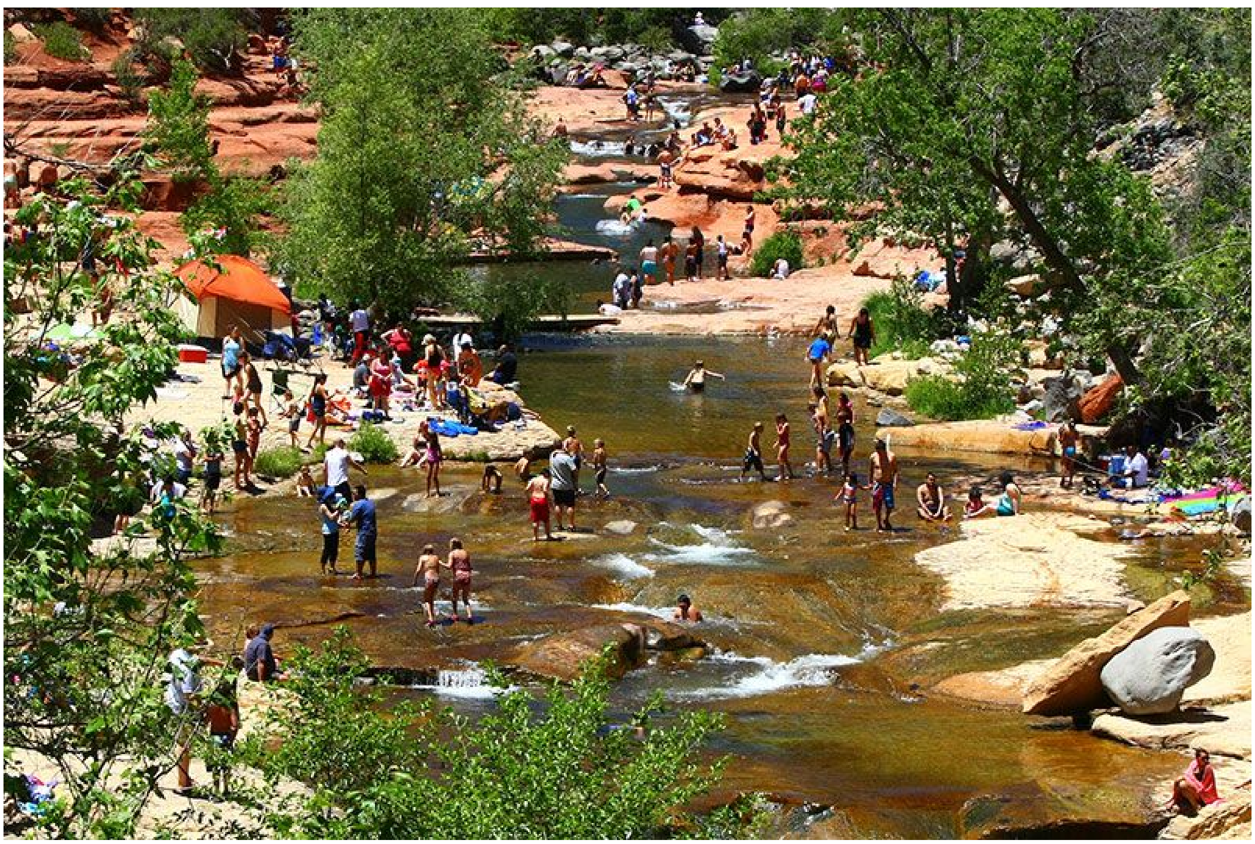
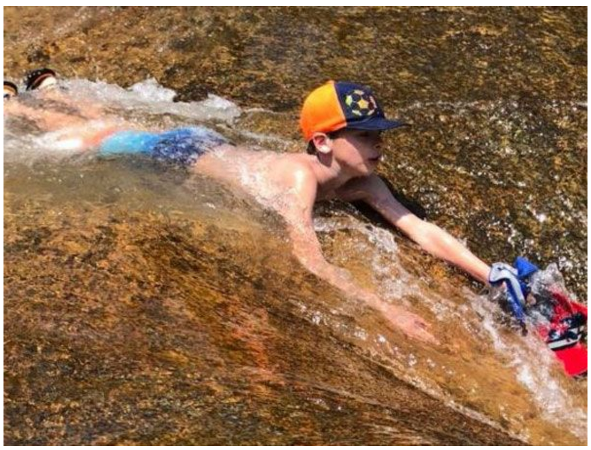
July 2019 Newsletter

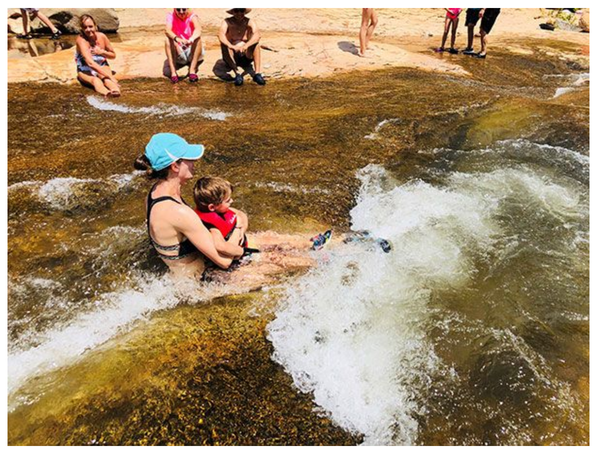
SLIDE ROCK STATE PARK



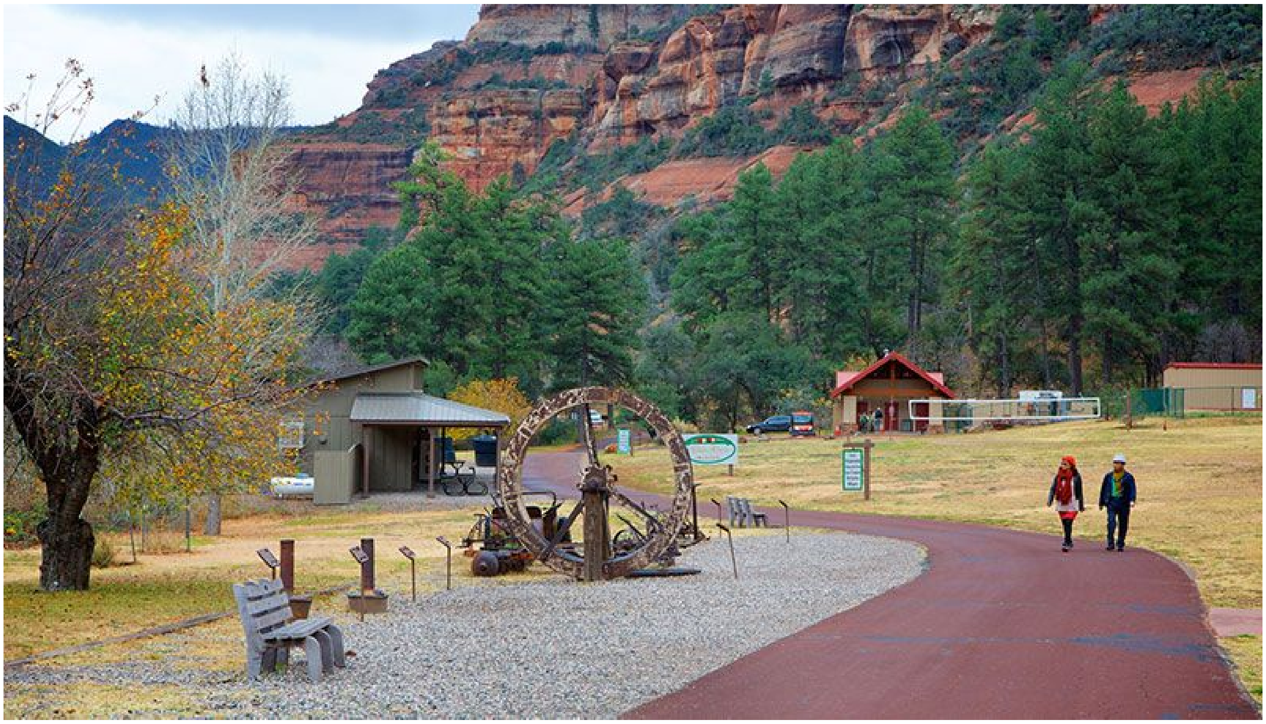
(Slide Rock State Park courtesy of Arizona State Parks)

Slide Rock State Park is one of Arizona's most popular recreational spots, especially welcome in the summer when you can escape the heat in the cool water of Oak Creek. Less than ten miles north of Sedona’s red rock landscape, there’s a narrow crimson canyon that is nature’s answer to a water park. At Slide Rock State Park, Oak Creek narrows to an 80-feet long chute of smooth red sandstone where children and adults ride down a series of mini cascades into white water pools (feels cold on hot skin, enough to take your breath away.) Slabs of russet stone on either side make ideal sunbathing spots (with little shade) or diving platforms into deeper pools.





You can also stroll scenic trails suffused with the herbaceous scent of Junipers or peer into Arizona’s pioneer history at the Pendley family homestead and orchard. There you can see their 1927 home, antique farming equipment and, between August and October, pick or purchase Red Delicious apples. During the fall festival, you can also sip fresh-pressed cider, watch a blacksmithing demo or build a scarecrow. There's a market on the premises for items you may have forgotten.



There is a fee per vehicle (up to 4 adults; children apparently free) of $30 from May 25th through Labor Day and a sliding scale thereafter. And remember, what you pack in you have to pack out as well. As you can see from most of the photos, people wear water shoes because (as the name implies) Slide Rock is slippery. And there are no lifeguards on duty. Safety first while you have fun!

Be sure to see the photograph of Patrick with the Suns' gorilla at the recent Phoenix Suns Sixthman Elite golf tournament, Michael Margrave as part of an optical illusion painting, as well as Patrick's article on Avoiding Litigation Over Earnout Provisions.

Patty Copeland, Editor

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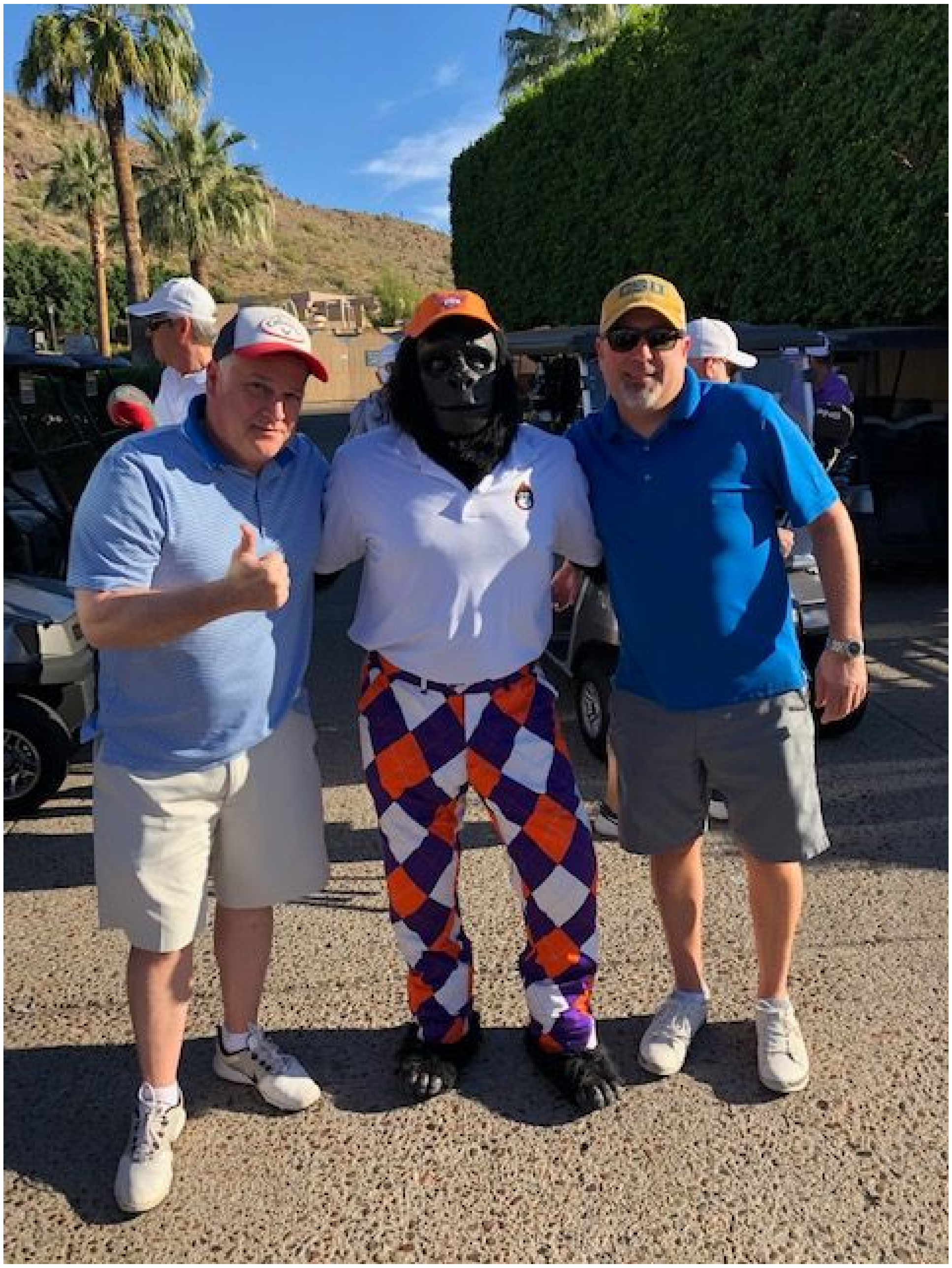
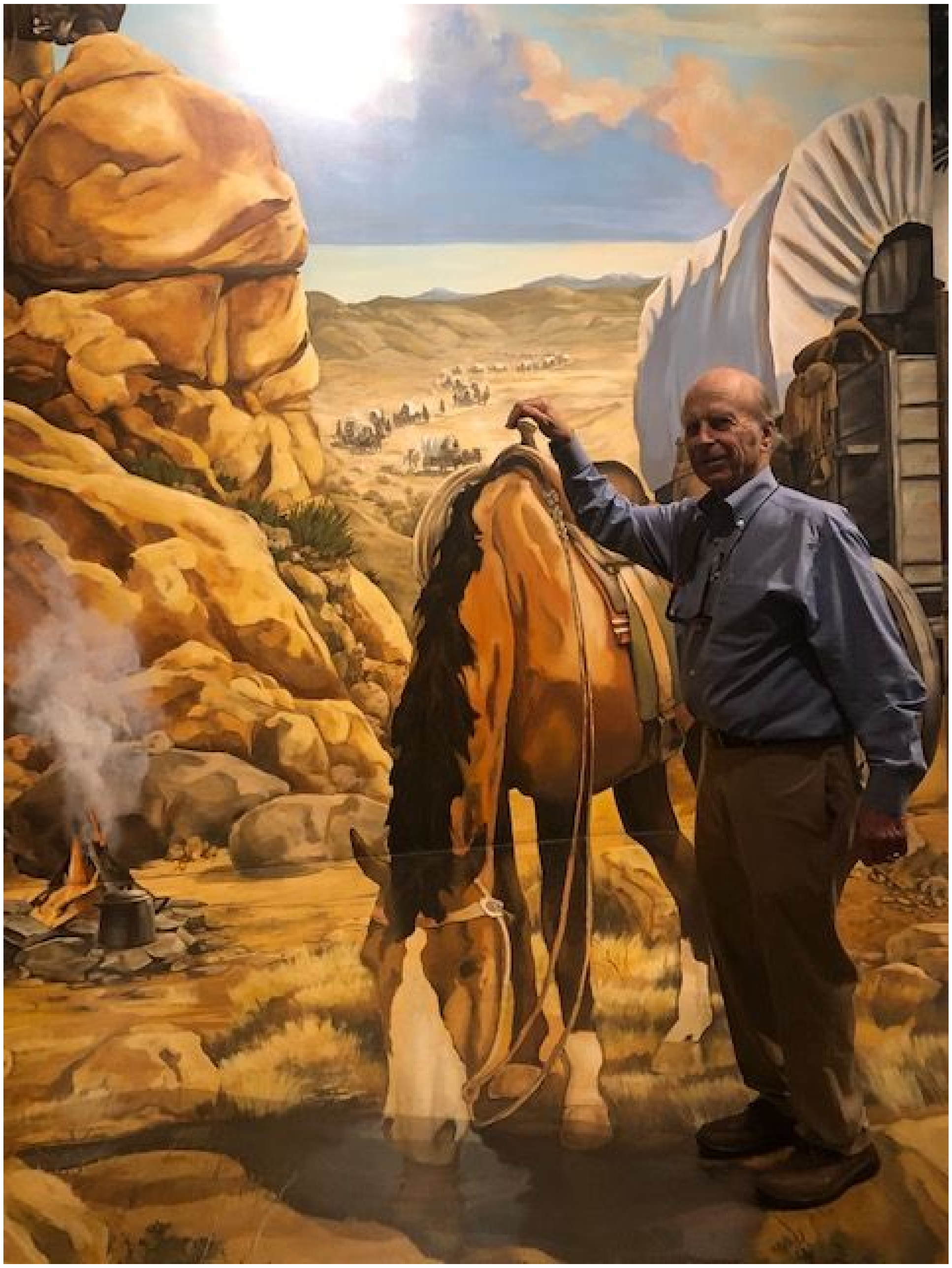
IN THE NEWS



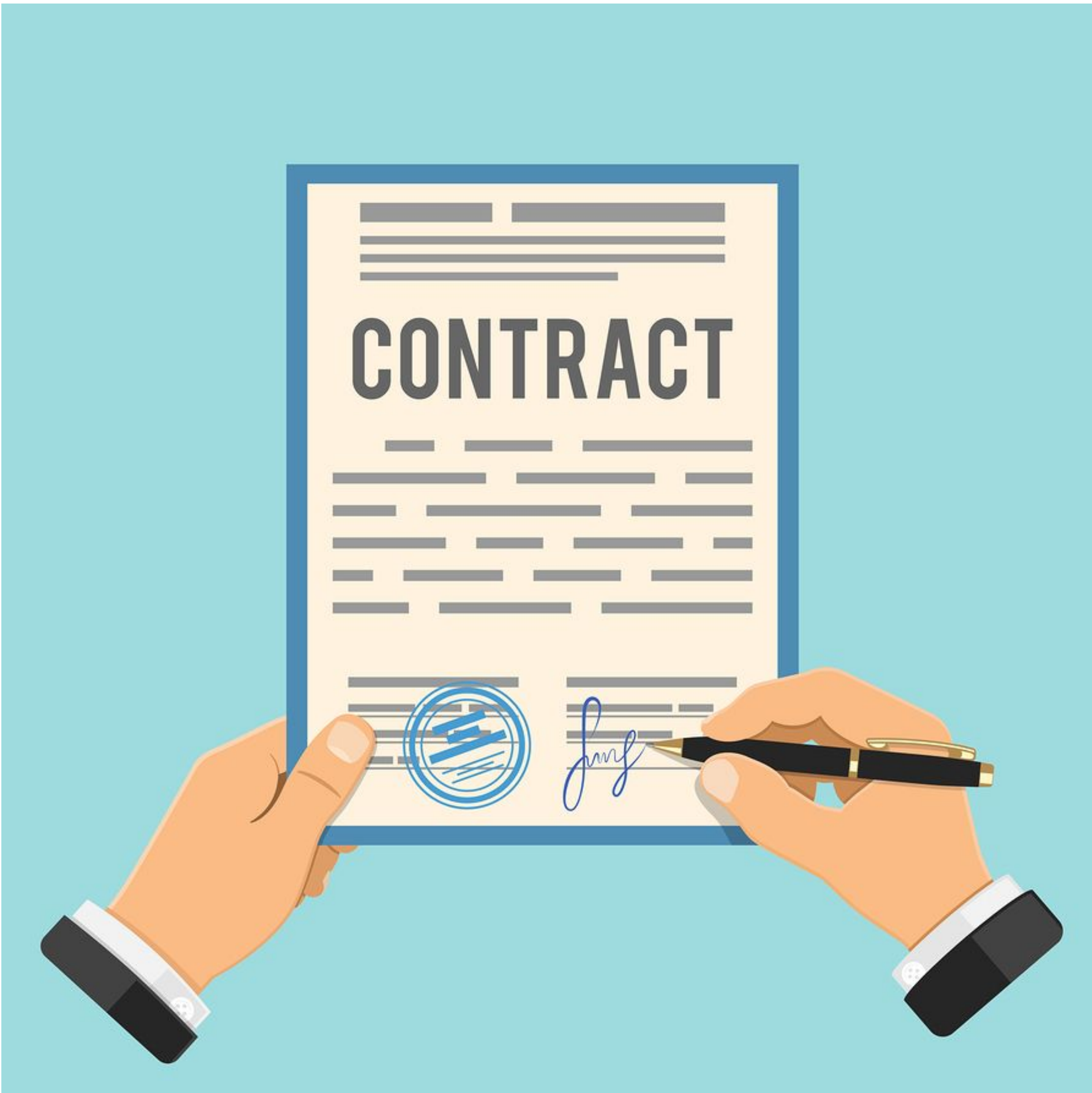
Patrick Van Zanen and client Bud Hanke
at the recent Phoenix Suns Sixthman Elite Golf Tournament.



Michael Margrave in an optical illusion painting at a recent civic event at Western Spirit: Scottsdale's Museum of the West.

THIS MONTH'S ARTICLE

Avoiding Litigation Over Earnout Provisions
by Patrick Van Zanen



Agreements for the sale of a company (including asset purchase agreements) sometimes contain earnout provisions whereby some portion of the purchase price is paid long after closing and is dependent upon the performance of the company after the buyer takes ownership and operates the company for a period of time. This often happens when the buyer and seller cannot agree on the purchase price. Earnout agreements are fertile ground for litigation because the consideration paid to the seller is dependent upon the buyer's efforts and competence as well as accurate measurements of the company's profitability. As such, sellers should be careful when using them. Nevertheless, if an earnout is going to be used, clear, understandable language establishing a standard of diligence along with measurable metrics will result in an earnout agreement that is far more workable than one dependent upon critiquing the parties' efforts and behaviors to ferret out compliance with the implied covenant of good faith and fair dealing as it pertains to the earnout provisions.

The buyer typically benefits from more broadly stated generalizations regarding the buyer's duties, which leave the door further open for good faith claims, which are rarely successful. In contrast, the seller benefits from clearly stated, measurable benchmarks and metrics related to the buyers' diligence during earn out periods. The buyer always wants as much control as possible over the acquired business while seeking to minimize future payments. The seller, on the other hand, wants to stay involved to ensure that the buyer diligently develops the business and maximizes future payments to the seller. This often makes negotiating an earnout agreement difficult, and sellers often try to rely upon good faith litigation to remedy poor negotiating outcomes.

There are a few primary considerations in drafting an earnout agreement:

- The length of the earnout period?
- Who controls the business operations during the earnout period?
- How and by what measure are earnout payments triggered?
- The amount of the earnout payment?
- Who monitors the buyer to ensure compliance?

Clarity and precision are the key to avoiding litigation in drafting earnout agreements. The language defining milestones must be unambiguous and terminology should be clear, and examples are often helpful to explain how the earnout provisions work. Indeed, there are many reported cases holding that courts will not rewrite poorly drafted earnout agreements. From the buyer's perspective, provisions geared towards granting sellers significant control of operations post-closing should be avoided to instead allow the buyer to conduct business as it chooses, and implied duties of good faith and fair dealing may be disclaimed.

From the seller's perspective, drafting pointers include:

- Specific and measurable metrics should be used, e.g., growth in number of employees, growth in number of accounts, growth in net profit, etc.

- Terms that require the buyer to use “best efforts” are too broad and undefined.
- Limitations on the buyer’s ability to dispose of assets should be limited or the consequences and effect on the earnout calculation should be clearly stated.
- Similarly, the buyer’s ability to spin off business lines should be limited or the consequences and effect on the earnout calculation should be clearly stated.
- Considering limitations on the buyer’s ability to remove a proven sales force to replace it with “its own people.”
- Considering other concrete measurements, like investment in technology and marketing.
- Avoid conflict by clarifying in advance accounting language to be used by the buyer and thus, determine whether earnout milestones have been met. Avoid using metrics based on “net” numbers in favor of “gross” numbers because net numbers are subject to manipulation.

Again, the more general the terms of the earnout, the more likely a claim under an implied covenant will result. As such, specificity, clear language and metrics that are unambiguous and immune from manipulation are best from a seller’s perspective.

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