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CARES Act Will Affect Earnouts, Purchase Price Adjustments

By **Josh Gutter, Alan Schwartz, Sean Tevel and Jeff Stamm** (May 27, 2020, 5:20 PM EDT)


Josh Gutter


Alan Schwartz


Sean Tevel


Jeff Stamm

As the CARES Act continues to provide relief for businesses across the country, M&A attorneys and financial advisers must be mindful of the law's implications for earnouts and purchase price adjustments.

Because earnouts are heavily influenced by a target's earnings before interest, taxes, depreciation and amortization (an income statement-driven calculation) and purchase price adjustments are heavily influenced by a target's net working capital and outstanding indebtedness (both of which are balance sheet-driven calculations), M&A professionals must be mindful of (1) how the CARES Act will impact past deals and (2) how EBITDA, net working capital, and indebtedness will be defined in future transaction documents.

Furthermore, "quality of earnings" analyses (which normalize a target's earnings by stripping away nonrecurring revenues and expenses) might be even more important for future deals, particularly with respect to understanding the impact of the temporary relief provided by the CARES Act, as well as the overall impact of COVID-19 on a target's run-rate earnings flow (i.e., the extrapolated financial performance of a target into future periods).

The Paycheck Protection Program

To understand how past M&A deals might be impacted by the CARES Act, consider the Paycheck Protection Program and the following simplified example, whereby a business was sold on Jan. 1, 2019.

Per the transaction document's earnout provision, (1) if the business generates $10 million in EBITDA during its second year of operation following the sale (i.e., Jan. 1, 2020, to Dec. 31, 2020) and (2) the underlying accounting figures are in compliance with generally accepted accounting principles, then the seller will receive an earnout payment of $2.5 million. Fast forward to present day, the business applied for (and received) a PPP loan on April 15. With respect to the loan:

- The amount is $1.8 million, payable with 1% annual interest and a term of two years.

- Per the U.S. Department of the Treasury, "loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities."

- By June 30, the business is eligible to receive loan forgiveness in the amount of $1.5 million due to its use of the PPP loan in accordance with the items listed above.

The mechanics and timing of PPP loan forgiveness are being finalized by the U.S. government. Nevertheless, the purpose of this exercise is to highlight how such PPP loan forgiveness will impact EBITDA calculations in an earnout period. Accordingly, please proceed to the following analysis.

The CARES Act provides that loan forgiveness will not be treated as income from discharge of indebtedness for income tax purposes, and recent IRS guidance provides that taxpayers receiving PPP loans cannot deduct normally deductible expenses to the extent the expenses were reimbursed by a loan that was forgiven.

Notwithstanding the foregoing, from a financial accounting perspective, loan forgiveness would be recognized as income from discharge of indebtedness, resulting in a $1.5 million boost to EBITDA on June 30, 2020. This is because earnings (the "E" in EBITDA) recognizes the fact that, on June 30, the business no longer has to pay back $1.5 million of its PPP loan. Consequently, what happens if the business reports $11 million in EBITDA for the year ending December 31, 2020 because of this unexpected boost to the business's bottom line? Can the buyer argue that EBITDA should have only been $9.5 million and that seller is not due its earnout of $2.5 million?

The answer will hinge on how EBITDA is defined in the relevant transaction document. If a traditional definition of EBITDA is used (which doesn't normalize earnings), then a seller hoping for an earnout payment may be in luck and benefit from the recognized income from discharge of indebtedness.

Alternatively, if a transaction document defines some type of "adjusted EBITDA" that excludes nonrecurring revenues and expenses, then a buyer might not have to worry about the loan forgiveness contributing to an earnout payment. As such, past M&A deals will need to analyze the EBITDA definition set forth in their respective transaction documents, while future M&A deals may consider carving out exceptions for such a scenario.

Finally, while the focus of this article relates to M&A deals, please note that changes to EBITDA definitions apply equally to EBITDA based loan covenants. This also includes the more recent main street lending program, which utilizes a multiple of 2019 EBITDA to calculate the eligible amount of loan proceeds and allows for adjustments to definitional EBITDA based on existing loan covenants and/or standard EBITDA adjustments that are typical for businesses' industries when seeking debt financing.

The Balance Sheet Impact and Purchase Price Adjustments

With respect to future deals and purchase price adjustments, PPP loans — like other types of lending sources of capital — will also impact how net working capital and indebtedness are defined in transaction documents (due to increased accrued interest and outstanding debt in the liability section of the balance sheet). To assist with the explanation of this section (and the Federal Insurance Contributions Act deferral example below), consider the components of a standard purchase price adjustment formula:

(1)	Enterprise Value / Purchase Price
(2)	Plus / Minus: Net Working Capital (Closing NWC minus Target NWC) [NOTE: If Closing NWC exceeds Target NWC, this usually results in an increased Purchase Price due to the Seller; and vice versa, if Closing NWC is less than the Target NWC, this usually results in a decreased Purchase Price due to the Seller.]
(3)	Less: Net Indebtedness (Outstanding Debt minus Cash)
=	**= Adjusted Purchase Price / Net Proceeds to Seller**

In addition, also consider the classic definition of working capital — "current assets minus current liabilities." As noted in the formula above, a net working capital, or NWC, adjustment only captures the delta between a target amount of working capital and the actual amount of working capital at closing. And because target working capital is typically set based upon a historical average that might include accrued interest, a buyer would not receive a dollar-for-dollar adjustment for such accrued interest if it is included in current liabilities.

Alternatively, an indebtedness adjustment typically reduces the purchase price for all indebtedness dollar-for-dollar, and as a result, accrued interest is better handled as an indebtedness adjustment from a buyer's perspective. This same balance sheet analysis is relevant for the next CARES Act topic, the FICA deferral.

The FICA Deferral

As an alternative to PPP loans, pursuant to the business tax provisions of the CARES Act, businesses are eligible to defer their FICA tax deposits and payments during the period beginning on March 27 and ending Dec. 31, 2020. These payments will instead be made 50% by Dec. 31, 2021, and 50% Dec. 31, 2022.

Notably, however, taxpayers that receive PPP loan forgiveness are not eligible for the FICA deferral. With respect to an M&A deal, deferred payroll taxes will impact a purchase price adjustment differently depending on whether they are categorized under working capital or indebtedness in transaction documents (as was highlighted in the accrued interest example above).

Accordingly, buyers may wish to allocate the deferred FICA taxes to the indebtedness portion of a purchase price adjustment, as it represents amounts owed by the seller for which the buyer will receive no benefit, and therefore, should not be obligated to pay post-closing. To the extent that the working capital or indebtedness definitions do not cover FICA deferrals, the "pre-closing taxes" definition for purposes of the tax indemnity should explicitly include deferred payroll taxes resulting from the CARES Act.

Additional Tax Changes Under the CARES Act

In addition to the FICA tax deferral, there are other CARES Act tax law changes that might affect earnout and purchase price adjustment negotiations (due to potential impacts on working capital and/or EBITDA).

For example, the CARES Act temporarily adjusts the ability to utilize net operating losses by providing a five-year carryback for NOLs arising in any tax year beginning in 2018, 2019 or 2020 and temporarily removing the existing 80% taxable income limitation on the use of NOLs to allow NOLs to fully offset taxable income in any tax year beginning before Jan. 1, 2021.

While the focus of this article is the impact of the CARES Act on future M&A deals, it is worth noting that because these NOL rule changes were not anticipated, parties should review acquisition agreements for recently completed transactions to determine whether the buyer or seller may be entitled to NOLs and other tax deductions and refunds, in addition to the parties' respective rights with respect to prior year tax returns.

Quality of Earnings Reports — CARES Act Considerations

A financial due diligence report (colloquially, a quality of earnings report) is a key component to most M&A transactions for both buyers and sellers, as it is a third-party report that analyzes and describes the historical earnings of a business to assist both a buyer and seller to understand the "normal" or "recurring" amount of unlevered, (i.e., debt-free), pre-tax cash flow a business should be expected to earn on an annual basis.

Accordingly, the following list highlights how certain CARES Act laws might impact these analyses. For reference, the numbers below refer to the components of the above purchase price adjustment formula:

1. Quality of Earnings

Quality of earnings, or adjusted EBITDA, is an analysis which (in most cases) is used as a proxy and/or primary step for determining run-rate cash. It is anticipated that third-party diligence providers will be tasked with assisting either the buyer or seller (depending on which has engaged the diligence provider) in quantifying the nonrecurring impact to historical earnings resulting from either challenges or windfalls businesses experienced during the pandemic. This would include losses sustained as a result of supply-chain issues and government-mandated operational shutdowns and/or nonrecurring earnings from excess demand for essential business's products or services and gains recorded as a result of governmental relief provided through the CARES Act.

2. Quality of Working Capital

Quality of working capital, or adjusted NWC, is an analysis which is used to determine historical average working capital required to run the business on a cash-free, debt-free basis. It is anticipated that adjusted NWC analyses going forward will include adjustments to normalize working capital for impacts to short term assets and liabilities impacted by (1) changes in operating environment (e.g., longer outstanding receivables due to difficulties collecting, lower inventory levels due to supply chain issues, stretched payables as a result of short-term cash flow issues, etc.) and (2) balance sheet amounts resulting from CARES Act provisions such as increased payroll tax liabilities as a result of payroll tax deferral or tax refunds resulting from CARES Act provisions. To reiterate, however, it is possible that the FICA deferral will be better categorized in net debt (below) for a buyer, due to the dollar-for-dollar purchase price adjustment impact.

3. Net Debt and Debt-Like Items

Net debt and debt-like items, or net indebtedness, summarizes liabilities reported both on and off the target's balance sheet that should be included in the definition of indebtedness within a purchase agreement (and therefore drives the Indebtedness portion of the purchase price formula). The net debt and debt-like items analysis within quality of earnings reports in a post-COVID-19 world will include the outstanding balances associated with any debt obtained via the CARES Act (including PPP, Economic Injury Disaster Loan, Main Street Lending Program loans and associated accrued interest) as well as any payment deferrals arising from the CARES Act (e.g., deferred payroll taxes).

Other scenarios arising from COVID-19 may also lead to other items being treated as Indebtedness rather than net working capital. For example, aged-payables resulting from stretching vendor terms to maintain cash flow during the pandemic may be treated as debt-like items by a buyer, as the benefit of using the related assets or services received by the business from such vendors will likely have been already realized by the seller (and therefore the buyer should not have to settle such liabilities for which it will receive no post-close benefit).

Conclusion

As the CARES Act continues to impact the balance sheets and income statements of businesses across the country, M&A attorneys and financial advisers should pay careful attention to the definitions used in future transaction documents as they relate to EBITDA, net working capital, and indebtedness. Collectively, these definitions will shape future earnout provisions and purchase price adjustments and, in addition, the CARES Act tax changes (such the treatment of NOLs) will lead to new tax-related deal points.

Finally, third-party financial diligence and quality of earnings reports will be more important than ever to assist both buyers and sellers in understanding the CARES Act and other COVID-19 implications. Aside from reshaping the valuation process, such analyses can also contribute to how EBITDA, net working capital, and indebtedness will be defined in future M&A transaction documents.

Josh Gutter is an associate, and Alan Schwartz and Sean Tevel are partners, at Holland & Knight LLP.

Jeff Stamm is a director at Daszkal Bolton LLP.