MEMO TO THE PARTNER

PROPOSED EARNOUT AGREEMENT PROVISIONS

ELIZABETH A. CLIPPARD*

TO:	Law Office Partner
FROM:	Associate
RE:	Proposed Earnout Agreement Provisions

I. INTRODUCTION

Attached are proposed terms and provisions to be inserted into the current draft of our Earnout Agreement (the "Earnout") between our client, McClelland & Sons, LLC ("McClelland") and Private Prisons, Inc. Executed simultaneously with the Asset Purchase Agreement at closing, the Earnout will allow our client to realize a more accurate purchase price based upon the client's valuations, provided that it can come to an agreement with state leaders and finalize an additional long-term government contract.

In the Rider attached to this memorandum, I have drafted the terms of the payment to be made post-closing in the earnout period. I have also contemplated necessary limitations on the rights under this agreement, post-closing covenants, and dispute resolution provisions based on drafting norms in similar transactions. The remainder of this memorandum sets forth the pertinent facts and the driving factors for each party to the transaction, addresses the legal issues we face in making drafting decisions, and expresses my rationale for the proposed solutions represented in the attached Rider A.

II. TRANSACTIONAL CONTEXT

Our law firm was recently retained to advise McClelland and their representatives on the sale of their family business. McClelland is a

* B.A., The University of Mississippi; J.D., The University of Tennessee College of Law. Ms. Clippard is an associate in the Corporate practice group at Butler Snow LLP in Nashville, Tennessee. The author would like to thank Professor Joan MacLeod Heminway for her comments and continued support throughout the writing and editing process of this work.

closely held limited liability company organized under Tennessee law. It owns and operates a number of large private prison facilities across Tennessee, its largest customers being the State of Tennessee and the State of Kentucky. It is my understanding that McClelland is run primarily by the children and grandchildren of the founding family members. The third generation of the family business is no longer interested in managing the business in the long term, and their working relationships are not as amicable as those of the previous two generations. As the second generation leaders of the company are aging, they feel that their best option is to sell the company while it is still a profitable business and allow the family to pursue other ventures with the proceeds.

The McClellands have received many offers to purchase their business over the years, but only from one company, Private Prisons, Inc. ("PPI"). PPI is a large corporation incorporated in Delaware that owns private prison facilities in 12 states (largely in the Northeast and Midwest). It has been interested in acquiring McClelland's facilities as a way to enter into the southeastern market. This acquisition will give PPI its first facility in this area, and together with McClelland's existing government contracts and goodwill, will bring further value to PPI's expansion into the Southeast. Thus, the parties have entered into a non-disclosure agreement with our client to facilitate further discussions on the potential acquisition.

In negotiations, McClelland and PPI have not been able to agree on a valuation of McClelland. PPI valued McClelland at $20 million without taking into consideration the potential cost of adding new states as clients and the reasonable projected cost of expansion on the current property. McClelland believes it is worth $30-35 million with the high likelihood that negotiations with the State of South Carolina will close within the year. Recently, other surrounding states have made inquiries into using McClelland as a contractor. McClelland contends that its spotless reputation in the Southeast and potential to win additional government contracts from surrounding states is worth a great deal in addition to its extensive physical assets. PPI's position is that McClelland has had plenty of opportunities to seize additional state contracts, but has failed to do so because of limited space and aversion to expanding. Its valuation gives little weight to goodwill and potential new clients; it also takes into account necessary renovation and expansion costs. Thus, the gap between the parties' valuations is significant and unlikely to be closed in negotiations without the drafting of an Earnout.

Before sale of the business was broached, McClelland's leaders began negotiations with the State of South Carolina to accept hundreds of new inmates from overcrowded South Carolina prisons. If the agreement is completed, McClelland could see a drastic increase in revenue over the next ten years with multiple options to renew. PPI is not willing to take this transaction into consideration in its valuation because this opportunity has previously come up for McClelland and fallen through before a final agreement could be reached. PPI has agreed, however, to negotiate an Earnout Agreement in conjunction with the Asset Purchase Agreement, so as to value the company with the contract only if the government contract comes to fruition within the agreed upon term of the Earnout Agreement.

McClelland has only one class of common stock held by 10 family members spanning three generations. It has no major outstanding debt other than short-term liabilities incurred in the ordinary day-to-day operations of the prison facility. It is duly organized as a member-managed LLC under the predecessor Tennessee Limited Liability Company Act and has not opted into the new Tennessee Limited Liability Company Act.[1] Under T.C.A. § 48-244-201(b), a member-managed LLC, after notice has been given to all members, voting and nonvoting, may sell all or substantially all of its assets not in the regular course of business upon a majority vote in favor of the sale by the members present at a duly called and held meeting.[2] The McClelland family recently called a special meeting of all members in order to vote on the proposed sale of the business. All 10 members attended and voted unanimously for the sale of the business and agreed upon the earnout mechanism as the best way to handle a disagreement over valuation. We have advised the company that under McClelland's operational documents a sale of substantially all of the firm's assets is an event of dissolution. McClelland's Charter states that in the event of such a sale, the company is to file a notice of dissolution within a reasonable period of time after closing and distribute assets to the members. We will be advising the firm through this process as well. A notice of dissolution will be filed with the Secretary of State as soon as

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[1] T.C.A. §§ 48-203-101 and 102 require that a person or persons file with the Secretary of State articles of the LLC for the purpose of any lawful business. TENN. CODE ANN. §§ 48-203-101, -102 (West 2014).

[2] *See* TENN. CODE ANN. § 48-244-201(b) (West 2014).

practicably possible after closing, and McClelland will be wound up and assets distributed to the members according to procedures set out in T.C.A. § 48-245-1101.[3]

PPI is a publicly traded corporation with only one class of authorized common stock and one class of authorized preferred stock held by key insiders. PPI's officers have assured us that PPI is duly organized under the General Corporation Law of the State of Delaware[4] and that it has the specific power to purchase assets in the ordinary course of business without shareholder approval.[5] PPI has additionally agreed to concede the choice of law provision in favor of our clients. In both the Asset Purchase Agreement and the Earnout, Tennessee law will govern all disputes and contract interpretation, and the choice of venue for dispute resolution will be Nashville, Tennessee.[6]

III. KEY SUBSTANTIVE ISSUES

The most important assurance that we need to give to our client in this transaction is that it will be able to continue negotiations with South Carolina in the same manner it was able to conduct those negotiations before the acquisition, so that it may receive some or all of the earnout payment. If PPI were to thwart McClelland's efforts or drastically change the operations of the business so as to turn the

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[3] *See* TENN. CODE ANN. § 48-244-1101 (West 2014).

[4] Delaware General Corporate Law ("DGCL") §101 requires that a person or entity incorporate to conduct any lawful business or purposes by "filing with the Division of Corporations in the Department of State a certificate of incorporation which shall be executed, acknowledged and filed in accordance with § 103 of this title." DEL. CODE ANN. tit. 8, § 101 (West 2014).

[5] DGCL § 122(4) states that "[e]very corporation created under this chapter shall have the power to: [p]urchase, receive, take by grant, gift, devise, bequest or otherwise, lease, or otherwise acquire, own, hold, improve, employ, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, and to sell, convey, lease, exchange, transfer or otherwise dispose of, or mortgage or pledge, all or any of its property and assets, or any interest therein, wherever situated." DEL. CODE ANN. tit 8, § 122 (West 2014).

[6] We anticipate that the parties will agree on an alternative dispute resolution provision to be contained in the Asset Purchase Agreement. Venue for such negotiations, mediations, and arbitrations will be in Nashville, Tennessee, at the principal offices of McClelland. In the event that a dispute cannot be resolved outside of litigation, proceedings will be held in the appropriate court of Davidson County, Nashville, Tennessee.

prospective client away, McClelland could lose its opportunity to obtain the additional contingent portion of the purchase price provided for in the Earnout Agreement. PPI could do this innocently in an attempt to maximize profits while integrating McClelland's business into its current operations, or it could purposefully attempt to poison the contract negotiations in order to avoid making the earnout payment.[7] Thus, it is in our client's best interest to include provisions allowing key employees to remain integrated in the operations of the business uninterrupted and compelling the cooperation of the leaders at PPI throughout the term of the earnout period. In order to give our client this assurance, I have included in Rider A terms for post-closing operation of McClelland's business and the cooperation of the acquiring company. The provision incorporates language promising commercially reasonable efforts to aid key employees and prohibiting any bad faith efforts to render McClelland an unattractive provider of services.

Another important consideration is dispute resolution. Detailed alternative dispute resolution terms are common in earnout agreements that are based on a determination of financial benchmarks.[8] Where an earnout employs financial benchmarks, such as operating margin or revenue, for example, parties often dispute the manner in which such financials were calculated. To avoid such disputes, it is important for these parties to agree to detailed dispute resolution procedures, which often include neutral third parties to audit the acquired firm's financials. Payment under our proposed Earnout provisions hinge on the occurrence of a non-financial benchmark. McClelland will be aiming to execute an agreement with a new client based on certain minimum contract numbers. Thus, while this Earnout may be less susceptible to disputes, it is likely that either party will have objections as to the performance of the other under this agreement. Our client has made

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[7] Taking into consideration that a court may imply good faith and fair dealing provisions even if they are not explicitly addressed in the agreement. *See* Horizon Holdings, LLC v. Genmar Holdings, Inc., 244 F. Supp. 2d 1250, 1257-58 (D. Kan. 2003) (holding that the earnout payment was part of the purchase price and it was implied that the target company would be allowed the fair opportunity to operate the company in a way to maximize their earnout potential).

[8] ABA PUBL'G, *The 18th Annual National Institute on Negotiating Business Acquisitions, Section J: Purchase Price Adjustments, Earnouts and Other Purchase Price Provisions*, *in* NEGOTIATING BUSINESS TRANSACTIONS 2013, F-37 to F-45 (2013), *available at* https://www.bloomberglaw.com/document/3831754280.

clear that it does not want to end up in litigation with PPI over the contingent portion of the purchase price given PPI's size and strength. For this reason, I have included in Rider A a good faith negotiations requirement and, if that is not successful, binding arbitration with costs to be split equally between the parties. Binding arbitration with costs split equally is a recognized norm in earnout agreements in relation to the sale of a business.[9]

Finally, the right to future payment contingent upon the satisfaction of a few conditions has attributes similar to those of a security, and neither party to this transaction would like to register the offer or sale of this right to payment with the U.S. Securities and Exchange Commission ("SEC"). The SEC has issued a series of no-action letters on this issue that identify elements distinguishing a right under an earnout agreement from a security regulated under federal and state securities law.[10] I have included a "No Assignment" provision in the Earnout to help ensure that the rights under the Earnout Agreement do not fall within the realm of securities regulation.

IV. ANALYSIS OF MAJOR DRAFTING DECISIONS

To begin Rider A, I have drafted the most important provision of the Earnout, the earnout payment. The lump cash sum to become payable upon the effectiveness of the contract between McClelland and the State of South Carolina is $5,000,000.[11] This amount reflects the agreed-upon increase in value due to the revenue stream the contract will supply, as well as the enhanced prospect of attracting additional government clients. The difference between PPI and McClelland's valuations was more than $5,000,000; however, our client was willing to keep this number lower in order to gain cooperation in all other terms of

9 *Id.* at F-56. (Arbitration is the norm. Parties often split the costs associated with arbitration, but they also may let the losing party bear all costs).

10 *See* Great Western Financial Corp., SEC No-Action Letter, 1983 WL 28156 (Apr. 14, 1983); Northwestern Mutual Life Insurance Co., SEC No-Action Letter, 1983 WL 30832 (Mar. 3, 1983); Lifemark Corp., SEC No-Action Letter, 1981 WL 25420 (Nov. 17, 1981); and Kaiser Aetna, SEC No-Action Letter, 1973 WL 9661 (July 30, 1973).

11 I chose an all-cash payment over a stock payment or a combined stock and cash payment because it makes the right to payment more clearly fall outside the definition of a security (to be discussed further below). Our client's shareholders have also expressed the desire to deal exclusively in cash consideration due to their anticipated dissolution after closing and their desire to seize new investment opportunities.

the Earnout,i.e., choice of law, dispute resolution, post-closing cooperation, and term. This language was modeled after a precedent document in a similar transaction employing a similar non-financial payment trigger.[12] The contract to be executed with the State of South Carolina must meet certain minimums in order to trigger PPI's obligation to make the earnout payment. McClelland and the State of South Carolina must agree to a "long-term" contract to exceed [ ] years, and the contract must provide for at least $[ ] amount in income per year.[13] As long as the contract reaches these two parameters, PPI will be obligated to pay the additional portion of the purchase price under the Earnout.

The three remaining provisions represent our client's biggest concerns in entering into this agreement. The next few paragraphs of this memorandum address the principal decisions made in drafting those sections in the order in which the relevant text appears in the Rider.

First, because the trigger for the earnout payment is the effectuation of a contract between McClelland and the State of South Carolina, our client needs to be assured that it will be able to continue working in the ordinary course of business toward the definitive agreement between McClelland and the State of South Carolina. This will require support from and the cooperation of PPI. Accordingly, the post-closing cooperation provision is designed to cover three things: (1) McClelland's key employees' primary control and involvement in continued negotiations, (2) PPI's obligation to act in good faith, and (3) PPI's commitment to exerting commercially reasonable efforts to aid McClelland's employees in reaching a Definitive Agreement, as defined in Rider A. The phrase "commercially reasonable efforts" has long been a subject of litigation in mergers and acquisitions. In general, "commercially reasonable efforts" is a less onerous standard than those clauses that utilize "best efforts."[14] I chose to include this standard so that PPI would feel that it is able to operate its newly integrated business

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12 Language initially modeled after Section 4.1.2, which details the portion of the purchase price contingent on non-financial milestones. UniTek Global Servs., Inc., Asset Purchase Agreement, (Ex. 2.1, Form 8-K) (Sept. 12, 2012).

13 The minimum term and price of contract between PPI and the State of South Carolina is to be determined by the parties at the final stage of negotiation.

14 *Earn-outs*, PRAC. LAW CORP. & SEC., Practice Note 0-500-1650. (Aug. 2014).

in the way it best sees fit, so long as that process does not substantially interfere with the goal McClelland's employees have of selling that process to a large government client.

Second, I have drafted an alternative dispute resolution provision to better ensure that our client does not end up in a lengthy and expensive litigation situation. Although most earnout agreements include detailed dispute resolution provisions in order to resolve any financial and accounting discrepancies by independent parties, we want to ensure our client will be paid under the Earnout Agreement without unnecessary objections from PPI about the contents of the Definitive Agreement. For this reason, I have tailored the language to require a 30-day negotiation period, and if that is not successful, binding arbitration. From my research, binding arbitration is a norm in earnout agreements,[15] and it is also the preference of our client. In order to ensure an unbiased proceeding and prevent any undue influence from PPI, I included procedure for selecting the three arbitrators, adherence to the standard AAA rules, and our client's preferred venue.

Finally, both parties to this transaction are adamant that the Earnout Agreement in conjunction with the Asset Purchase Agreement be drafted in a manner to avoid all federal securities regulations. Section 2(a) of the Securities Act of 1933, as amended, defines "security" broadly to include notes, stock, investment contracts, certificates of interest in a profit-sharing agreement, evidence of indebtedness, security futures, among other rights to payment.[16] Under the Supreme Court's decision in *Howey*, an "investment contract" is "a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment."[17] Otherwise stated, the term includes any situation where a person or firm was led to invest money and expect profits solely from the efforts of others.[18] Because the right to future payment under earnout agreements could be construed to fit within this definition, the SEC has issued a series of no-action letters offering a

[15] *See* NuPathe Inc., Contingent Cash Consideration Agreement (Ex. 99.1, Form8-K) (Dec. 16, 2013) (labeling Section 22 as "Negotiation; Arbitration."); Alcoa Inc., Earnout Agreement (Ex. 10.1, Form 8-K) (June 27, 2014) (labeling Section 7.10 as "Arbitration").

[16] *See* 15 U.S.C.A. § 77b (West 2012).

[17] SEC v. W.J. Howey Co., 328 U.S. 293, 298 (1946).

[18] *Id.*

limited regulatory safe harbor for this type of transaction and payment structure. The SEC should not bring action on this limited basis. The letters may or may not prevent a claim that the earnout is a security; however, courts tend to give no-action letters the effect of regulations. The SEC has stated that the following factors demonstrate that a particular earnout agreement should not be considered a security and thus will not necessitate registration:

> [1] The earnout right was granted to the sellers as part of the consideration for the sale of their business and neither the buyers nor the sellers viewed the right as involving an "investment" by the sellers; [2] The earnout right did not represent an ownership interest in the buyer and was not evidenced by any certificates; [3] The earnout right could not be transferred except by operation of law; [4] The earnout right did not entitle the owner to voting or dividend rights.[19]

The Asset Purchase Agreement will specifically reference that the earnout payment is a portion of the consideration for the purchased assets and that the acquisition will result in the winding up of the McClelland business. Thus, the right to the earnout payment cannot be construed as an investment in an ongoing business, as it will cease to exist. The earnout is a right to a lump-sum cash payment. No portion of the consideration paid to McClelland will consist of PPI stock. Thus, McClelland will not acquire any ownership interest, voting, or dividend rights in PPI as a result of this transaction. Finally, the right to the earnout payment cannot be transferred except by operation of law. To restrict transfer of McClelland's right to the earnout payment, I have included in Rider A a specific "No Assignment" provision prohibiting McClelland from transferring its interests under the Earnout Agreement unless done by operation of law or as a transfer of their membership

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[19] ABA PUBL'G, *supra* note 8, at F-58 (citing to the following SEC no-action letters: Great Western Financial Corp., SEC No-Action Letter, 1983 WL 28156 (Apr. 14, 1983); Northwestern Mutual Life Insurance Co., SEC No-Action Letter, 1983 WL 30832 (Mar. 3, 1983); Lifemark Corp., SEC No-Action Letter, 1981 WL 25420 (Nov. 17, 1981); and Kaiser Aetna, SEC No-Action Letter, 1973 WL 9661 (July 30, 1973)).

interest in the winding up of McClelland.[20] This drafting should allow the parties to avoid the application of federal securities regulation, including the need to register the offer and sale of the earnout right.

V. MINOR DRAFTING DECISIONS

Below are some of the less significant drafting choices I made in drafting the provisions included in the Rider:

- By defining in section one the minimum parameters of the contract with the State of South Carolina, I attempted to manage PPI's expectations for the contract, so that the payment cannot be delayed by an objection to the ultimate quality of the agreement.
- In section two, I gave McClelland sole discretion in proceeding in negotiations with the State of South Carolina. I believe this is the most clear-cut way to set out who will be responsible for executing the definitive agreement. In opting not to use the term "cooperation," I hope to give McClelland more control post-closing over the earnout's success or failure. PPI's directors and officers will have reasonable access to information on the progress of negotiations and will be allowed to exercise oversight to the extent that is required by law or corporate governance rules elected in the organizational documents.
- In section two, I chose to use the phrase "unduly burden" to qualify the exercise of discretion by McClelland in negotiating the final terms of the contract with the State of South Carolina. I think it is unlikely PPI would agree to the "sole discretion" standard if it were not modified by this covenant. Taken together, the sole discretion standard and the undue burden limitation give each party what it desires: control in its own area of expertise.

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[20] I have contemplated that our client's members may wish to transfer all or a portion of their membership interest to another family member before a large distribution for preferable tax treatment.

RIDER A
EARNOUT AGREEMENT BETWEEN
MCCLELLAND & SONS, LLC AND PRIVATE PRISONS, INC.

1. **Earnout Payment**. PPI shall pay to McClelland as additional consideration for the Purchased Assets under the Purchase Agreement a total of $5,000,000 in cash (the "**Earnout Payment**"), which amount shall become payable upon the occurrence of the following conditions: (i) PPI in conjunction with McClelland's representatives come to a final agreement in writing with the State of South Carolina (the "State") for the use of the Acquired Business's services (the "**Definitive Agreement**"); (ii) the Definitive Agreement shall have an initial term of not less than ten years including any renewal periods; and (iii) the Definitive Agreement shall generate at least $1,000,000 in income per year during its initial term. For the purposes of this section, "income" shall mean all consideration paid by the State to PPI for the services rendered by the Acquired Business and shall not take into account any deductions, expenses, set offs, or costs.

2. **Post-Closing Covenants**. Subject to the terms of this Agreement and the Purchase Agreement, subsequent to the Closing, McClelland's representatives shall have primary control with regards to matters relating to the negotiation of the Definitive Agreement as long as McClelland's discretion does not unduly burden PPI in operating the Acquired Business in a commercially reasonable manner. PPI shall not, directly or indirectly, take any actions in bad faith that would have the purpose of avoiding the Earnout Payment provided for in this Agreement. And further, PPI shall use, and shall cause its respective officers, managers and employees to use, commercially reasonable efforts to aid McClelland's representatives in finalizing the Definitive Agreement.[21]

3. **Negotiation, Arbitration**. (a) Prior to any arbitration, all parties to this agreement shall agree to negotiate in good faith for a period of 30 days to resolve any controversy or claim arising out of or relating

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[21] *See* Alcoa Inc., Earnout Agreement (Ex. 10.1, Form 8-K) (June 27, 2014) (modeling last sentence after language found in Section 2.4).

to this Agreement, including the alleged breach of this Agreement.[22] (b) After the expiration of the 30-day period, any controversy or claim arising out of or relating to this Agreement, including any alleged breach of this Agreement, shall be settled by binding arbitration administered by the American Arbitration Association under its Commercial Arbitration Rules. The number of arbitrators shall be three. PPI and McClelland shall each select one person experienced in mergers and acquisitions to act as arbitrator. The two selected arbitrators shall select a third similarly experienced person to act as arbitrator. The location of the arbitration shall be Nashville, Tennessee. The written opinion of the arbitrators shall be delivered within 180 days of the commencement of arbitration. All fees and expenses incurred in relation to any arbitration, including the costs and expenses billed by the arbitrators, shall be paid by both parties in equal parts.[23]

4. **No Assignment**. The right to payment under this Agreement shall not be sold, assigned, transferred, pledged, encumbered, or in any other manner transferred or disposed of, in whole or in part, other than through a Permitted Transfer. A Permitted Transfer includes (a) a transfer of any or all of the membership interests and right to distributions by McClelland in the winding up of the business upon death, by will or intestacy, by gift or other estate planning purposes; (b) a transfer made under the order of a court with competent jurisdiction (such as in connection with divorce, bankruptcy or liquidation); or (c) a transfer made by operation of law.[24]

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[22] *See* NuPathe Inc., Contingent Cash Consideration Agreement (Ex. 99.1, Form 8-K) (Dec.16, 2013) (modeling language after Section 22(a)).

[23] *Id.* at § 22(b).

[24] *Id.* at § 5.