Nishith Desai Associates
LEGAL AND TAX COUNSELING WORLDWIDE

MUMBAI SILICON VALLEY BANGALORE SINGAPORE MUMBAI BKC NEW DELHI MUNICH NEW YORK

Deal Destination

Designing Earnouts & Working Capital Adjustments in India

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Designing Earnouts & Working Capital Adjustments in India

– Supratim Guha & Ruchir Sinha

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Contents

One of the most common disputes in any merger and acquisition (**"M&A"**) transaction relates to the computation and payment of earnouts and working capital adjustments. While working capital adjustments are mere post-closing adjustments to the total consideration, and are typically paid within 30 – 90 days of closing, based on a true up of the closing date balance sheet, earn-outs are contractual tools that serves as a bridge to overcome a valuation mismatch and are usually paid in tranches ranging from 1 – 4 years post-closing.

In this paper, we focus on the negotiation strategies, and the regulatory and tax environment concerning earn-outs in India. Considerations for working capital adjustments are largely similar, and, wherever appropriate, we have specifically referred to deal points for working capital adjustments.

1. Earn-outs: A Risk Hedging Mechanism

- The seller and the purchaser may have differing perspectives as regards the valuation of the business (which is based on performance forecasts and assumptions as to long term prospects) that is being sold. As a mechanism to hedge against such uncertainties, parties resort to utilisation of deferred consideration strategies, such as 'earnouts'.

- In a typical earnout deal, parties will provision for only a part of the purchase price to be paid upfront; the balance consideration, i.e. the earnout, is linked to the achievement of certain pre-defined financial, operational or commercial post-acquisition milestones. The earnout is therefore structured as a function of the post-acquisition performance of the business.

- The earn-out becomes payable only upon the satisfaction of the pre-defined milestone(s) which are intrinsically linked to the manner in which the business will be managed post-acquisition. For instance, where parties agree to retain seller-managers during the transitory phase, the agreed upon milestones might be something that is a function of the performance of these seller-managers, such as a revenue target or an EBITDA multiple.

- Earnouts may be seller-managed or purchaser-managed. A typical seller-managed earnout deal would see the seller or its representatives being retained in the management of the business during the earnout period or the transitory phase post-acquisition. It is the seller that will aid in driving the business towards the agreed upon milestone(s).

- In a purchaser-managed earnout, however, the seller plays a more passive role; the seller does not typically participate in the day-to-day management of the company and will have limited rights of oversight and veto powers restricted to crucial business decisions.

- In India, of course, earnout transactions generally tend to be in the nature of purchaser-managed earnouts. Of the few seller-managed earnout transactions that have come into the public domain, most are structured in a manner where representatives of the seller-management are retained as employees during the transitory phase. These managers are paid out the earnout component as a component of their overall compensation package. In other words, seller-managed earnout transactions have popularly restricted the earnout from being reflected in the total consideration for the M&A deal.

- The earnout period and milestones agreed upon by the parties is the product of lengthy negotiations and is of particular importance to the earnout mechanism. Typically, parties will choose one or more of a revenue and/ or non-revenue based milestone.

- A revenue-based milestone is usually a variation of EBITDA and/ or gross revenue targets, and a non-revenue based milestone might be based on the creation of new intellectual property, new product lines and/ or new customers.

Empirical Data of Earnout Deal Points

Theoretically, the purchaser is able to apprise itself of more value-relevant information during the earnout period; hence, the valuation risk is apportioned between the parties. Several studies have been undertaken on the use of earnouts in M&A deals which indicate the primary motivations of parties using earnout deals:

- *An early study of earnout strategies, based on a sample of 61 (sixty one) earnout deals between 1996 and 1997 in the United State of America (**"US"**), found that the primary motive of the purchaser in negotiating the earnout was to overcome valuation differences between the purchaser and the seller, or retain the seller-managers post-acquisition, or both.*[1]
- *The milestones utilised in a seller-managed deal also tend to be different from those utilised in a purchaser-managed deal; whereas, seller-managed deals opted largely for income or revenue-based targets such as an EBITDA valuation, or gross revenue generated during the earnout period, while purchaser-managed earnouts tended to use more specific, non-accounting parameters (such as the development or innovation of a product, the solicitation of new customers, forays into untapped markets, and so on).*

1. Srikant Datar, Richard Frankel, & Mark Wolfsen, Earnouts: The Effects of Adverse Selection and Agency Costs on Acquisition Techniques, The Journal of Law, Economics, & Organization, Vol. 17, No. 1 (2001), pp. 201-238.

2. Drafting an earn out provision

In the haste of quick-fixing a valuation gap, parties tend to agree to ambiguous earn-out provisions, which then come to haunt the transaction at a later stage when the earn-outs are to be computed and paid. Hence, it is most critical that parties exercise abundant caution in the structuring and the implementation of their earnout strategies. The following provisions require merit special attention to avoid disputes later on:

- **Business Management:** Typically, in an earnout transaction, the management of the acquired business is left to the management of either party (or their representatives). The roles and the responsibilities of each party vis-à-vis the management of the business must be incorporated in the agreement. Apart from standard affirmative and negative covenants, parties may even consider drawing up a charter of 'dos' and don'ts' enabling either party to exercise sufficient oversight over the actions of the other party in relation to the management of the business.

- **Specific Revenue-based or Non-Revenue based Milestones:** As was highlighted earlier, the parameters specified in the case of a seller-managed earnout would differ from the parameters in the case of a purchaser-managed earnout. Parties can agree to any combination of accounting principles and policies for the purposes of the earnout valuation. Parties may even agree to use separate accounting principles (distinct from the accounting principles and policies used to maintain the books of the business).

- **Revenue-based Milestone:** A seller-managed deal tends to utilize various accounting goals (earnings/ revenue based goals) such as EBITDA, gross revenues, earnings per share, etc. However, these accounting milestones could be interpreted or misinterpreted on a prejudiced reading of the relevant accounting standards at times.

  » Parties should bear in mind that accounting standards are flexible to afford parties the opportunity to adapt accounting practices specific to their business environment. The purchaser must apprise itself of the specific accounting practice at the business in order to propose and design the appropriate milestone(s).

  » Often, disputes might arise on the basis of the accounting practices in place at the business prior to the acquisition. These disputes will center about the differences in interpretation of IAS/ IFRS.

  » The adoption of a fresh set of accounting practices by the purchaser might materially affect the chances of the earnout taking place.

  » In order to avoid these disputes, parties must lay down specifically the accounting principles, and revenue/ expenditure recognition rules to be utilized. Where past accounting practices are to be retained by the purchaser, parties might even strive to identify the particular issues that are likely to be contentious. It is imperative that parties are cognizant of the exact implication of each milestone being laid down for the earnout calculation.

  » For instance, where the purchaser has failed to specify the method of calculation of the EBITDA milestone, the seller-managers might push to have expenses on research and development, marketing or advertising curtailed in order to boost the possibilities of the milestone being achieved.

  » As highlighted in our example above, parties must establish appropriate linkages between the accounting milestone(s) and the behavioral curbs agreed upon.

- **Non-Revenue based Milestone:** Utilization of non-revenue milestones such as the obtaining of regulatory approvals, the development of intellectual property, the number of products sold, or the development of a new product line is trickier for parties to incorporate into the earnouts clause. These milestones tend to have a qualitative aspect for which an objective evaluation mechanism must be built into the earnouts clause.

» Parties might develop criteria for the determination of the performance quality in fulfilling the milestone(s).

» For instance, where parties agree to a milestone for the sale of products, the important considerations for the parties might be (i) the regulation of the cost functions; (ii) marketing strategies for products; and (iii) target consumer groups.

» Parties might also consider the engagement of external agencies to evaluate the business performance during the earnout period. Where, for instance, the agreed upon milestone is the development of intellectual property, parties may consider instituting a joint mechanism for the monitoring of the process of development.

» The mechanisms adopted are especially crucial to sellers to ensure that the purchasers do not impede the achievement of the milestone by curtailing budgetary allocations, diverting human resources towards other business functions, etc.

- **The earnout period:** The earnout period must be clearly defined. The length of the earnout period is often a focus of heavy negotiations, and parties might even agree to a staggered earnout period for different milestones. The earnout period would, in that case, be the aggregate of all the staggered periods. Typically, it is the sellers that bargain for the adoption of staggered periods in earnout deals in order to enhance the probability of the earnout for each of the milestones achieved.

- **Standstill Provisions:** The standstill provisions are crucial to management of the business during the earnout period. These standstill provisions serve to (i) mould and regulate the management of the business during the earnout period; and (ii) to establish the level of co-operation that parties agree to extend to each other during the earnout period.

» The nature and the extent of the standstill provisions are dependent on the bargaining power of either party; the agreement must then be drafted in a manner that places the correct proportion of behavioural curbs (as was agreed upon by the parties).

» In doing so, care must be taken to specify the obligations of either party as unambiguously as possible. Disputes often arise in relation to claims that the acquired business was operated by the purchasers in a manner that would be prejudicial to the possibilities of the earnout.

» A water-tight standstill provision is essential to avoid post-closing disputes. Accordingly, the provisions must clarify the level of co-operation expected between the parties,

» Typical standstill provisions are in the nature of an affirmative right or a veto matter requiring the approval of the seller. For instance, sellers might bargain for veto/ approval rights for matters relating to:

  - The execution, delivery and/ or termination of material client contracts;
  - The infusion of further capital into the acquired business including through third-party credit facilities;
  - Budgetary allocations towards research and development and marketing of prodcuts;
  - Sale and disposal of the acquired business and other M&A transaction; and
  - The hiring and firing of key managerial employees.

- The design of the earnouts provisions will follow the negotiations and bargaining between the parties. The following table illustrates a typical negotiation pattern relating to earnout provisions:

Negotiation Matrix

Issue	Negotiation Objective	Drivers / Considerations for Negotiation
Business Management	Transition support and seller incentivisation	▪ Degree of involvement of seller-management in order to incentivise the seller. ▪ List of standstill matters (to determine the extent to which the purchaser can operate independently during the earnout period). ▪ List of standstill matters where seller can refuse/ veto business decisions proposed to be undertaken by the acquired entity.
Milestones	Revenue-based milestones (EBITDA, etc.)	▪ EBITDA computations (or variations thereof) to be as close to conservative accounting principles as possible. ▪ Whether based on your understanding of the financial diligence, would it be appropriate to allow for continuance of same accounting practices and procedures that have been in place at the acquired company. Often, sellers will opt for an interpretation of accounting standards that is liberal and that allows them to secure the continuance of accounting practices. ▪ Accounting principles to be utilised towards the computation of the EBITDA milestone. ▪ Standstill provisions regulating expenditure and investments maybe used to manipulate the EBITDA computations.
	Non-revenue based milestones (number of customers, development of IP, etc.)	▪ Not very common in Indian context. Typically, asserted by purchasers considering the subjective nature of the milestones. Typically, resisted by sellers given that milestones are more susceptible to manipulation. ▪ Components of the earnout mechanism including the earnout period and the standstill provisions.
Earn-out Period[2]	Number of years	▪ Consider the period of time keeping in mind the time that may be consumed in the transitory phase of the acquisition. ▪ Negotiate for a staggered earnout period for various milestones to be achieved across the staggered timeline.
Standstill Provisions	Execution and/ or termination of material contracts	▪ Carefully define 'ordinary course of business' as that may be a qualifier to standstill provisions. For instance, any matter that requires a specific board approval or shareholder approval should not qualify as ordinary course of business. ▪ Provision for appropriate capital expenses in order to maintain operational autonomy for businesses. Similarly, consider the obligation to make necessary capital expenditure where required. ▪ Provision for impairments ▪ Accounting policies and practices are negotiated to be clearly defined and strictly follow principles of conservatism. This enables purchasers to recognise expenses in the books that earlier may not have been reflected.

2. Please note that the earnout period for cross border transactions is capped at a maximum of 18 (eighteen) months from the date on which the acquisition agreement is signed, under the automatic route. Any earnout period beyond the prescribed time is subject to RBI approval.

		▪ The continuation of past accounting practices of the acquired firm is typically the stance adopted by seller, given their familiarity with the methodology and adaptation to the acquired business. ▪ This stance has to be carefully evaluated against representations around the validity of accounts. Purchasers may exploit representations where an accounting practice followed by the seller is not fully compliant with a conventional interpretation of applicable accounting standard such as the IAS.

3. Dispute Resolution Strategies

- Several recent deals have seen disputes arising in relation to or in connection with the interpretation of earnouts provisions.

i. From our experience, we have seen disputes in deferred consideration deals (including earnouts and working capital adjustments) arise in the context of:

» Past accounting practices of the business and the differing interpretation of accounting standards;

» Preparation of the true-up balance sheet based on International Financial Reporting Standards (**"IFRS"**) as opposed to Indian Accounting Standards (**"IAS"**)/ Indian GAAP;

» Breaches of, and interpretation of the standstill provisions;

» Transactions undertaken by the seller-and/or purchaser-management in bad faith with the view to reduce the probability of the earnout; and

» Differing interpretation of provisions regarding the management of the business.

» Disputes relating to the principles of contractual interpretation are also common to earnout transaction. Certain illustrations are as follows:

- The ability of parties to take up the claim that the implied covenant of good faith and dealing should be read into the standstill covenants;
- The degree to which the purchaser may allow sellers (or their representatives) to access and inspect books of the business;
- The interpretation of the business judgment rule in light of the standstill provisions and the ability of parties to exercise business judgment over hyper-technical reading of a provisions; and
- The appointment of the neutral, third party expert.

ii. Parties must therefore be cognizant of the applicable laws, accounting principles, customs and practices applicable to the acquired business while designing the earnout mechanism.

iii. Considering the inherent complexity, earnouts are often viewed as valuation disputes deferred to a later stage. Indeed, most disputes relating to deferred consideration mechanisms, including work capital adjustments and earnouts, arise in relation to or in connection with the behaviour of the parties vis-à-vis the agreed mechanism.

iv. As indicated above, a large number of earnouts disputes arise on account of the interpretation of the earnouts provisions in light of the conflicting interpretation of the past accounting practices of the acquired business and the interpretation of IFRS/ IAS/ Indian GAAP.

For instance, it may be noted that under IAS and Indian GAAP, the amount of the contingent consideration (earnout) will be recognised in the books of the purchaser as a contingent liability only upon the amount becoming determinable. However, under IFRS the fair value of contingent consideration must be recognised in the books as a liability or as equity, as appropriate. Further, changes in the fair value of the contingent consideration must also be recognised periodically (which might materially affect the profits or losses of the business in any financial year).

v. Often, a point in dispute between parties is the interpretation of what constitutes a "past accounting parties". Disputes often centre on whether a one-off accounting treatment of an expenditure, a write-off of an existing account, or even the recognition of contingent liabilities.

vi. Further, parties must be cautious in usage of terms such the "fair value", "fair market value", "written down value" in their earnouts provisions. The parties must evaluate the import of each of these accounting terminologies before agreeing to the usage of any such computation mechanism.

I. Drafting the Disputes Resolutions Clause

Earnouts and other deferred consideration strategies are devised in order to bridge over valuation gaps between the parties. However, these differences often prove to be insurmountable and disputes become unavoidable. For this reason, parties must also formulate an appropriate dispute resolution mechanism as part of the earnout provisions.

A. Distinct Mechanism

Given the complexity of issues relating to earnout and working capital disputes, parties must formulate a dispute resolution mechanism that is distinct from the dispute resolution mechanism to be adopted for the entire purchase agreement. The dispute resolution mechanism for the earnouts provision must specifically identify the items of dispute to which it will apply. These identified items might be, for instance, regarding (a) interpretation of the true-up balance sheet; (b) the interpretation of the accounting principles, procedures and accounting practices for the computation of the earnout; (c) the actions of the parties in light of the standstill provisions, etc.

A related point, of course, is the inevitable difficulty of determining the manner in which the dispute resolution mechanism devised for the earnout will apply to claims that might also be claims for indemnification for breach of representations and warranties, fraud and breach of covenants agreed upon.

B. Parameters of the dispute

For various reasons, including the urgency to close the deal, and the difficulties in agreeing upon the contours of the earnout dispute, parties may opt to determine the parameters of the dispute ex post. For instance, in the case of working capital adjustment disputes, parties may agree to limit their dispute to corrections and modifications to the true-up balance sheet prepared for the purpose. Accordingly, it is imperative that the earnout provisions specify: (a) the manner in which the true-up balance sheet will be prepared; (b) the party responsible for the preparation of the same; (c) the participation and review rights that the other party will have; and (d) audit process (if any) to be delegated to a third party and independent audit firm.

Examples of Common Misconceptions in Working Capital Adjustments

From our experience, we have noticed that there are common perception issues relating to disputes and dispute resolution in cases involving working capital adjustments and other similar deferred consideration mechanisms.

i. Cash and Bank Balances

- *A considerable degree of the confusion stems from the interpretation of provisions describing the computation methodology for the adjustment. A typical working capital adjustment transaction would involve the computation of a true-up, or a* *closing balance sheet. The adjustments should be a strict function of the changes in the values of inventory, receivables and other current assets.*

- *Very little attention is, however, paid to the manner in which cash and bank balances are to be treated for the working capital adjustment. No doubt cash and bank balances is integral to the computation of working capital. The movement of cash and bank balances is however not a mere function of the operation side of the business; for instance, investment activities (such as availing of loans, or sale of scrap), or changes in the credit policy provided to customers can be tweaked in order accelerate cash flow. These will have significant bearing on the computation of the working capital adjustments.*
- *Other concerns involve the applicability of accounting rules involving write-offs and depreciation. Attempts to write-off the value of inventory, stores and other current assets are often opposed on the ground that depreciation and write-offs are not in line with past business practices, or that such depreciation can only be made at the end of the financial year.*
- *Sometimes, cash is excluded from a working capital adjustment on the ground that cash is shown an absolute basis and no true up is needed for that. However, keeping cash outside the purview of true- up can be very dangerous since sometimes cash can be artificially inflated without any real benefit to the company.*

ii. Working Capital Adjustment Claims

- *There is considerable confusion regarding the distinction between claims under working capital adjustment and a claim for a breach of contract. Differences in the methodology employed in the computation of the adjustments cannot be treated as a breach of the agreement.*
- *The problem is accentuated when the differences in the computation is linked to the contravention of a covenant (such as the standstill provisions).*
- *For instance, where the purchaser has covenanted not to carry on any activity outside the ordinary course of business, any activity that impinges on the working capital adjustment can be construed as either a breach of the agreement, or a claim for working capital adjustment. However, the issue that stands out here is how a party should deal with such duality of claims. A claim for a breach against a party does not preclude its ability to pursue a claim under the working capital adjustment. A breach claim may result in claim for damages or indemnity, but the purchaser will be obligated to first pay the working capital adjustment amount strictly as per the contract, and then claim for indemnity separately; unless the agreement allows for setoff of counter-claims.*

C. Determination of the disputed amount

Proceeding with our example relating to the working capital adjustment, parties must exercise abundant caution in drafting the dispute resolution procedure involving third party, independent firm. The dispute resolution clause must clearly lay out:

- The manner in which the firm will be engaged;
- The scope of the firms' mandate and whether such mandate is limited to only the points in dispute;
- The value of the firm's findings and whether such findings are final and binding on the parties; and
- Whether the firm is bound only to the claims made by the parties, or whether the firm is to conduct a fresh assessment of the true position of the working capital adjustment.

D. Use of Alternative Dispute Resolution Methods

Parties may evaluate the insertion of alternative dispute resolution methods, such as negotiations and private mediation, prior to reference of any dispute to arbitration. Negotiations may, of course, not be very effective in earnout disputes which are often characterised by rigid bargaining positions. Mediation, on the other hand, involves a managed dialogue between the parties where a neutral third party is supposed to balance party expectations and interests towards the settlement of the dispute.

E. Offsetting Earnouts against Indemnities

Purchasers often face the question regarding whether the earnout to be paid (if any) should be set off against indemnity claims that the purchaser brings against the seller.

Typically, a purchaser would wish to link any payment of the earnout against claims of an indemnity. This approach requires that parties ensure that there is a specific provision in the purchase agreement enabling parties to adjust amounts and sums payable against claims that have been made against the other parties. In the absence of a provision providing for such a mechanism, parties cannot have resort to any contractual claim for a set-off.

However, parties must also be cognizant of the fact that the inclusion of such a provision would likely bring several points of disputes within the earnout dispute.

F. Using Case-Law Guidance

There has been striking variety in the judicial interpretation to earnouts provisions. This poses a challenge, especially, for cross-border deals where parties must adjust and calibrate their earnouts provisions based on the jurisprudential trend in the parties' respective jurisdictions.

i. No Duty to Maximize Earnouts

- In the US, the Supreme Court of the state of Delaware, in *Lazard Technology Partners, LLC v Qinetiq North America Operations, LLC* [3] settled that earnouts clauses must be strictly interpreted. In that case, it was decided that the purchaser may not take any action that is with the intent to defer or reduce the earnout. However, the earnouts clause must specifically provide for the exact actions that the purchaser may not have resort to. In the absence of a specific clause prohibiting the purchaser to undertake a particular action, the seller could not claim that an action by the purchaser that might have the effect of reducing the earnout is against the spirit of the agreement and the implied covenant of good faith.

- However, this position is also complemented by other equally influential judicial positions: for instance, courts in the state of New York have resorted to the gap-filling role of reading the implied covenant of good and fair dealing into the earnout agreement, while courts in the state of Massachusetts have imputed the duty of reasonable efforts to parties to an earnouts agreement.[4]

- *Given this trend toward the interpretation of earnout provisions in other jurisdictions, it is suggested that parties exercise abundant caution in the drafting of earnouts clauses. Parties should not rely on any implicit covenant of good faith and fair dealing in the drafting of earnouts provisions.*

3. 114 A.3d 193 (Del. Apr. 23, 2015)
4. Sonoran Scanner, Inc v PerkingElmer, Inc. 585 F.3d 535 (1st Circuit, 2009)

ii. Judicial Position in India

- In India judicial guidance on the interpretation of earnout contracts is sparse. Where it is apparent from the construction of the terms of the agreement, courts have accepted that parties may bind themselves to obligations absolutely.[5]

- Generally, courts in India are reluctant to take up a 'gap-filling' role [6]; the Supreme Court of India in *United India Insurance Company Limited v Manu Bhai Dharamasinbhai Gajera and others* [7] held that an unexpressed term can be held to be implied if and only if the court finds that the parties must have necessarily intended that term to form part of that contract: the parties must demonstrate to the court that such implied term was essential to give business efficiency to the contract.[8]

- *If the contract makes commercial sense in the absence of a specific provision, the court cannot read such terms into the contract.*[9] *Considering the approach of the Supreme Court of India, it is likely that performance obligations in the earnouts clause would be given its plain meaning only. Parties should, therefore, ensure that their earnouts contract spells out clearly the obligation, consent requirements, and other performance obligations that must be binding on the parties.*

5. Pattahmull Rajeshwar v KC Sethia AIR 1960 Cal 702
6. Pragdas Mathuradas v Jeewanlal AIR 1948 PC 217
7. United India Insurance Company Limited v Manu Bhai Dharamasinbhai Gajera and Others (2008) 10 SCC 404
8. *Ibid*
9. Satya Jain (Dead) Through Legal Representatives v Anis Ahmed Rushdie (Dead) Through Legal Representatives AIR 2013 SC 434

4. Tax Considerations

In light of sensitivity of the deferred consideration deal to the accounting methodology adopted, parties must ensure that the earnouts provisions accurately reflect the commercial understanding of the parties accurately. Accordingly, it is imperative that the earnouts provisions unambiguously state the exact principles of accounting and the rules to be applied to the computation of the earnout.

The tax treatment of earnouts raises several fundamental questions regarding the structure of the earnout arrangement that parties would want to opt for. Some considerations that parties must evaluate are as follows:

- Is the earnout contingent upon the promoter's continued employment at the acquired business? If so, what is the capacity in which the services of the promoter/ seller-manager are to be provided?

- What is the tax cost that either party is agreeable to bear? In other words, what is the specific categorization of taxable income that parties would opt for – 'salary' income under section 17 of the Income Tax Act, 1961; section 28 of the Income Tax Act, 1961; or section 45 of the Income Tax Act, 1961?

- On a parallel basis, (and depending on what is the structure of the earnout mechanism,) the parties must also determine when the tax on the purchase price (including the earnout component) shall be payable.

In light of these considerations, the parties must also factor in tax costs applicable to the earnouts provisions being designed. The particular nature of the earnout deal from a taxation perspective might significantly contribute to costs that parties must incur and factor in. The alternatives that parties may have resort to are as follows:

I. Contingent Consideration and Capital Gains Tax

Where the earnouts pay-out is treated as part of the purchase price payable upon the achievement of the milestones, the parties must compute tax costs as capital gains tax. IAS requires the purchaser to recognise the true and fair value of the potential earnout as on the date of the acquisition.[10] The valuation of the earnout may be adjusted in the books on a periodical basis based on the potential of the future payment.

It is recommended that the capital gains tax is paid on the full value of the consideration on the date of acquisition in order to avoid controversies with the revenue department. In the event of an earnout failing to materialise, the seller can claim a refund based on the adjustments made in the books of the parties;

II. Manager Compensation

Parties looking to avoid complications of contingency accounting may opt for the earnout to be classified as 'compensation' for the seller-manager as part of the salary pay-outs. These pay-outs can then be deducted from the net earnings of the business and the tax payable on the total consideration for the acquisition may be proportionately reduced.[11] It may be noted, however, that the seller-managers must bear a tax cost of up to 30% (thirty percent) (exclusive of surcharge, etc.) on the total 'salary' of the manager.

Since revenue authorities will rely on the earnouts provisions and the books of the parties, it is essential that parties leave no room for ambiguity on the commercial understanding of the parties.

10. Paragraph 39 of IAS 103 (Business Combinations).
11. Paragraph 27 of IAS 37 (Provisions, Contingent Liabilities and Contingent Assets)

In re, Anurag Jain [12], the Madras High Court, looking into the substance of the arrangement, found that the 'earnout' component was linked only to the performance of the manager and not directly linked to the performance of the acquired business. The contingent payment was therefore, held to be 'profits in lieu of or in addition to salary' under section 17 of the Income Tax Act, 1961.

On the other hand, where the contingent pay-out is part of the total purchase price, the entire purchase price will be subject to the taxation for capital gains under the Income Tax Act.[13]

III.How to compute earnouts tax?

In addition to ambiguities owing to the characterization of income, the taxation of earnouts also sees challenges such as the year of taxability of income or even the quantification of the deferred payment and consequent revisions (if any) of the purchase price.

For instance, earnouts being in the nature of contingent pay-outs, capital gains may never arise in a particular transaction owing to the underperformance of the acquired business. For such reasons, it would be onerous for the seller to have to pay tax on the entire projected purchase consideration.

Delhi High Court

The manner in which tax is to be computed is as yet unsettled in law. The Delhi High Court in *Ajay Gulia v Assistant Commission of Income Tax* [14] held that the full value of the consideration received in the assessment year be subject to the tax irrespective of the year of receipt or accrual. The court, citing *Ashokbhai Chimanbhai* [15], found that a conjoint reading of section 45 and section 48 of the Income Tax Act, 1961 indicates that the full value of consideration received or accruing in any year as a result of transfer of the capital asset shall be taxed in the year in which transfer takes place irrespective of the year of accrual or receipt.

The High Court also took into account that there was no material on record suggesting that the title to the shares would revert to the seller if the entire consideration or part is not paid. Therefore, the true nature of the transaction was determinable at the point of transfer and the adoption of a deferred payment mechanism would not detract from the chargeability of the shares when sold. Consequently, the income would be accrued at the time of transfer of the shares, and the whole sale consideration would be subject to capital gains tax.

Bombay High Court

In contrast the Bombay High Court, in *Commissioner of Income Tax v Hetel Raju Shete* [16], held that the total consideration will <u>not be deemed</u> to be have been received in the assessment in which transfer was effected. The computation for capital gains will take place as and when the earnout pay-out is made.

In that case, the High Court found that the deferred consideration was payable to the assesse over a period of 4 (four) years and the agreement was clear in providing that the deferred consideration would be paid out conditional upon the profits made by the business during the said period.

12. 308 ITR 302
13. *In re Moody's Analytics, Inc.*, USA, AAR No. 1186 of 2011; AAR No. 1187 of 2011; AAR No. 1188 of 2011; AAR No. 1189 of 2011
14. ITA 423 of 2012
15. *CIT v Ashokbhai Chimanbhai*, 56 ITR 42 (SC)
16. Ordinary Original Civil Jurisdiction, ITA No. 2348 of 2013

The High Court, relying on the Supreme Court decisions in *Morvi Industries* [17] and *ED Sassoon & Co* [18], held that the amount sought to be taxed was the maximum amount payable to the assessee and not an assured consideration. Therefore, the amount sought to be taxed failed to meet the test of accrual, i.e. whether there is a right to receive the amount thought later and whether such right is legally enforceable.

The Court held that the whole amount cannot be said to have accrued to the assessee on the date of the transfer of shareholding as it was not certain if such assessee would actually be entitled to the maximum amount. In other words, the assessee is not liable to pay any taxes on the earnout component of the purchase price till such sum does not accrue to the assessee (upon the satisfaction of the milestones).

As it currently stand, the Indian tax regime places potential liability to pay tax for the entire consideration on the sellers. The ruling in *Ajay Gulia* is of concern as it might significantly enhance the transaction costs of the acquisition.

Furthermore, the tax regime provides no mechanism for recovery of tax paid in the event of reduced consideration linked to the underperformance of the business. It is of course open to assesses to offer the full amount of consideration to tax and claim capital loss in subsequent assessment years[19] ; however, the position is far from clear.

17. *Morvi Industries v CIT*, 82 ITR 835 (SC)
18. *ED Sassoon & Co. v CIT*, 26 ITR 27 (SC)
19. *TV Sundaram Iyengar v Commissioner of Income Tax* (1959) 37 ITS 26 (Chennai)

5. Exchange Control Considerations

- Earnouts in India are difficult for cross board M&A deals. Earlier, in the case of a transfer of equity instruments where the non-resident purchaser proposes the deferment of payment of the amount of consideration, prior approval of the Reserve Bank of India would be required.[20]

- The position has recently been relaxed: *where a foreign investor purchases the shares of an Indian company from a resident seller (or vice versa), the consideration may be deferred on the following conditions: (i) the deferred component cannot exceed 25% of the total purchase price; and (ii) the period of deferment of the payment must not be more than 18 months from the date of acquisition agreement.*

- If the provisions of the earnout contract does not meet the conditions (i) and (ii) above, the parties would be required to obtain the approval of the Reserve Bank of India. Importantly, parties must note that the period of deferment commences from the date of the acquisition agreement, and not from the date of closing. This makes the earnout period available to parties considerably shorter.

- Further, in practice, obtaining the Reserve Bank of India approval to deferred consideration requires considerable cost and time.

- For earnout transactions where the parties structure the earnout component as a perquisite to the seller managers, the ceilings prescribed by the Reserve Bank of India might not apply, given that in such cases the earnout component is not part of the purchase consideration.

- Given the position of law, deals between resident parties and foreign investors have less dynamic earnout mechanisms. The earnout period is capped to about a year and a half, and is far too short for a proper evaluation of the commercial value of the investment.

- A point of discussion between parties often centers about the manner in which the earnout component will be treated during the earnout period; typically, the debate tends to be between placing the earnout amount in an escrow account or deeming the earnout component as a 'promise to pay'. The seller would generally prefer having the earnout component secured in an escrow account managed by a third party, independent trustee. Conversely, the purchaser would prefer a mechanism which would least affect its liquidity. Considering that the entire earnout component is contingent in nature, purchasers would push for the sum to be classified as a 'promise to pay'.

- Given the tax and exchange control considerations affecting the earnout transaction, parties should analyze and evaluate the deal mechanisms in order to optimize tax and exchange control costs to be incurred.

20. A.P. (DIR Series) Circular 63, April 22, 2009.

6. Alternative Earnout Structures

I. Deferred Consideration

- To illustrate the need for parties to optimize the earnout mechanism, a simple earnout transaction matrix has been provided in the table below:

	Purchase Price (~INR 100 million)	**Stake Purchased**
Payment Upfront	60 million	90%
Earnout	40 million	10%

- In the transaction represented above, it may be noted that the parties have not acquired the entire business prior to the earnout.
- The sale of the balance 10% is contingent on the milestone(s) being satisfied. In other words, in the transaction above, the earnout is fashioned as a sale of the remaining stake at a price that corresponds to the balance purchase price that had initially been pegged for the complete acquisition of the business.
- It is imperative that parties factor in tax and exchange control considerations of the transaction. In the event that the transaction involves a foreign investor seller and a resident purchase, parties must be conscious of the pricing guidelines (especially, the ceiling prices) applicable to the transfer of the first tranche for 60 million. In this case, the domestic purchaser will not be able to quote a price that is higher than the ceiling price for the first tranche shares.
- Given that the transaction illustrated here envisages two independent transfers, parties must further be conscious of the tax implications on each leg of the transfer. It is not unlikely that the first leg of 90% stake sale for INR 60 million will raise concerns of fair market value and might potentially attract tax under section 56 of the Income Tax Act, 1961.
- Inversely, since further sale by the purchaser (then in this capacity as a seller) will happen on FIFO basis, the purchase (in his capacity as seller) will also be made to bear capital tax implications in future for any transfers of securities that is part of the first leg, given that the cost of acquisition of the shares in the first tranche shall be very low.
- The seller, too, will be required to factor in capital gains implications for the 10% sale of shares in the second leg, since the cost basis for the shares in the second tranche will correspond to the value of 40% (as in the factual matrix above) of the business.

II. Implications of Manager Compensation

- Structuring the earnout component as a compensation to the seller-manager is a popular alternative.
- The payout, as highlighted previously, will typically be classified as 'profits in lieu of or in addition to salary' under section 17 of the Income Tax Act, 1961 and the seller-manager will have to bear a tax cost of about 30% (thirty percent).
- In earnout transactions structured as compensation arrangements, parties must ensure that the 'employee' status of the seller-manager is clearly defined.
- It is imperative that parties remain conscious that the payment of the compensation to the managers is likely to be paid out by the business. Under these circumstances, the purchaser must ensure that there is sufficient liquidity in the business for the payout to be made.

Alternative arrangements

- Given that the on 'salary' income offer little by way of tax arbitrage to the seller/ seller-managers, parties may think of structuring the engagement of the seller(s) as a consultancy or a professional services agreement. The fees for the services shall be paid only if the milestone for each year is met. This may potentially reduce the tax burden on the sellers.

III. Earnouts as Commission/ Service Fee

- In our experience, we have also seen parties resort to earnout arrangements outside the trappings of purchase price, or of 'salary'. Structuring the earnout as a commission has similar considerations to the professional engagement structure mentioned above.
- For instance, parties have agreed to link the earnout to the revenues generated during the earnout period. Here, the purchase had acquired the entire business from the seller. The earnout component of the consideration was linked to the performance of the marketing team of the seller.
- Upon the achievement of the milestone(s) agreed upon, a commission (i.e. the earnout) is paid out to the seller.
- This approach to the payout might not fall within the purview of the caps prescribed by the Reserve Bank of India, given that the circular covered only deferred consideration mechanisms. Where, in an earnout, the milestone(s) is linked to performance of the respective parties, as opposed to the performance of the acquired business, the payout should not be considered as part of the purchase price from an exchange control and tax perspective.
- However, parties must be cognizant of the fact that the commission income is subject to business income tax at rate of 30% (thirty percent) in the hands of the seller. Further, considerations of service tax (and other indirect taxes) must also be accounted for.

IV. Redeemable Preference Shares

- In our experience, it may be beneficial to the domestic promoters/ selling shareholders of the business to utilize a mechanism involving the redemption of redeemable preference shares.
- Typically, in these transactions, the purchaser takes over 100% of the equity of the acquired business. The selling shareholder is simultaneously issued redeemable preference shares at a nominal value.
- The nominal value must be determined on the basis of the parties' valuation of the shares and attendant tax implications.
- The terms of redemption of the preference shares must include a redemption premium (which represents the earnout) shall become payable once the milestone(s) agreed between the parties have been achieved.
- In cases where the earnout has not been achieved (within the earnout period), the preference shares shall become redeemable only at face value.
- Parties must be cognizant of the tax implications of resorting to an earnout transaction through the redemption of preference shares. However, the judicial position relating to the redemption of preference shares is far from settled.

- In recent cases, Income Tax tribunals have held that the redemption of preference shares should be taxed under section 45 of the Income Tax Act, 1961, i.e. capital gains. However, controversy remains regarding whether redemption of preference shares should instead be taxed as ‘deemed dividend’ as defined under s. 2(22) of the Income Tax Act, 1961.

7. Drafting Points for your Earnout Provisions

Given how sensitive earnouts are to the various factors, the parties must exercise abundant caution in order to produce a well-balanced agreement. In light of the considerations highlighted above, the following are practice points for minimizing risks for post-closing earnout disputes:

i. **Specificity and clarity:** It is evident that for earnout deals, the specificity and clarity in drafting is the clinching factor. The contract should clearly highlight the source of the earnout payment, the exact duration of the earnout period and the mutual obligations of the parties.

Wherever possible, in order to ensure clarity, the parties should consider providing examples to illustrate how the earnout provisions would function in various circumstances.

ii. **Parallel review by accountants:** Since the commercial value of the contract lies in the performance of the business (or managers) relative to the parameters decided upon, it is recommended that accountants and other financial advisers of the parties monitor the manner in which the earnouts contract is drafted. It is significant that the language of the contract must reflect the exact commercial intent of the parties in terms of the earnouts formula agreed upon. Any leverage that the parties may be capable of exercising post-acquisition may lead to a deviation from the earnouts formula, or commercial valuation contemplated by the parties.

iii. **Accounting treatment:** It is essential that the parties specifically provide for the adjustment and exclusions of income/ expenditure heads in the calculation of EBITDA, revenue, or any other parameter agreed upon. The approach should be to spell out specifically which accounts heads are to be adjusted for the earnouts formula. Further, where parties are looking to structure their transaction as compensation for the efforts of the management, the language relating to accounting treatment must in no uncertain terms link the earnout parameters to the performance of the managers.

iv. **Detailed list of obligations:** From the study of the trend of judicial interpretation of earnouts contracts, it is recommended that parties spell each and every curb that they wish to place on the behavioral autonomy of each other. Courts will tend to look at the plain meaning of the commercial contract, and may not be persuaded to take up a 'gap-filling' role. For this reason, it is essential that the template of 'dos'' and 'don'ts' is detailed, specific and stipulates exactly what the obligations of the parties are.

v. **Unambiguous Set-off Clause:** It is recommended that parties include an unambiguous clause allowing for an indemnity clause to be set-off against the earnout payment (if any). However, parties must also be cognizant of the fact that the inclusion of such a provision would likely bring several points of disputes within the earnout dispute.

vi. **Inclusion of appropriate disclaimers:** it is often recommended that parties consider placing appropriate disclaimers to the existence of any relation that is not being contemplated. In a seller-managed earnout, for instance, the seller-managers may consider negotiating a disclaimer to any fiduciary duty (in their capacity as managers) to the purchaser in order to emphasize their role and to incentivize the outlook for the purpose of the earnout.

–**Supratim Guha & Ruchir Sinha**

You can direct your queries or comments to the authors

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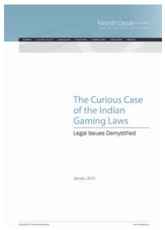

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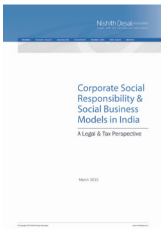

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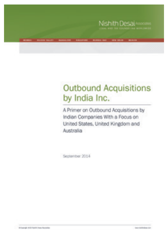

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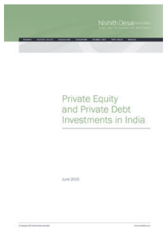

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