate and informed. Earn-outs are not appropriate in every transaction. Lawyers are advised to propose an earn-out as a solution to a valuation disagreement only after considering and discussing with their clients the increased transaction costs and risks associated with an earn-out. The following circumstances tend to favor earn-out structures:

1. High-Growth or Early-Stage Target Companies.

When the target is a high-growth or early-stage company whose value is premised largely on future performance rather than historical results, earn-outs provide a rational mechanism for allocating the risk of that growth trajectory. The seller who believes that revenues will substantially increase in the foreseeable future can, through an earn-out, receive additional consideration if that prediction proves correct. The buyer who is skeptical of those projections can cap its exposure to the upside while paying a fair price for the demonstrable current value.

2. Businesses with Uncertain or Unproven Revenue Streams.

Businesses whose revenue depends on contingent events—such as regulatory approval of a drug, execution of a major customer contract, or successful launch of a new product—present particular valuation challenges. An earn-out that ties additional consideration to the occurrence of those events allows both parties to price the transaction appropriately given the uncertainty at closing, without requiring the buyer to pay full value for a contingency that may never materialize.

3. Founder-Led Companies Where Key-Person Retention is Critical.

In many acquisitions of founder-led businesses, the seller's continued engagement with the business is essential to its post-closing value. An earn-out can serve the dual purpose of deferred purchase price and retention incentive, aligning the founder's financial interest in the business with the buyer's interest in a smooth transition. Counsel must be careful, however, to ensure that the earn-out is structured as genuine contingent purchase price rather than disguised compensation, as the distinction has significant tax consequences, discussed in Part V below.

4. Volatile Industries or Macroeconomic Uncertainty.

When external market conditions make forward projections unreliable, earn-outs allow parties to share the risk of an uncertain environment. Rather than pricing the transaction based on projections that both parties acknowledge may not materialize, an earn-out allows the parties to agree on a base price reflecting current conditions and provide upside participation if the environment improves.

5. Disagreements on Projections or Future Performance.

Perhaps the most common trigger for earn-out discussions is a simple disagreement between buyer and seller about what the business will earn in the future. If the seller projects $10 million in EBITDA next year and the buyer thinks $7 million is more realistic, an earn-out that pays the seller additional consideration if the $10 million target is achieved allows the parties to avoid an impasse without either side conceding their view of the business's prospects.

B. Advantages for Each Party.

From the seller's perspective, the earn-out preserves the opportunity to realize the full value of the business if post-closing performance vindicates the seller's projections. In a deal where the seller believes deeply in the business's trajectory, an earn-out may be far preferable to accepting a lower fixed price. The seller retains economic exposure to the upside that

prevalence following the onset of the Covid-19 pandemic, apparently as parties sought mechanisms to bridge valuation uncertainty arising from disrupted historical financial results and unreliable forward projections.

would have been permanently surrendered in an all-cash deal at a lower valuation.

From the buyer's perspective, the earn-out is a risk management tool. By deferring a portion of the purchase price and conditioning it on performance, the buyer avoids overpaying for projected performance that may not materialize. The earn-out also creates alignment: the seller has a direct financial incentive to work hard during the earn-out period and to ensure a smooth transition of the business.

From a transaction-facilitation perspective, earn-outs are sometimes the only mechanism that allows a deal to get done. Where the parties have exhausted other negotiating tools and remain far apart on price, an earn-out can provide a path to closing that preserves the economic interests of both sides without requiring either to fully capitulate.

C. Risks and Disadvantages.

The advantages of earn-outs are real, but counsel must candidly assess the significant risks before recommending them to clients.

1. Post-Closing Disputes and Litigation Exposure.

Earn-outs have a tendency to generate disputes and litigation.[4] The disputes are not limited to unique and unusual situations; they arise from ordinary disagreements about accounting methodology, operating decisions, and the interpretation of contractual language that likely seemed clear to the drafters and the parties at the time of drafting.

2. Integration Conflicts Between Earn-Out Obligations and Business Operations.

The post-closing period is often the most operationally sensitive phase of an acquisition. The buyer is trying to integrate the acquired business, realize synergies, eliminate redundancies, and implement new systems and processes. These activities are often in direct tension with the buyer's earn-out obligations to operate the business as a standalone unit in accordance with historical practice. The result is a structural conflict that no amount of clever drafting can fully resolve.

3. Management and Cultural Friction.

When the seller remains involved in the business during the earn-out period—as is common in founder-led transactions—the arrangement creates a two-master dynamic that is inherently unstable. The seller is simultaneously an employee or consultant of the buyer and a creditor of the buyer with respect to the earn-out. These roles inevitably conflict, and the personal and professional friction that results can be destructive to the business and the relationship alike.

4. Complexity and Administrative Burden.

Even in a best-case scenario where the earn-out is never disputed, it imposes ongoing administrative obligations on both parties. Financial statements must be prepared and delivered on schedule, earn-out calculations must be performed and reviewed, and any disagreements must be dealt with through the applicable contractual dispute resolution mechanism. For the buyer's finance team, managing earn-out obligations across multiple acquisitions can become a significant burden.

III. KEY STRUCTURAL DECISIONS IN EARN-OUT DESIGN.

A. Duration.

The earn-out period—the duration over which the seller's performance is measured—is one of the most consequential structural choices. Most earn-out periods in private M&A transactions range from one to five years, with two to three years being the most common in general M&A and longer periods appearing more frequently in life sciences and technology transactions involving developmental milestones.[5]

Shorter earn-out periods reduce the risk of dispute and are generally preferable from both parties' perspectives. A one-year earn-out provides clarity quickly, minimizes the period of management friction, and limits the opportunity for either party to manipulate results. Longer earn-out periods introduce compounding uncertainty: market conditions change; businesses evolve; and the longer the earn-out period lasts, the less likely it becomes that the financial results of the target are related to the inherent value of the purchased business versus the results of management and operation of the business by the purchaser post closing.

The appropriate duration depends heavily on the nature of the earn-out metric. A revenue-based earn-out in a straightforward business may work well over a one to-two-year period. A milestone earn-out tied to FDA approval of a drug candidate, by contrast, may necessarily extend over five or more years simply because of the regulatory timeline involved.

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[4] Abena Opong-Fosu, *ANALYSIS: Earnouts Are Showing Up in More M&A Deals—and Lawsuits (Correct)*, BLOOMBERG LAW ANALYSIS, June 23, 2023, updated November 15, 2023, available at https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-earnouts-are-showing-up-in-more-m-a-deals-and-lawsuits (reporting a rise in earn-outs in M&A deals leading to "the inevitable flood of earnout disputes").

[5] SRS Acquiom, 2026 M&A DEAL TERMS STUDY (2026) at 23.

B. Financial vs. Non-Financial Metrics.

The choice of earn-out metric is the single most important structural decision in earn-out design. Different metrics present different advantages, risks, and manipulation opportunities, and the best metric for a given transaction depends on the nature of the business, the sources of the valuation gap, and the relative sophistication and bargaining power of the parties.

1. Revenue-Based Earn-Outs.

Revenue is the most commonly used earn-out metric, favored for its simplicity and relative objectivity.[6] Revenue figures are generally easier to define and verify than earnings-based metrics, and they are less susceptible to manipulation through discretionary accounting choices. Revenue metrics are favored in part because they are more difficult for buyers to manipulate than earnings-based metrics, which can be influenced by discretionary expense allocations and accounting choices. The seller's primary concern with revenue-based earn-outs is that the buyer may take actions that depress reported revenue—for example, by restructuring the acquired business's customer contracts, shifting revenue to affiliated entities, delaying billing or collection of receivables, or delaying new business efforts—without technically breaching any contractual obligation.

Revenue-based earn-outs are particularly common in service businesses, software companies, and other businesses where revenue growth is a primary value driver and gross margins are relatively predictable. They are generally less appropriate for businesses with highly variable margins, where revenue growth without attention to profitability can mask deteriorating financial performance.

2. EBITDA and Other Earnings-Based Metrics.

Earnings-based metrics such as EBITDA (earnings before interest, taxes, depreciation and amortization), EBIT (earnings before interest and taxes), and net income are common in transactions where the seller's management will remain in control of day-to-day operations and the buyer is comfortable that the seller cannot manipulate the earnings figure to its advantage. Earnings-based earn-outs are generally riskier for sellers, because buyers can depress earnings through increased overhead allocations, higher management fees, accelerated depreciation, timing of capital expenditures, bonuses to a buyer management team, and other accounting choices that reduce reported earnings without reducing the fundamental value of the business.

EBITDA-based earn-outs require particularly careful drafting, because EBITDA is not a defined term under GAAP and its components are subject to significant variation. Counsel must carefully specify what is included in and excluded from EBITDA for earn-out purposes, addressing intercompany charges, management fees, one-time items, and the treatment of deal-related costs. A failure to address these items with precision is a reliable predictor of post-closing disputes.[7]

3. Gross Profit and Margin Targets.

Gross profit and gross margin targets occupy an intermediate position between revenue and EBITDA metrics. Gross profit is calculated by subtracting direct costs of producing goods (cost of goods sold) or providing services from revenues. Gross profit excludes operating expenses such as rent, insurance, taxes and administrative costs. A measurement of gross profits captures more information than revenue alone—distinguishing between high-revenue/low-margin activities and sustainable profitable growth—while avoiding many of the manipulation opportunities associated with fully-loaded earnings metrics. Gross profit earn-outs work best when cost of goods sold is well-defined and not subject to manipulation through overhead allocation or intercompany pricing.

4. Milestone-Based Earn-Outs.

Milestone-based earn-outs condition payment on the occurrence of specific events such as regulatory approval, a product launch, execution of a material customer contract, achievement of a technical development target, or completion of a clinical trial.[8] Milestone-based earn-outs are particularly well-suited to transactions in the life sciences and technology

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[6] American Bar Association Business Law Section, PRIVATE TARGET MERGERS & ACQUISITIONS DEAL POINT STUDY (2026) at 18 (in 2024-25, earn-outs determined by revenues constituted 48% of the reported transactions); SRS Acquiom, 2026 M&A DEAL TERMS STUDY (2026) at 23 (earn-outs determined by revenues constituted 69% of 2025 reported transactions, 65% of 2024 reported transactions and 65% of 2023 reported transactions).

[7] EBITDA is not a defined term under U.S. Generally Accepted Accounting Principles (GAAP) and is not recognized by the Financial Accounting Standards Board (FASB) as a standard financial measure. Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 22-8176, Exchange Act Release No. 34-47226, 68 Fed. Reg. 4820 (Jan. 20, 2003). Because there is no authoritative GAAP definition, parties to M&A transactions must construct a bespoke definition for earn-out purposes.

[8] In life sciences transactions, milestone earn-outs commonly track regulatory events including Investigational New Drug (IND) applications, Phase I, II, and III clinical trial completion, New Drug Application (NDA) or Biologics License Application (BLA) submission and approval, and commercial launch milestones.

sectors, where the principal sources of value are binary events rather than progressive financial performance.

Milestone earn-outs present their own drafting challenges. The milestone must be defined with precision sufficient to avoid disputes about whether it has been achieved, while remaining flexible enough to accommodate changes in regulatory requirements or technical specifications. The parties must also address the buyer's obligation—or lack thereof—to pursue the milestone actively, and the consequences of events outside either party's control that may delay or prevent achievement.

5. Hybrid Structures.

Some earn-out provisions combine multiple metrics, providing payments upon achievement of financial targets as well as specific milestones. Hybrid structures can be well-tailored to the specific value-enhancing elements of a business, but they add complexity and increase the risk of unintended interactions between components. Counsel should ensure that the various components of a hybrid earn-out are internally consistent and that the aggregate maximum payment is clearly defined.

C. Measurement Period Structure.

Beyond the choice of metric, the parties must decide how to structure the measurement period. Annual measurement is the most common approach, with earn-out calculations performed separately for each year of the earn-out period. Cumulative measurement, by contrast, assesses performance against a single aggregate target over the entire earn-out period. Cumulative structures can be more forgiving of year-to-year volatility but may be less motivating if the target appears out of reach early in the period.

Tiered payment schedules—where the earn-out amount increases as performance exceeds successive thresholds—are common and generally preferable to cliff structures that pay nothing until a single target is achieved and then pay the full earn-out. Cliff structures create increased risk for sellers and adverse incentives for buyers near the threshold.

Catch-up and clawback provisions add additional complexity. A catch-up provision allows underperformance in one period to be recovered through overperformance in a subsequent period. A clawback provision permits the buyer to recover earn-out payments previously made if subsequent performance reveals that earlier results were misstated. Both mechanisms have legitimate uses but require careful drafting to avoid unintended consequences.

D. Payment Mechanics.

Earn-out payments are most commonly made in cash, but stock consideration is used in transactions where the buyer is a public company or where the parties want to incentive sellers with an ownership interest in the combined enterprise. Stock earn-outs introduce additional complexity, including registration requirements, securities law considerations, and the need to specify the valuation mechanism for the stock at the time of payment.

In transactions where there is concern about the buyer's ability or willingness to pay the earn-out when due, the seller should consider negotiating for security arrangements such as an escrow, a letter of credit, guaranties, or a pledge of assets. Unsecured earn-out obligations are in effect subordinated debt of the buyer, and the seller's ability to collect depends entirely on the buyer's continued solvency and good faith.

Acceleration triggers—events that cause the entire remaining earn-out to become immediately due and payable—can be an important protective mechanism for sellers. Common acceleration triggers include a change of control of the buyer, a material breach of the earn-out operating covenants, and termination of a key seller-employee without cause. The buyer will typically resist broad acceleration provisions, arguing that they create adverse incentives and may force payment before performance has been demonstrated.

E. Caps, Floors, and Thresholds.

Most earn-outs include a maximum payment cap, which limits the buyer's total earn-out liability regardless of how significantly the target outperforms. Caps serve legitimate purposes—they allow the buyer to predict its maximum acquisition cost and prevent sellers from benefiting from windfalls driven by factors unrelated to their own performance—but they can also reduce seller motivation once the cap appears within reach.

Minimum performance thresholds require the target to achieve a baseline level of performance before any earn-out is payable. Thresholds serve as a protection for buyers against paying additional consideration for performance that merely meets expectations rather than exceeding them. The negotiation over threshold levels is often contentious, as sellers view thresholds as a mechanism to deny them earn-out payments they have effectively earned.

IV. DRAFTING THE EARN-OUT PROVISION: CRITICAL ELEMENTS.

A. Defining the Earn-Out Metrics with Precision.

If there is a single lesson that can be drawn from the earn-out litigation in the courts and commercial arbitration panels over the past two decades, it is this: imprecise financial definitions are the primary cause of earn-out disputes. Parties who carefully define every term in the earn-out metric—and anticipate every ambiguity before it arises—dramatically reduce their litigation exposure.

The starting point is the choice of a recognized financial reporting framework. Earn-out metrics that are measured in accordance with GAAP (generally accepted accounting principles) benefit from the weight of established accounting guidance, even if GAAP leaves some room for judgment. But relying on GAAP alone is insufficient, because many of the issues that generate earn-out disputes—intercompany allocations, the treatment of one-time charges, the exclusion of deal-related costs—are not definitively resolved by GAAP.

Counsel should work with the parties' financial advisors to identify every item that could affect the earn-out metric and to address each item explicitly. The definition of "Revenue" for earn-out purposes, for example, should specify: (i) whether it is measured on an accrual or cash basis; (ii) how it treats deferred revenue; (iii) whether it includes intercompany revenues and, if so, at what prices; (iv) how it treats customer returns, allowances, and discounts; (v) the currency conversion methodology for non-dollar revenues; and (vi) the treatment of revenues from acquired businesses completed during the earn-out period.

B. Operating Covenants and Buyer Obligations.

The most heavily negotiated provisions in any earn-out agreement are the buyer's post-closing operating covenants. These provisions determine what the buyer can and cannot do with the acquired business during the earn-out period, and they fundamentally shape the seller's ability to achieve the earn-out targets.

1. The "Efforts" Standard.

Many earn-out provisions obligate the buyer to use a specified standard of efforts to achieve the earn-out targets or to operate the business in a manner that gives the seller a fair opportunity to earn the contingent consideration. The choice of efforts standard—"best efforts," "commercially reasonable efforts," or "reasonable best efforts"—has significant legal implications and has generated substantial judicial guidance, particularly in Delaware.[9]

Delaware courts have generally interpreted "commercially reasonable efforts" to require action consistent with the reasonable business judgment of a similarly situated party acting in its own economic self-interest, without requiring the obligated party to sacrifice its own economic interests. "Best efforts" has been interpreted more variably; some courts treat it as functionally equivalent to commercially reasonable efforts, while others view it as imposing a higher obligation. Counsel should understand the governing law's treatment of each standard and draft accordingly. In high-stakes earn-out transactions, relying on an efforts standard alone is insufficient. Specific covenants that prescribe or proscribe particular behaviors provide far more certainty than general efforts obligations. The general efforts standard should be treated as a backstop rather than a primary protection.

2. Obligation to Operate Consistently with Historical Practice.

A common earn-out covenant requires the buyer to operate the acquired business in a manner consistent with historical practice or in the ordinary course of business.[10] These provisions are designed to prevent the buyer from dramatically restructuring the business in ways that would make the earn-out targets unachievable. They are also one of the most frequently disputed provisions, because the buyer's legitimate interest in integrating and improving the acquired business is directly in tension with an obligation to maintain the status quo.

Courts interpreting historical-practice covenants have generally looked to whether the buyer's post-closing conduct represented a material departure from the business's pre-closing operating patterns. Ordinary course changes made in response to legitimate business needs are generally permissible; dramatic restructurings, changes in sales strategy, or the elimination of key personnel or lines of business that predictably harm earn-out achievement are more likely to constitute breaches.

3. Restrictions on Revenue Shifting, Accounting Changes, and Restructuring.

Specific covenants prohibiting particular categories of buyer conduct are more reliable protections than general efforts obligations. Sellers should consider pushing for express covenants that prohibit: (i) shifting revenue from the acquired business to affiliates; (ii) changes in accounting methodology

[9] Delaware courts have analyzed the meaning of efforts standards in the M&A context. *See, e.g., Akorn, Inc. v. Fresenius Kabi AG*, No. 2018-0300-JTL, 2018 Del. Ch. LEXIS 325, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018); *Williams Cos. v. Energy Transfer Equity, L.P.*, 159 A.3d 254 (Del. Ch. 2016), aff'd, 173 A.3d 247 (Del. 2017).

[10] Courts interpreting "ordinary course" operating covenants have looked to whether post-closing conduct was consistent with the acquired business's historical operating patterns and whether any departures were reasonable responses to changed business conditions. *See , e.g.*, *AB Stable VIII L.L.C. v. Maps Hotels & Resorts One L.L.C.*, No. 2020-0310-JTL, 2020 Del. Ch. LEXIS 353, 2020 WL 7024929 (Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021); *Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd.*, No. 8980-VCG, 2014 Del. Ch. LEXIS 223, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014).

that affect the earn-out metric; (iii) intercompany charges not in existence at closing; (iv) material reductions in the acquired business's sales force, marketing budget, or capital expenditures; (v) changes in billing and collections practices; and (vi) divestitures of business lines or assets that contribute to the earn-out metric.

Buyers will resist these provisions as unduly limiting their ability to manage the combined enterprise. The negotiation typically results in a set of covenants that prohibit the most egregious manipulation while preserving the buyer's ability to make reasonable business decisions. The precise scope of these covenants is one of the most important—and most carefully negotiated—elements of any earn-out provision.

C. Seller's Rights During the Earn-Out Period.

The earn-out provision should specify the seller's information and oversight rights during the earn-out period. At minimum, the seller should be entitled to periodic financial statements showing the performance of the acquired business against earn-out targets, prepared on a basis consistent with the earn-out definition. More robust provisions include the right to inspect the books and records of the acquired business, to receive management reports and financial forecasts, and to attend periodic review meetings with the acquired business's management.

Audit rights—the seller's ability to engage independent accountants to verify the earn-out calculation—are a fundamental protection that sellers should rarely waive. Without audit rights, the seller is entirely dependent on the buyer's accurate and good-faith reporting of the information on which the earn-out payment is calculated. The buyer will often seek to limit audit rights to once per year and to exclude them from the dispute resolution mechanism, but sellers should resist significant limitations.

D. Dispute Resolution Provisions.

Every earn-out provision should include a detailed dispute resolution mechanism governing disagreements about the earn-out calculation. The absence of a clearly specified mechanism is an invitation to expensive and protracted litigation.[11]

The standard structure begins with the buyer's delivery of an earn-out statement showing the calculation of the earn-out payment (or the absence of a payment) for the relevant period. The seller is given a review period—typically thirty to sixty days—during which it can object to any item in the calculation by delivering a notice of disagreement specifying each disputed item and the seller's proposed adjustment. Items not disputed within the review period are deemed accepted.

Disputed items are subject to a negotiation period during which the parties attempt to resolve disagreements directly. Items that cannot be resolved through negotiation are referred to an independent accountant or expert, who determines the proper treatment of each disputed item. The independent accountant's determination is typically final and binding, subject only to manifest error. The provision should specify the scope of the independent accountant's authority—in particular, whether the independent accountant is limited to the specific items identified in the notice of disagreement or may consider the earn-out calculation more broadly.

The allocation of costs—who pays for the independent accountant's fees—should be addressed explicitly. Common approaches include a "loser pays" structure that allocates costs to the party whose position is furthest from the final determination, or a proportional allocation based on the outcome. These mechanisms provide incentives for reasonable behavior during the dispute process.

E. Integration and Operational Issues.

The degree to which the acquired business will be integrated into the buyer's enterprise during the earn-out period is one of the most practically significant issues in earn-out design. Full integration—consolidating the target's operations, systems, and personnel into the buyer's existing business—typically makes it impossible to calculate the earn-out metric on a standalone basis, because the financial results of the target are no longer separately identifiable. A requirement to operate the target as a separate unit limits the buyer's ability to realize synergies and may impose significant costs.

Counsel must work through these issues carefully and reach explicit agreement before closing. If the parties intend for the target to be fully integrated, the earn-out provision must establish a clear methodology for carving out the acquired business's financial results

[11] The scope of the independent accountant's authority—whether limited to the specific disputed items or extending to the earn-out calculation more broadly—is a critical drafting issue. The case of *Sapp v. Industrial Action Services, LLC*, 76 F. 4th 205 (3d Cir. 2023) illustrates the need for clarity in dispute resolution provisions. The lower court in the case involving an earn-out dispute ordered arbitration based on dispute resolution language calling for an accounting firm to settle disputes related to calculation of the earn-out amount. The appellate court reversed, finding that the agreement only allowed the accounting firm to analyze financial information but not to resolve other legal questions, which under the terms of the agreement needed to be resolved in litigation, not arbitration.

from the combined enterprise's consolidated statements. If the target will operate as a standalone unit, the provision should address the allocation of shared resources and the extent to which the buyer can impose centralized services, technology platforms, or management structures.

F. Acceleration and Forfeiture Provisions.

The earn-out provision should address the events that accelerate or forfeit the seller's right to earn-out payments. Acceleration provisions that make the remaining earn-out immediately payable upon the occurrence of specified events protect the seller against the most common forms of buyer misconduct and are an important element of any well-drafted earn-out agreement. Common acceleration triggers include a material breach of the operating covenants, a change of control of the buyer, and the termination of a key seller-employee without cause.

Forfeiture provisions, conversely, terminate the seller's right to earn-out payments upon the occurrence of specified seller defaults, such as a breach of the purchase agreement, violation of non-compete obligations, or termination for cause of a seller-employee whose continued involvement was a condition of the earn-out. Forfeiture provisions must be carefully drafted to avoid being construed as penalties, which may be unenforceable in some jurisdictions, and to ensure that the forfeiture is proportionate to the nature of the breach.[12]

V. ACCOUNTING AND TAX CONSIDERATIONS.

A. Accounting Treatment of Earn-Outs Under ASC 805.

The financial accounting treatment of earn-out provisions under ASC 805 (Business Combinations) is a significant consideration for buyers who are public companies or who otherwise prepare financial statements under GAAP. Under ASC 805, earn-out obligations are generally classified as contingent consideration and are recorded at fair value as of the acquisition date, with subsequent changes in fair value recognized in earnings.[13]

The classification of earn-out consideration—as contingent purchase price versus compensation expense—is one of the most consequential accounting determinations in the transaction. If the earn-out is forfeited upon the seller's departure from the business, ASC 805 requires that it be treated as compensation expense rather than purchase price, resulting in significant differences in the timing and treatment of the cost. Deal counsel must understand this classification issue and work with the parties' accounting advisors to ensure that the earn-out structure achieves the intended accounting treatment.[14]

Subsequent changes in the fair value of contingent consideration classified as purchase price are recognized in the buyer's income statement, not as adjustments to goodwill. This means that an earn-out that becomes more likely to be paid after closing will result in additional expense items on the buyer's income statement, a consequence that some buyers may not fully appreciate at the time of the transaction.

B. Tax Structuring of Earn-Out Payments.

The tax treatment of earn-out payments depends critically on whether they are characterized as additional purchase price or as compensation for services. This distinction is not merely formal; it determines whether the seller's earn-out receipts are taxed at capital gains rates (as additional purchase price) or at ordinary income rates (as compensation).

1. Contingent Payment Sales – Installment Method Under I.R.C. § 453.

a. General Rule.

When an earn-out is deemed to be contingent, the contingent earn-out payments are reported on the installment method. The IRS has promulgated detailed regulations on how contingent payment on a sale transaction is reported. The following discussion summarizes the rules set forth in Treasury Regulation section 151.453-1(c) and (d).

First, the term "contingent payment sale" means a sale or other disposition of property in which the aggregate selling price cannot be precisely determined

[12] Forfeiture provisions that operate as penalties—i.e., provisions that impose a forfeiture disproportionate to any actual harm—may be unenforceable under the law of some jurisdictions. Restatement (Second) of Contracts § 356 (1981) (liquidated damages and penalties). Counsel should structure forfeiture provisions as reasonable estimates of harm rather than punitive forfeitures.

[13] FASB Accounting Standards Codification Topic 805, Business Combinations (ASC 805), establishes the accounting framework for business combinations, including the treatment of contingent consideration. Under ASC 805-30, contingent consideration is recognized at fair value as of the acquisition date and classified as either a liability or equity. Subsequent changes in fair value of contingent consideration classified as a liability are recognized in the acquirer's income statement rather than as adjustments to goodwill. ASC 805-30-25; ASC 805-30-35.

[14] The ASC 805 classification of contingent consideration as compensation expense versus purchase price depends principally on whether the arrangement is contingent on continued employment. FASB ASC 805-10-55-25 provides indicators for making this determination. If forfeiture upon termination of employment is a significant feature of the earn-out, the arrangement is more likely to be characterized as compensation expense.

by the close of the taxable year in which such sale occurs.

Second, The term "contingent payment sale" does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law, a retained interest in the property that is the subject of the transaction, an interest in a joint venture or a partnership, an equity interest in a corporation or similar transactions.

b. Maximum Selling Price.

Most contingent payment sale agreements have a maximum selling price included in the earn-out. For reporting purposes, the stated maximum selling price is determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement. The seller's basis is allocated to payments received and to be received under a stated maximum selling price agreement. The stated maximum selling price, as initially determined, is treated as the selling price unless subsequently reduced. When the maximum amount is subsequently reduced, the gross profit ratio will be recomputed with respect to payments received in or after the taxable year in which an event requiring reduction occurs.

For example, A sells all of the stock of X corporation to B for $100,000 payable at closing plus an amount equal to 5% of the net profits of X for each of the next nine years, the contingent payments to be made annually together with adequate stated interest. The agreement provides that the maximum amount A may receive, inclusive of the $100,000 down payment but exclusive of interest, shall be $2,000,000. A's basis in the stock of X inclusive of selling expenses is $200,000. Selling price and contract price are considered to be $2,000,000. Gross profit is $1,800,000, and the gross profit ratio is 9/10 ($1,800,000/$2,000,000). Accordingly, of the $100,000 received by A in the year of sale, $90,000 is reportable as gain attributable to the sale and $10,000 is recovery of basis.

c. Fixed Period of Payment.

When a stated maximum selling price cannot be determined, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the Seller's basis (inclusive of selling expenses) is allocated to the taxable years in which payment may be received under the agreement in equal annual increments.[15]

d. Neither Stated Maximum Selling Price nor Fixed Period.

If the agreement neither specifies a maximum selling price nor limits payments to a fixed period, a question arises whether a sale realistically has occurred or whether, in economic effect, payments received under the agreement are in the nature of rent or royalty income. Arrangements of this sort will be closely scrutinized. If, taking into account all of the pertinent facts, including the nature of the property, the arrangement is determined to qualify as a sale, the seller's basis (including selling expenses) shall be recovered in equal annual increments over a period of 15 years commencing with the date of sale. However, if in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than basis allocated to the year, no loss shall be allowed unless it is otherwise determined in accordance with the timing rules generally applicable to worthless debts that the future payment obligation under the agreement has become worthless; instead the excess basis shall be reallocated in level amounts over the balance of the 15 year term. Any basis not recovered at the end of the 15th year shall be carried forward to the next succeeding year, and to the extent unrecovered thereafter shall be carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless.

e. Special Rules.

The regulations have special rules with regard to when (i) the general rule of level allocation of basis in level amounts over the first 15 years will substantially and inappropriately accelerate recovery of the seller's basis in early years of that 15-year term, (ii) the installment sale calls for payment in foreign currency; (iii) the nature and productivity of the property sold is not independently relevant to the basis to be recovered in any payment year and the seller's basis may appropriately be recovered by using an income forecast method; and (iv) when the seller can demonstrate that application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis.

f. Requirements for Using Open Transaction Treatment.

If the transaction qualifies as an "Open Transaction", the seller doesn't report gain until the seller has recovered all of the basis in the property sold. However, qualifying a transaction for open treatment is an extremely high hurdle set by both the courts and the IRS. The legal foundation for this narrow exception stems primarily from the 1931 Supreme Court decision

[15] However, if the terms of the agreement incorporate an arithmetic component that is not identical for all taxable years, basis shall be allocated among the taxable years to accord with that component of the contract.

in Burnet v. Logan. The Logan standard requires that the future payments are highly contingent and lack an ascertainable value.

The central requirement is demonstrating that the contingent consideration received has no readily ascertainable fair market value (FMV). Taxpayers must show that the valuation is not just difficult, but truly impossible due to the speculative nature of the underlying income stream. The IRS position is that almost every payment right can be valued, even if the valuation is low, making this exception exceedingly rare.

A taxpayer must present evidence that the contingencies are so uncertain that any valuation would be a mere guess, failing the standard for reasonable accuracy. For instance, payments tied to the future success of a revolutionary, unproven technology would typically meet the standard more easily than payments tied to established royalty rates. The mere presence of a contingency does not automatically grant open transaction status.

g. Election Not to Report an Installment Sale on the Installment Method.

A seller may elect not to report an installment sale on the installment method. If the seller elects out of the installment sale reporting, the seller must recognize gain on the sale in accordance with the seller's method of accounting. Receipt of an installment obligation is treated as a receipt of property, in an amount equal to the fair market value of the installment obligation, whether or not such obligation is the equivalent of cash. An installment obligation is considered to be property and is subject to valuation. If an installment obligation contains both a fixed amount component and a contingent payment component, the fixed amount component shall be treated under the general reporting rules, and the contingent payment obligation is determined by disregarding any restrictions on transfer imposed by agreement or under local law. The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale).

2. Imputed Interest Under I.R.C. §§ 483 and 1274.

Earn-out obligations that are paid more than six months after the sale may be subject to the imputed interest rules of I.R.C. 26 U.S.C. §§ 483, 1274.[16] [17]These provisions treat a portion of each earn-out payment as interest rather than purchase price, which is taxable as ordinary income to the seller and deductible by the buyer. The amount treated as imputed interest depends on the applicable federal rate and the payment schedule.

The implications of imputed interest for earn-out structuring are significant. Even where the parties agree that the earn-out represents purchase price, the tax law may recharacterize a portion of the payment as interest, affecting the seller's effective tax rate on the earn-out consideration. Deal counsel should ensure that the transaction documents accurately reflect the parties' intent and that the parties' tax advisors have addressed the imputed interest rules in their analysis.

3. Employment Tax Implications.

Where the earn-out is conditioned on the continued employment of the seller or other key individuals, the IRS may recharacterize the earn-out payments as compensation subject to employment taxes.[18] The recharacterization risk is highest where the earn-out payments are substantial in relation to the fixed consideration and where the forfeiture provision is triggered by termination of employment. Structuring the earn-out to reduce recharacterization risk—for example, by making the earn-out transferable and not conditioned on continued employment—should be considered but must be weighed against the buyer's legitimate interest in ensuring key personnel retention.

4. Purchase Price Allocation.

The lump sum purchase of more than one asset ordinarily requires an allocation of the lump sum price to each of the acquired assets based on their respective fair market values on the acquisition date. Under I.R.C. Section 1060, a residual-method allocation rule applies

[16] I.R.C. § 483 provides for the imputation of interest on certain deferred payments in sales of property where the stated interest rate is below the applicable federal rate (AFR) established under I.R.C. § 1274(d). Where § 483 applies, a portion of each deferred payment is recharacterized as interest income to the seller (taxable as ordinary income) and interest expense to the buyer (potentially deductible).

[17] I.R.C. § 1274 applies to certain deferred payments in sales of property and imputes interest at the AFR where the stated interest rate is inadequate. Unlike § 483, which applies to contingent payment sales, § 1274 generally applies to non-contingent deferred payment obligations. Practitioners must determine which provision applies to a given earn-out structure based on the contingency of the payment and other factors.

[18] The IRS has asserted that earn-out payments contingent on the seller's continued employment should be recharacterized as compensation subject to employment taxes. See Rev. Rul. 98-21, 1998-1 C.B. 975. Whether an earn-out is recharacterized as compensation depends on the specific facts and circumstances, including whether the payment is conditioned on continued service, transferable, and proportionate to the seller's equity interest.

where assets constituting a business are acquired in a lump sum transaction qualifying as an "applicable asset acquisition." The parties to an applicable asset acquisition can agree in writing to an allocation of consideration for, or a determination of the fair market value of, any asset in the acquisition.[19] The agreement is generally binding on the parties. But the existence of a written agreement doesn't restrict IRS from challenging those allocations or values. Unless otherwise excluded from this requirement by the Commissioner, the seller and the purchaser in an applicable asset acquisition each must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred on I.R.C. Form 8594. When an increase or decrease in consideration is taken into account after the close of the first taxable year that includes the first date assets are sold in an applicable asset acquisition, the seller and the purchaser each must file a supplemental asset acquisition statement on Form 8594 with the income tax return or return of income for the taxable year in which the increase (or decrease) is properly taken into account.[20]

C. Interaction with Representations and Warranties Insurance.

Representations and warranties insurance (RWI) has become a standard feature of private M&A transactions. The interaction between RWI and earn-out provisions raises several important issues. RWI policies typically cover breaches of seller representations, but they generally do not cover the buyer's earn-out payment obligations or the seller's right to receive earn-out consideration. A seller who believes the buyer has manipulated results to avoid an earn-out payment cannot look to RWI for recovery.[21]

The presence of RWI can, however, affect the earn-out negotiation in indirect ways. Where the buyer obtains robust RWI coverage, sellers may be more willing to provide meaningful representations about the historical financial performance of the target, which in turn provides a stronger foundation for the earn-out metric. Counsel should ensure that the RWI policy and the earn-out provision are consistent and that neither undermines the other.

VI. CASE LAW.

A. Summaries of Certain Cases.

Earn-out provisions tend to be the most disputed provisions in M&A transaction agreements.[22] Presented below are summaries of a few recent cases involving earn-out provisions, which illustrate how these disputes arise and how Texas and Delaware courts[23] have tended to resolve these disputes.

The Texas Supreme Court dealt with an earn-out provision in the case of *Fischer v. C.T.M.I, L.L.C.*[24] Plaintiff Ray Fischer sold the assets of his tax-consulting business to C.T.M.I. The asset purchase agreement provided for a series of earn-out payments calculated as 30% of business revenue in excess of $2.5 million for 2008, 2009 and 2010. In addition, the 2010 payment provision included and additional payment obligation based on work in progress at the end of 2010. Specifically, the agreement provided:

> By January 31, 2011, a list of projects that were in-progress as of December 31, 2010, will be generated with a percentage of completion assigned to each project as of December 31, 2010. The percentage of completion will have to be mutually agreed upon by [CTMI] and [Fischer]. The 2010 Adjustment will include revenue based upon the percentages assigned to these in-progress projects, but the portion of the 2010 Adjustment reflecting the in-progress projects will not be payable to [Fischer] until the respective revenue is actually collected …[25]

C.T.M,I argued that this provision was an unenforceable agreement to agree. After a lengthy analysis of Texas cases dealing with the enforceability of agreements to agree, the court found that C.T.M.I. could not avoid its obligation to pay Fischer by arguing that the provision was unenforceable. The court stated:

> Thus, when the parties agreed to generate "a list of projects that were in-progress as of December 31, 2010 ... with a percentage of completion assigned to each project as of

[19] Reg. § 1.1060(c)(4).

[20] Reg. § 1.1060-1(e).

[21] Representations and warranties insurance has become a standard feature of private M&A transactions. RWI policies generally cover losses arising from breaches of seller representations and warranties but do not cover earn-out payment obligations or the buyer's post-closing conduct.

[22] In a 2022 case involving an earn-out, the court noted: "In what is an all-too-predictable pattern in these transactions, the parties … became embroiled in a seemingly intractable dispute regarding whether the earn-out targets were satisfied." *Fortis Advisors v. Dematic Corp.*, No. N18C-12-104 AML CCLD, 2022 Del. Super. LEXIS 1456; 2022, WL 18359410 (Del. Super. Ct. Dec. 29, 2022) at 1.

[23] See F. Dario de Martino, Clare O'Brien, & Mara Goodman, *The Art and Science of Earn-Outs in M&A*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE, July 11, 2025, at 5-13, available at https://corpgov.law.harvard.edu/2025/07/11/the-art-and-science-of-earn-outs-in-ma/ for an analysis of several recent Delaware Chancery Court cases dealing with earn-out provisions in M&A transaction agreements.

[24] *Fischer v. CTMI, L.L.C.*, 479 S.W.3d 231 (Tex. 2016).

[25] *Id.* at 235.

> December 31, 2010," they knew exactly how the process would work because they had just done it with then-existing accounts. We read the 2010 pending-projects clause to require the parties to engage in the same process in January 2011 with respect to outstanding revenues from pending projects as they did in 2007 with respect to accounts receivable on incomplete projects.[26]

The case of *Spain v. Phoenix Electric, Inc.*[27] dealt with the sale of a Houston, Texas electrical contracting business. The purchase and sale agreement included an earn-out provision providing for payments to the seller based upon retainage collected by the target company on contracts entered into by the company within 100 miles of downtown Houston during the 36-month period following the closing. The agreement also included the following provision:

> Purchaser Best Efforts. Purchaser shall use its best efforts in the operation of the Company's business from and after the Closing in a manner that maximizes the Earn-Out Payments to the Selling Shareholder, provided that Purchaser shall not be required to enter into any agreement that does not meet its historical profitability requirements.[28]

The seller argued that the purchaser breached the "best efforts" provision because it did not maintain adequate staffing and the company submitted far fewer bids on projects than it had in the year before the sale. The court included a detailed analysis of Texas law regarding "best efforts" clauses and found that the "best efforts" clause in this agreement was unenforceable because:

> … the contract at issue here lacks a clear set of guidelines against which Phoenix Electric's best efforts can be measured. The Purchase Agreement does not specify *how* Phoenix Electric is to maximize Earn-Out Payments to the Trustees, for example, by requiring Phoenix Electric to bid on as many new contracts as possible or by requiring Phoenix Electric to prioritize more lucrative new contracts that would yield a higher amount of retainage. The only parameters were that the Purchasers need not enter a new agreement that does not meet "historical profitability requirements." This is not enough to go on to determine whether the Purchasers used their best efforts to procure new contracts that would qualify for Earn-Out payments.[29]

The lesson for a practitioner representing a seller in a Texas-governed agreement with earn-out provisions that include a post-closing covenant with an efforts clause is to consider including a "clear set of guidelines" against which the efforts can be measured.

The Delaware Supreme Court case of *Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC*[30] involved a merger agreement with an earn-out provision that "prohibited the buyer from tak[ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment."[31] The earn-out was not achieved and the seller brought suit arguing that the earn-out provision precluded the buyer from taking any action that it knew would reduce the seller's ability to achieve its earn-out. In determining the case, Chief Justice Strine found for the buyer and ruled that the language did not include a knowledge standard. Because the seller had not proved that the buyer's actions were taken with the intent of reducing the earn-out, seller could not prevail.

Fortis Advisors v. Dematic Corp.[32] involved a merger agreement that included an earn-out provision requiring the buyer to pay additional consideration if sales of the target company products satisfied certain revenue and EBITDA targets in the fourteen months following the closing. The buyer took the position that the earn-out was not met and did so by limiting the products, the sales of which were counted towards measuring the earn-out target. The selling shareholders argued that the buyer wrongfully excluded products from the measurement. The case turned on the interpretation of the term "Company Products" in the merger agreement. The court tells us that the term "Company Products" was defined by reference to a disclosure schedule that included "extremely general terms"[33] such as "Core Software Modules" including "Platform," "Business Intelligence" and "Inventory Management," and "Warehouse Control Software Modules" including "Sorters," "Mergers," and "Presorts." The plaintiffs presented evidence that the buyer had embedded target company code in products

[26] *Id.* at 241.
[27] *Spain Spain v. Phx. Elec., Inc.*, No. 01-22-00656-CV, 2024 Tex. App. LEXIS 1714, 2024 WL 971661 (Mar. 7, 2024) (Tex. App., Houston—1st Div, 2024).
[28] *Id.* at *5-6.
[29] *Id.* at *25.
[30] *Lazard Tech. Partners, L.L.C. v. Qinetiq N. Am. Operations L.L.C.*, 114 A.3d 193 (Del. 2015).
[31] *Id.* at 194.
[32] *Fortis Advisors v. Dematic Corp.*, No. N18C-12-104 AML CCLD, 2022 Del. Super. LEXIS 1456, 2022 WL 18359410 (Dec. 29, 2022).
[33] *Id.* at *49.

sold by the buyer during the earn-out period and that the buyer did not include these products in its calculations of the earn-out. The plaintiffs also presented evidence that the buyer took steps to curtail its sales force's effort to sell target company products. After extensive discovery and a lengthy trial, the court found that the plaintiffs had satisfied the burden of proving that the buyer breached the merger agreement and awarded the plaintiffs the entire amount of the earn-out consideration.[34]

Shareholder Representative Services LLC v HPI Holdings, LLC[35] is a Delaware Chancery Case involving a merger in which the merger agreement provided that the selling stockholders would receive a $6 million earn-out payment conditioned upon replacing an agreement with a customer, Brevard Physician Associations (BPA), that notified the target company that it would be terminating its service agreement with the company during the merger negotiations. The merger agreement provided that the earn-out would be paid to the selling stockholders:

> If BPA (A) signs a new agreement with [the target company or an affiliate of the acquiring company] with substantially the same economic terms as the Company's existing agreement with BPA but without the early termination clause contained therein, (B) signs an amendment to the Company's existing agreement with BPA that removes the early termination clause contained therein or (C) signs a new agreement with [the target company or an affiliate of the acquiring company] satisfactory to [the acquiring company] in its sole discretion after the Closing.[36]

After the closing, BPA signed an "Agreement to Amend Service Agreement" that did not remove the early termination clause. The Chancery Court found that the agreement with BPA was not a new agreement and because it did not remove the early termination clause, the selling stockholders were not entitled to the earn-out.

STX Business Solutions, LLC v. Financial-Information-Technologies, LLC[37] is also a case in which a seller lost on its claim to be paid under an earn-out. The case involved an asset sale with an earn-out if the purchased assets met certain revenue goals or upon a sale of the acquiring company. The purchase agreement included the following provision regarding operation of the target business by the buyer, which the court noted was "buyer friendly".[38]

> Seller and each Seller Party acknowledges that Buyer is entitled, after the Closing, to use the Purchased Assets and operate the Business in a manner that is in the best interests of Buyer or its Affiliates and shall have the right to take any and all actions regardless of any impact whatsoever that such actions or inactions have on the earn-out contemplated by this Section 2.7; provided, that, prior to the Earn-Out Measurement Date, Buyer shall not take any action in bad faith with respect to Seller's ability to earn the Earn-Out Consideration or with the specific intention of causing a reduction in the amount thereof.[39]

After the closing of the sale and during the earn-out period, the buyer was approached by Walmart to respond to a request for proposal. In inviting the buyer to respond, Walmart told the buyer that its product appeared to be the only viable solution to the services needed by Walmart. On the final day to respond, the buyer told Walmart that it was declining to respond. Fifteen days after declining to respond to the Walmart request, the defendant sold a 48.1% interest in the business to an outside investor and retained a 48.1% interest in the business.

The plaintiff raised various claims including breach of the purchase agreement, alleging that if the business had secured the Walmart contract, it would have easily achieved the revenue needed to satisfy the earn-out. However, the court stated that based on the language of the purchase agreement, the seller could only establish a breach if the buyer acted in bad faith or with the intention of causing a reduction in the earn-out. The court found that the plaintiff had failed to "allege facts supporting a reasonable inference that the Buyer acted in bad faith."[40]

For purposes of the provision of the purchase agreement triggering the earn-out upon a subsequent sale of the acquiring company, the purchase agreement defined sale of the company by reference to the definition of sale of the company in the company's company agreement. That definition defined sale as a transaction or other arrangement which gave a new owner control of a majority of the company's board of

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[34] *Id.* at *71.

[35] *S'holder Representative Servs. L.L.C. v. HPI Holdings, L.L.C.*, No. 2022-0166-PAF, 2023 Del. Ch. LEXIS 91, 2023 WL 3092895 (Apr. 26, 2023).

[36] *Id.* at *4.

[37] *STX Bus. Sols., L.L.C. v. Financial-Information-Technologies, L.L.C.*, No. 2024-0038-JTL, 2024 Del. Ch. LEXIS 354, 2024 WL 4645104 (Del. Ch. Oct. 31, 2024).

[38] *Id.* at *2.

[39] *Id.* at *2-3.

[40] *Id.* at *8.

managers. Under its agreement with the new investor, each of the new investor and the buyer had a right to elect two managers to the board, giving them shared control of the board. The plaintiff alleged that the buyer acted in bad faith by structuring the transaction with the new investor to evade the definition of sale of the company that would trigger the earn-out. While this might seem like a plausible argument by the plaintiff, the court found that the reason the buyer had a shared arrangement was to avoid being a minority owner and not for purposes of evading the earn out.

B. Lessons from Litigation for Drafting Practice.

A review of the case law involving earn-out disputes teaches several important lessons. Specificity is the most reliable protection against earn-out disputes: an agreement that precisely defines every term, addresses every scenario (including specific efforts required by the buyer during the earn-out period), and leaves no room for reasonable disagreement is far less likely to generate litigation than one that relies on general principles and efforts standards. The additional drafting time and cost required to achieve this level of specificity is a sound investment.

No amount of contractual drafting can fully protect against a determined bad actor. A buyer who is willing to breach its contractual obligations in order to avoid an earn-out payment will find ways to do so that may be difficult to detect and costly to prove. This reality means that sellers should be thoughtful about whom they are selling to, not just what the contract says.

Pre-closing alignment on post-closing operations is invaluable. Many earn-out disputes arise not from bad faith but from genuine disagreement about how the acquired business should be managed. Parties who have frank conversations about their post-closing integration plans before closing—and who document those conversations in the agreement or in ancillary side letters—are far less likely to find themselves in litigation.

VII. NEGOTIATION STRATEGIES AND PRACTICAL GUIDANCE.

A. Buyer's Perspective.

Buyer's counsel should approach earn-out negotiations with a clear view of the buyer's operational objectives and integration plans. The buyer's primary interest is in preserving flexibility to manage the acquired business as it sees fit, while limiting its earn-out payment obligations to genuine positive financial performance.

On operating covenants, the buyer should resist open-ended obligations to operate the business "in the ordinary course" without qualification. Buyers should seek language that permits ordinary course integration activities, centralization of back-office functions, and the application of parent-company policies and procedures. Specific exclusions should be negotiated for actions that the buyer knows it intends to take after closing.

On information and audit rights, buyers should push to limit the seller's access to confidential business information after closing, to establish reasonable review periods and frequency limitations, and to restrict the scope of any audit to the specific items relevant to the earn-out calculation.

Buyers should also pay close attention to the acceleration provisions. Broad acceleration triggers that cause the entire remaining earn-out to become payable upon a change of control or management decision can impose significant unexpected costs. The buyer should negotiate for carve-outs and limitations that preserve its ability to make legitimate business decisions without triggering acceleration.

B. Seller's Perspective.

Sellers must approach earn-out negotiations with a realistic assessment of the earn-out's value. An earn-out is not equivalent to cash consideration; it is a contingent right that is subject to performance risk, manipulation risk, litigation risk, and the creditworthiness of the buyer. Sellers who treat the earn-out as equivalent to fixed consideration in assessing the overall deal value are likely to be disappointed.

Because specific terms of an earn-out are often included a letter of intent, sellers are well-advised to include counsel in negotiation and preparation of the letter of intent. While terms such as earn-out details in a letter of intent are typically non-binding, it is often difficult to change these terms once the letter of intent is signed. Attempts to change key terms, such as earn-out details, will be viewed as "retrading the deal" and may lead to a price reduction by the buyer or otherwise damage or hinder the parties' ability to successfully complete the transaction.

The most important protection a seller can obtain is objective, verifiable metrics. The harder it is for the buyer to manipulate the earn-out metric, the more the earn-out is actually worth. Sellers should favor revenue-based metrics over earnings-based metrics precisely because revenue is more difficult to manipulate. Where earnings metrics are unavoidable, sellers should negotiate for the most comprehensive set of adjustments and exclusions that the parties can agree upon.

Sellers should also prioritize anti-manipulation protections. Express covenants prohibiting revenue shifting, accounting methodology changes, and material reductions in investment in the acquired business provide the seller with specific, provable claims in the event of buyer misconduct. General

efforts obligations, while useful, are harder to enforce and more susceptible to buyer defenses.

Perhaps most importantly, sellers must understand the risk of "phantom consideration." An earn-out that is achievable only in ideal circumstances, or that is structured in a way that gives the buyer effective control over whether the target is met, is not real consideration—it is an illusion of upside that the seller has effectively given away in exchange for a lower fixed price. Sellers should be critical and realistic in assessing the practical achievability of earn-out targets under the operating covenant structure the buyer is proposing.

C. Deal Counsel's Role.

Deal counsel plays a critical role in earn-out transactions that extends beyond drafting the agreement. Counsel's first responsibility is to educate the client about the practical realities of earn-outs before the structure is agreed to in principle. Clients who enter earn-out negotiations with unrealistic expectations about the earn-out's value or enforceability are poorly served. Lawyers are well advised to have a frank discussion of the risks of earn-outs with their clients.

Coordinating with financial and tax advisors is essential. The financial definitions that are central to the earn-out provision must be vetted by accountants who understand how the target's financial results are actually generated. The tax structure must be analyzed before closing, not after. Earn-out provisions that work beautifully from a legal perspective can create significant unintended tax consequences if not reviewed by competent tax counsel.

Finally, counsel should give careful thought to the dispute resolution mechanism. The mechanism that the parties will actually use—one that provides quick, expert resolution of financial disputes at manageable cost—is far preferable to a mechanism that is technically comprehensive but practically unusable. Independent accountant procedures work well for pure accounting disputes; complex questions of contract interpretation may require arbitration by a panel with both legal and financial expertise.

VIII. SPECIAL TOPICS AND EMERGING ISSUES.

A. Earn-Outs in Private Equity Transactions.

Private equity (PE) buyers present a distinct earn-out dynamic. PE-backed buyers are typically sophisticated, financially oriented, and incentivized to maximize the returns on their investment. They are also experienced at managing earn-out obligations and are generally aware of the strategies available to influence earn-out results. Sellers dealing with PE buyers should be particularly attentive to the operating covenant structure and to the protections against revenue shifting and margin manipulation.[41]

Private equity transactions also raise specific issues around add-on acquisitions during the earn-out period. PE buyers routinely pursue add-on acquisitions as part of their value-creation strategy, and these acquisitions can dramatically affect the earn-out metric if revenues and expenses from the acquired business are commingled with the seller's results. The earn-out provision must address whether, and on what basis, add-on acquisitions are included in or excluded from the earn-out calculation.

B. Earn-Outs in Cross-Border M&A.

Cross-border earn-outs introduce currency risk, jurisdictional complexity, and the interaction of multiple legal and accounting systems. Currency fluctuations during the earn-out period can significantly affect the seller's realized value, particularly in transactions where the earn-out metric is measured in the target's local currency but paid in the buyer's currency. The earn-out provision should specify the currency in which the metric is measured and the exchange rate at which payments are converted.

Choice of law and dispute resolution are particularly important in cross-border earn-out transactions. The parties should select a governing law that provides a sophisticated and predictable legal framework for earn-out disputes, and should specify a dispute resolution mechanism that is accessible to both parties regardless of their jurisdiction. International arbitration under established rules (ICC, LCIA, AAA/ICDR) is generally preferable to litigation in either party's home courts.[42]

C. Earn-Outs in Distressed M&A.

Earn-outs appear in distressed M&A transactions, though their utility is limited. In a distressed sale, the seller's principal concern is closing the transaction and receiving as much fixed consideration as possible; the

[41] The treatment of add-on acquisitions in earn-out calculations is a significant issue in private equity transactions. Where the earn-out metric is revenue or EBITDA of a specific business unit, the acquisition of a complementary business during the earn-out period creates difficult questions about how to allocate combined results.

[42] International arbitration is generally preferred over domestic court litigation for cross-border earn-out disputes because arbitral awards are more readily enforceable across jurisdictions under the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958). Practitioners should specify the seat of arbitration, the number of arbitrators, the language of proceedings, and the applicable institutional rules (ICC, LCIA, or AAA/ICDR) in the dispute resolution provision.

ability to earn additional contingent consideration is secondary. Buyers in distressed situations are often reluctant to accept earn-out obligations that might complicate a future restructuring or add-on transaction.

Where earn-outs are used in distressed transactions, they typically function as a mechanism to bridge the gap between the seller's minimum acceptable price and the buyer's view of the business's stabilized value. The earn-out period is usually short, and the metric is often tied to near-term financial performance rather than longer-horizon milestones.

D. Earn-Outs in the Life Sciences and Technology Sectors.

Life sciences and technology transactions represent the most sophisticated and complex applications of earn-out structures. In life sciences, earn-outs commonly track regulatory milestones (IND filing, Phase I/II/III completion, NDA approval, commercial launch) and commercial milestones (achieving specified net sales thresholds). These transactions may involve earn-out periods extending over a decade or more, with payment obligations that can dwarf the initial closing consideration. Technology transactions present different challenges, with earn-outs often tied to the retention of key customers, the successful integration of technology platforms, or the achievement of product roadmap milestones. In both sectors, the principal drafting challenges are defining the milestone with sufficient precision to avoid disputes, allocating responsibility for achieving the milestone between buyer and seller, and addressing the consequences of events outside either party's control that affect the likelihood of achievement.

IX. MODEL DRAFTING CHECKLIST.

The following checklist is intended to assist counsel in ensuring that earn-out provisions address the principal issues that arise in practice. It is not exhaustive, and the issues it identifies must be tailored to the specific circumstances of each transaction.

A. Pre-Drafting Diligence Items.

- Obtain and review the target's historical financial statements for the last three years, prepared on the same basis that will be used for the earn-out metric.
- Identify all items that could affect the earn-out metric, including one-time charges, intercompany transactions, management fees, and non-recurring revenue.
- Review the buyer's post-closing integration plans and identify potential conflicts with earn-out operating covenants.
- Consult with tax counsel regarding the characterization of earn-out payments and the availability of installment sale treatment.
- For public company buyers, consult with accounting advisors regarding ASC 805 classification and the income statement impact of contingent consideration.
- Assess the buyer's creditworthiness and the need for security arrangements to backstop the earn-out obligation.

B. Key Provisions Checklist.

- Definition of earn-out metric: precise financial or milestone definition with all inclusions and exclusions specified.
- Accounting methodology: GAAP vs. customized definitions; treatment of discretionary accounting choices.
- Earn-out period: duration, annual vs. cumulative measurement, catch-up provisions.
- Payment schedule: thresholds, tiers, maximum cap, timing of payment after earn-out period.
- Operating covenants: buyer obligations, ordinary course requirement, specific prohibitions.
- Information rights: periodic financial statement delivery, management reports, access to personnel.
- Audit rights: scope, frequency, cost allocation, confidentiality obligations.
- Dispute resolution: earn-out statement delivery and review periods, notice of disagreement, independent accountant procedure, scope of authority, cost allocation.
- Acceleration triggers: change of control, material breach, termination without cause.
- Forfeiture provisions: triggering events, proportionality, enforceability considerations.
- Security arrangements: escrow, letter of credit, guaranty.
- Integration restrictions: restrictions on add-on acquisitions, divestitures, and capital expenditures; treatment of acquired business as separate unit.

C. Common Drafting Errors to Avoid.

- Failing to define the earn-out metric with sufficient precision, leaving key terms undefined or subject to multiple reasonable interpretations.
- Relying on GAAP alone without addressing the specific items that are most likely to generate disputes.

- Using undefined "efforts" standards as the primary operating covenant without specifying particular obligations and prohibitions.
- Failing to address the treatment of add-on acquisitions, intercompany transactions, and management fee allocations.
- Omitting a detailed dispute resolution mechanism or using one that is not fit for purpose.
- Failing to address the accounting and tax treatment of earn-out payments before closing.
- Structuring the earn-out in a way that creates compensation recharacterization risk without addressing the tax consequences.
- Including acceleration provisions that are triggered by ordinary course management decisions, creating unintended liability for the buyer.

X. CONCLUSION.

A. Earn-Outs Are a Useful but Dangerous Tool.

Earn-outs are among the most powerful and the most dangerous tools available to deal counsel. When properly designed and carefully drafted, they enable transactions that would otherwise fail, fairly allocate the risk of uncertain future performance, and align the post-closing incentives of buyer and seller. When poorly designed or carelessly drafted, they generate disputes that consume resources, destroy relationships, and sometimes result in litigation costs that approach or exceed the earn-out's value.

The prevalence of earn-out litigation is not a reason to avoid earn-outs; it is a reason to do them better. The practitioner who understands the structural choices, the drafting pitfalls, the litigation patterns, and the accounting and tax considerations that govern earn-out provisions is in a position to construct agreements that achieve the parties' legitimate objectives while minimizing the risk of post-closing conflict.

B. The Importance of Clarity and Specificity in Drafting.

Every significant earn-out dispute traces to an ambiguity, a gap, or an inconsistency in the underlying agreement. The conclusion for practitioners is clear: specificity is not a luxury but a necessity. Every term in the earn-out metric must be precisely defined. Every operating covenant must be translated into concrete obligations and prohibitions. Every scenario that the parties can anticipate must be addressed before closing, because the window for reasonable negotiation closes at the moment the transaction documents are signed.

The investment in careful, thorough drafting—reviewing historical financial statements with accountants, working through integration scenarios with operations counsel, stress-testing the dispute resolution mechanism—pays dividends many times over in the form of disputes avoided, relationships preserved, and transaction value realized.

C. Final Recommendations for Practitioners.

For the practitioner advising a client contemplating an earn-out structure, the following recommendations are offered as organizing principles.

First, counsel clients honestly. The earn-out is not equivalent to fixed consideration, and clients who treat it as such will be disappointed. A candid assessment of the earn-out's practical value—taking into account performance risk, manipulation risk, and litigation risk—is an essential part of deal counsel's service.

Second, draft to prevent disputes rather than to win them. An agreement that is theoretically strong enough to prevail in litigation is less valuable than one that is clear enough to make litigation unnecessary. Invest in the drafting process; it is far cheaper than the alternative.

Third, coordinate with financial and tax advisors from the outset. The earn-out provision is as much a financial instrument as a legal one, and the legal drafter who works without the input of accountants and tax counsel is operating with an incomplete picture.

Fourth, educate the client about post-closing dynamics before closing. The parties who have a frank conversation about post-closing integration plans, management arrangements, and the practical administration of the earn-out—before the transaction documents are signed—are far better positioned for a constructive post-closing relationship than those who defer these conversations until problems arise.

The earn-out, for all its complexity and risk, remains an indispensable tool of the M&A practitioner. Used with discipline, drafted with care, and supported by diligent counsel, it can bridge the most intractable valuation gaps and enable transactions of significant value to both parties. The goal of this paper has been to provide practitioners with the knowledge and frameworks necessary to deploy this tool effectively.

APPENDIX A

Sample Earn-Out Provision (Revenue-Based)

SECTION [__]. EARN-OUT.

(a) Earn-Out Payment. In addition to the Closing Payment, subject to the terms and conditions of this Section [__], Buyer shall pay to Seller the Earn-Out Payment, if any, in accordance with this Section [__].

(b) Earn-Out Definitions. For purposes of this Agreement:

"Earn-Out Period" means the twelve (12)-month period commencing on [the first day of the calendar month immediately following the Closing Date] and ending on [the last day of the twelfth calendar month thereafter].

"Earn-Out Revenue" means the gross revenues of the Business during the Earn-Out Period, determined in accordance with GAAP applied consistently with the accounting principles and methodologies used in preparing the Financial Statements, adjusted to exclude: (i) revenues from transactions with Affiliates of Buyer not arising in the ordinary course of business of the Business as conducted immediately prior to Closing; (ii) revenues attributable to any business or assets acquired by Buyer after the Closing; (iii) the effect of any change in accounting principles, policies, or methodologies from those used in preparing the Financial Statements; and (iv) any revenues attributable to one-time or non-recurring transactions outside the ordinary course of business.

"Earn-Out Payment" means: (i) if Earn-Out Revenue is less than $[X], $0; (ii) if Earn-Out Revenue is equal to or greater than $[X] but less than $[Y], an amount equal to [__]% of Earn-Out Revenue; and (iii) if Earn-Out Revenue is equal to or greater than $[Y], $[Z] (the "Maximum Earn-Out Amount"); provided that in no event shall the Earn-Out Payment exceed the Maximum Earn-Out Amount.

(c) Earn-Out Statement. Within sixty (60) days after the end of the Earn-Out Period, Buyer shall prepare and deliver to Seller a written statement (the "Earn-Out Statement") setting forth in reasonable detail Buyer's calculation of Earn-Out Revenue and the resulting Earn-Out Payment, if any.

(d) Review; Dispute Resolution.

(i) Upon receipt of the Earn-Out Statement, Seller shall have thirty (30) days (the "Review Period") to review the Earn-Out Statement.

(ii) If Seller disagrees with any item or amount set forth in the Earn-Out Statement, Seller shall, within the Review Period, deliver to Buyer a written notice of disagreement (a "Notice of Disagreement") specifying in reasonable detail (A) each item or amount in the Earn-Out Statement that Seller disputes, (B) the amount of Seller's proposed adjustment to each such item or amount, and (C) the basis for each such dispute. Any item or amount in the Earn-Out Statement not specifically disputed in the Notice of Disagreement shall be deemed final and binding upon the parties.

(iii) For a period of twenty (20) Business Days following Buyer's receipt of a Notice of Disagreement (the "Resolution Period"), the parties shall negotiate in good faith to resolve any disputed items. If the parties resolve all disputed items during the Resolution Period, the Earn-Out Statement, as adjusted to reflect such resolution, shall be final and binding upon the parties.

(iv) If the parties do not resolve all disputed items during the Resolution Period, either party may submit the remaining disputed items to an independent nationally recognized accounting firm (the "Independent Accountant"). If the parties cannot agree upon the selection of the Independent Accountant within ten (10) Business Days, each party shall select a nationally recognized independent accounting firm, and those two firms shall jointly select the Independent Accountant.

(v) The Independent Accountant shall act as an expert, not as an arbitrator, and shall resolve only the specific items set forth in the Notice of Disagreement that remain in dispute. The Independent Accountant's determination shall be within the range of the parties' respective positions on each disputed item. The Independent Accountant shall render its determination within thirty (30) days of its engagement. The determination of the Independent Accountant shall be final and binding upon the parties, absent manifest error.

(vi) The fees and expenses of the Independent Accountant shall be allocated in proportion to the total dollar amount of disputed items resolved in favor of each party.

(e) Operating Covenants. During the Earn-Out Period, Buyer shall, and shall cause its Affiliates to: (i) operate the Business in the ordinary course of business consistent with past practice; (ii) not take any action, or fail to take any action, with the primary purpose of reducing or eliminating the Earn-Out Payment, including, without limitation, changing billing or collections practices including delaying any billings beyond the normal billing cycle or postponing or agreeing to the delay or extend any collections beyond the ordinary time of collection; (iii) not shift revenues of the Business to Affiliates of Buyer other than in the ordinary course of business; (iv) not change the accounting principles, policies, or methodologies used to calculate Earn-Out Revenue from those used in preparing the Financial Statements; and (v) maintain sufficient resources (including personnel, capital expenditures, and marketing expenditures) to conduct the Business substantially as conducted immediately prior to Closing.