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Earn-out, Locked Box, and Retention: Private Acquisitions (Hong Kong)

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A Practice Note summarising key features of earn-outs used in private company acquisitions in Hong Kong, including earn-out periods, calculation principles, and dispute resolution. It also discusses the use of locked box pricing mechanisms, and purchase price retention arrangements in Hong Kong.

The valuation of a target company and determination of a final purchase price are challenging aspects of any acquisition, and a buyer's ability to defer payment or adjust the purchase price based on financial results is often highly negotiated. The challenge can be even greater in cross-border transactions where parties from different jurisdictions may have different accounting systems, M&A customs, and business practices.

This Note considers the use of earn-outs in the acquisition of the shares of a private company in Hong Kong, where all or part of the purchase price will be calculated by reference to the future financial performance of the target company. It also summarises key aspects of value protection tools common in private company acquisitions in Hong Kong, namely locked box pricing mechanisms, retention arrangements, and escrow accounts.

This Note focuses on transactions where the seller and the target company are in Hong Kong and Hong Kong law applies to the purchase agreement.

Earn-Outs

An earn-out is a payment mechanism in acquisitions where the payment of a portion of the purchase price is contingent on the achievement of certain agreed performance metrics of the target's business within an agreed period of time post-closing. An earn-out is a useful tool to bridge the valuation gap between the seller and the buyer when they have different expectations on the future performance of the target. It allows the parties to complete the transaction first and "kick the can down the road" on the issue of valuation.

An earn-out can be beneficial to both the seller and the buyer. From the seller's perspective, it provides the potential to receive greater aggregate consideration than in a fixed price structure. From the buyer's perspective, it minimises the risk of overpaying for a target and reduces the amount of the purchase price payable upfront. Where it is important to the buyer that the seller continues to be involved in the business post-closing, an earn-out also promotes motivation and retention. However, earn-outs can be difficult to structure due to the competing priorities of the parties and must be carefully crafted to minimise uncertainty, especially with respect to post-closing operational matters. For example, while the seller wants to ensure that the business is run in a way that does not impede its potential to achieve the full earn-out, the buyer wants the flexibility to operate or integrate the business as it sees fit. Similarly, while the seller wants the buyer to devote a certain level of resources to the business, the buyer may not be motivated to do so during the earn-out period, especially if the expansion of the business is primarily due to the contribution of the buyer.

Earn-out structures are widely adopted in private company acquisitions in the life sciences sector and are becoming more popular in other sectors (such as technology) in Hong Kong due to the increasing difficulty in predicting the future outlook of the underlying business given the economic uncertainty.

When to Use an Earn-Out

Earn-outs are commonly used in transactions where:

- The seller and the buyer are motivated to complete the acquisition but cannot agree on the valuation.
- The target will operate as a stand-along business after the closing.
- The target has limited operating history but significant growth potential.

- The target has products that are under research and development (R&D).
- The target has experienced a recent drop in earnings that may be temporary (for example, due to COVID-19).
- The target operates in a highly volatile or highly competitive industry.
- The business of the target is dependent on relatively few customers.
- The buyer has difficulty making the payment of the purchase price upfront.
- The buyer sees the acquisition primarily as an "acqui-hire" of talent (for example, the engineering team) and the buyer wishes to retain certain key employees of the target post-closing and motivate them to grow the business post-closing.

Structuring Earn-Outs

Performance Metrics

Earn-outs are often structured based on the target's financial metrics (such as revenue, earnings, or EBITDA (earnings before interest, taxes, depreciation and amortisation)), non-financial milestones (such as regulatory approval or the launch of a new product), or a combination of both. The types of earn-out metrics to be adopted are determined by the parties with reference to the nature of the business and the stage it is at. For example, acquisitions of targets in the life sciences sector typically use a combination of metrics including regulatory approval and revenue, but rarely use earnings as the performance metrics, as it will generally take life sciences companies a considerable period of time to reach profitability due to the amount of costs incurred at the R&D stage.

Financial Metrics

Financial performance metrics include financial statement items such as revenue, earnings, or EBITDA. While the seller prefers revenue-based metrics (which do not include costs and expenses and are less impacted by the accounting practices of the buyer (if applicable)), the buyer generally prefers earnings or EBITDA as they are considered to reflect a company's operating performance more accurately.

Non-Financial Metrics

Some earn-outs are tied to milestones that are not based on financial performance. Commonly used non-financial metrics include regulatory approvals, launch of new products, store openings, and customer retention rate. The success parameters of these milestones must be carefully defined and objectively measurable to avoid dispute. Non-financial metrics are especially useful in the context of emerging companies where setting financial metrics may be difficult due to the high growth trajectory or the lack of historical information.

Earn-Out Periods

In Hong Kong, earn-outs typically last between one to three years. As a general principle, the earn-out period should be long enough to minimise any distortion of the performance results by short-term factors (such as COVID-19). In deciding the length of the earn-out period, the parties should consider various factors including the type of performance metrics underpinning the earn-out calculation, the period during which the seller is committed to the business post-closing, and the period of financial projection based on which the earn-out was structured. The buyer often negotiates a longer earn-out period to reduce the risk of the seller sacrificing the target's long-term interests for short term profits to maximise the amount payable to the seller under an earn-out. The seller generally wants the earn-out period to be as short as possible, so as to reduce any business or economic risk inherent in a longer earn-out period, which may result in it not being able to satisfy any earn-out metrics.

In some cases, the buyer may seek a buyout option in the event that the earn-out hinders the buyer's ability to operate the target. This can be useful if the buyer is likely to sell the target to another party before the earn-out period expires. Similarly, the seller may wish to include a provision to accelerate the earn-out payments on the occurrence of certain events that negatively affect the target's ability to achieve the performance goals, including a change of control of the buyer, or a termination of certain key employees without cause.

Accounting Principles Used for Earn-Out Reference Accounts

The parties are free to agree the accounting principles to be used for the earn-out reference accounts. If the target has historically prepared audited accounts prior to the acquisition, it is logical to use the same accounting principles already used by the target to produce accurate comparison results. The most common accounting principles adopted by parties for earn-out calculations in Hong Kong are the International Financial Reporting Standards (IFRS) or the Generally Accepted Accounting Principles (GAAP). In addition to the general accounting principles, the parties should also clearly set out in the share purchase agreement the methodology and process of calculating earn-outs, preferably coupled with examples demonstrating how key metrics (such as revenue and expenses) are measured. Ambiguity in the calculation methods often leads to disputes.

Security or Indemnity for Earn-Out Payments

The seller may ask for a security or indemnity from the buyer with respect to the earn-out payments, but it is not common and is likely met with strong resistance from the buyer. Given that the earn-out payments are contingent on the achievement of future targets, the buyer is generally not willing to set aside a portion of its funds or assets as of the closing for a payment obligation which may or may not materialise in the future.

Earn-Out Dispute Resolution and Expert Determination

Calculation of earn-outs is the most common subject matter of disputes in relation to an earn-out structure. The share purchase agreement usually refers any disagreement over calculation of earn-outs to an independent expert (usually an accountant) for determination. This allows the parties to resolve the specific dispute expediently without having to resort to costly and lengthy judicial or arbitral proceedings. The share purchase agreement typically provides that the expert will be appointed by the parties by mutual agreement, and if the parties fail to agree the appointment, they will each appoint an expert who will then jointly select a third-party expert to make the final determination. The parties should also agree how the expenses of the expert will be shared.

Challenging an Expert Determination

The share purchase agreement typically provides that the determination of the expert is final and binding, and may only be challenged on very limited grounds, such as fraud or manifest error. The scope and the effect of expert determination is a contractual matter.

Payments Between Buyer's and Seller's Lawyers

It is not common in Hong Kong for lawyers to make or receive earn-out payments on behalf of their clients. While lawyers in Hong Kong are permitted to hold client money, they must comply with the restrictions in the *Solicitors' Accounts Rules* (Cap 150F) in their handling of client money.

Buyer's Right to Set Off Against Warranties and Indemnities

The buyer usually requests a contractual right to set off any earn-out payments against any amounts owed to it by the seller in connection with any claims under the share purchase agreement. If the right to set-off is agreed, the seller will insist that the buyer is only entitled to withhold earn-out payments when a claim has been determined, rather than when a notice of claim has been served.

Seller Protection Mechanisms in Earn-Outs

There are various protective provisions to prevent the buyer from manipulating the performance of the target during the earn-out period to reduce the earn-out payment, and these include:

- The operation of the target in ordinary course consistent with past practice or an agreed business plan.
- Providing the target with an appropriate level of working capital and capital expenditure.
- Ensuring that all transactions between the target and the buyer group are on a commercial arms' length basis.
- Providing the seller with customary information and inspection rights.
- A covenant not to divert the business of the target to other entities controlled by the buyer.
- No material change in the nature or scope of the target's business.
- No material change to the target's accounting standards and policies.
- No sale or disposal of any material assets of the target.

Where the seller continues to operate the target post-closing, the seller, as a senior employee of the target, may owe fiduciary duties to the target (*South China Media Ltd v Kwok Yee Ning* [2018] HKDC 194). On this basis, the seller is required to act in the best interest of the target even when doing so could reduce the potential of receiving the full earn-out payments. However, the buyer should still include express covenants in the share purchase agreement to make sure that the target is not operated in a way that affects its long-term prospects.

Locked Box Mechanisms

A locked box is a pricing mechanism where the purchase price payable is agreed and fixed at the signing of the share purchase agreement based on a set of historical financial statements of the target drawn up as of a specified date before the signing date (locked box date). Under the locked box mechanism, the agreed purchase price is not subject to further adjustment except for any leakage in value that occurs between the locked box date and the closing date. This is an alternative to the completion accounts mechanism, where the purchase price is subject to adjustment based on the financial statements of the target drawn up as of the closing date.

The primary difference underpinning locked box and completion accounts transactions is the timing of the transfer of economic interests and risks of the target's business. In a locked box mechanism, the economic interests and risks pass to the buyer on a pre-agreed locked box date, and under the completion accounts mechanism, the economic interests and risks only pass to the buyer on the actual closing date, once the completion accounts have been prepared by the target and verified by the buyer.

Under the locked box mechanism, the buyer relies on the financial statements of the target prepared by the seller to determine the valuation of the target. As a result, the buyer generally requires robust representations and warranties relating to the completeness, accuracy, quality, and reliability of the financial statements.

In a locked box transaction, the buyer effectively assumes all the risk and benefit of the target's business retrospectively from the locked box date. This risk is of particular concern to a buyer in a transaction where there is a long period between the locked box date and the closing date, particularly where there are regulatory and other anti-trust conditions which cannot be satisfied within a reasonable period of time. Therefore, it is crucial that the buyer is compensated by the seller if the seller extracts value from the target or its subsidiaries (known as, a leakage) from the locked box date to the closing date. A leakage includes:

- Declaration or payment of dividends or distributions by the target or its subsidiaries to the seller and its affiliates.
- Creation, issuance, repurchase, redemption, reduction, or return of share capital or capital reserves of the target or its subsidiaries in favour of the seller and its affiliates.
- Making of any payments or transfer of any assets by the target or its subsidiaries to the seller and its affiliates.
- Assumption of any liabilities or the provision of any guarantee or indemnity by the target or its subsidiaries in favor of the seller and its affiliates.
- Incurrence of costs or expenses by the target or its subsidiaries in connection with the acquisition.
- Waiver, discharge, or provision of discount in respect of any liabilities owed to the target or its subsidiaries by the seller and its affiliates.

The seller usually requests certain anticipated or periodic payments to be carved out from the leakage prohibitions so that such payments do not operate to reduce the purchase price. Common examples of permitted leakage include remuneration payable to employees or consultants in the ordinary course of business, periodic interest payment for the target's debts, discharge of intra-group loans, and payments made pursuant to the share purchase agreement or approved in writing by the buyer, which should be clearly stated and defined in the share purchase agreement. From the buyer's perspective, the scope of permitted leakage should be as tight as possible and each item should be identified with sufficient details.

The locked box mechanism typically includes a limitation period during which the buyer may bring a claim for leakage, which is usually shorter than the limitation period for warranty claims. The parties would negotiate whether there should be a *de minimis* threshold or cap on the amount recoverable for leakage claims.

For more information on locked boxes, see Practice Note, Completion accounts and locked boxes: acquisitions.

Advantages and Disadvantages of Locked Box Mechanism

A locked box mechanism provides a seller with certainty in the purchase price and avoids lengthy negotiation over the preparation of completion accounts and the price adjustment to be made based on such accounts. It is particularly helpful to a seller in transactions involving auction bids, as it is easier to compare the bids submitted by different buyers under a locked box structure.

On the other hand, a buyer, particularly if it has not undertaken substantial due diligence on a target, may not be comfortable concluding the valuation relying on the historical financial statements of the target. The buyer will also likely hesitate to take up the business risk of the target as early as the locked box date when it has no control over the target's operations. Therefore, the buyer generally seeks to negotiate a completion accounts mechanism instead, as it ensures that the final purchase price paid by the buyer reflects the actual and current financial position of the business as of the closing date. For information on completion accounts, see Practice Note, Completion accounts and locked boxes: acquisitions.

For an example of a locked box clause for use in private company acquisitions tailorable for Hong Kong, see Standard Clause, Locked Box Mechanism: Cross-Border.

Retention

It is common for a buyer in private company acquisitions in Hong Kong to retain a portion of the purchase price, primarily to provide security for:

- Breach of warranties and indemnity.
- Post-closing purchase price adjustments.
- Non-performance of material future obligations.

A seller in a strong negotiating position may be able to resist a retention to minimise the risk of not getting the purchase price in full, and to avoid having to negotiate the terms of the retention and the release conditions, which can be quite complicated.

Purchase price retention is commonly used in transactions where:

- The seller is a holding company that does not have assets to satisfy claims by the buyer in respect of a breach of the seller's obligations under the share purchase agreement.
- The seller is an overseas entity without an established business presence in Hong Kong.
- The purchase price is subject to adjustment based on the financial statements of the target as of the closing date that are to be drawn up after the closing.
- The seller is required to perform certain material obligations that cannot be completed prior to the closing, the non-performance of which will materially affect the target or the buyer.

The retained purchase price is either held back by the buyer (known as, a holdback), or deposited into an escrow account with an independent escrow agent (known as, an escrow account (see Escrow Accounts and Arrangements). A buyer generally prefers a holdback structure, under which it makes a covenant to pay the retained purchase price in due course but is not required to make such amount available upfront. A seller, on the other hand, may not be comfortable simply relying on the buyer's covenant to pay, and generally requires an escrow structure, under which the amount deposited into the escrow agent's account will be separated from the buyer's other assets and liabilities and is readily available for release as soon as the release conditions are satisfied.

The retention amount typically ranges from 10% to 20% of the total purchase price and the retention period ranges from 12 months to 24 months in private company acquisitions in Hong Kong. With respect to any retention made for the purpose of providing security for breach of warranties and indemnity, the length of the retention period should commensurate with the agreed limitation period for breach of warranties and indemnity under the share purchase agreement. With respect to any retention made for the purposes of providing security for the post-closing price adjustments or the non-performance of material future obligations, the retention period should end as soon as the requisite action has been completed.

For an example of a retention clause for use in private company acquisitions tailorable for Hong Kong, see Standard Clause, Retention (Warranty Claims): Cross-Border.

Escrow Accounts and Arrangements

An escrow is a relatively costly arrangement compared to a simple holdback due to the expenses of the escrow agent. It also often results in a delay in the transaction process as the parties tend to leave the selection of the escrow agent and negotiation of the escrow agreement until the last minute. In some cases, the parties opt for a more expedient arrangement, which is for the buyer to deposit the retained purchase price in a joint bank account where any withdrawal must be signed off by both parties. However, this approach is not as widely adopted as holdbacks and escrows in Hong Kong as opening a bank account has become time consuming in recent years due to the banks and escrow agents' increasingly stringent know-your-client and anti-money laundering practices.

Under a typical escrow arrangement, once the parties agree on the appointment of the escrow agent and an escrow agreement is entered into, the buyer deposits the escrow amount into an escrow account. The funds are then held until the release condition is satisfied. It is crucial that the escrow agreement includes a clear and unequivocal release condition, which the escrow agent can rely on to release the escrow funds. The most common release condition includes the expiration of the retention period, the receipt of joint instructions from both the seller and buyer, or the receipt of third party (for example, the escrow agent) confirmation.

An escrow that is to be automatically released upon the expiration of the retention period should still be subject to pending indemnity claims that are notified by a party to the escrow agent before the release. An escrow that is released upon instruction from both the seller and the buyer provides certainty that no payment can be made unilaterally without the consent of the other party. However, it may potentially lead to disputes where one party refuses to authorise a payment.

Escrow Agent and Escrow Agent Liability

In Hong Kong, parties to an acquisition generally appoint reputable financial institutions or licensed trustee companies as escrow agents. Although it is permissible to appoint a party's lawyers as escrow agents in Hong Kong, it is less common as the parties prefer impartial third parties to play this role.

An escrow agent typically requires the escrow agreement to include limitation of liability clauses which exclude any liability of the escrow agent in connection with the operation of the escrow account, except for liability arising out of fraud, wilful misconduct or gross negligence. An escrow agent also typically requires the seller and the buyer to indemnify it against all costs and liabilities arising out of its service as the escrow agent. These provisions are often part of the escrow agent's standard documentation and there is little room for negotiation.

The escrow instruction letter delivered from the escrow agent to the escrow bank specifying the terms and conditions concerning the operation of the escrow account are generally prepared based on the standard form provided by the escrow bank, with necessary and appropriate amendments tailored for the particular escrow arrangement. The terms of the escrow instruction letter should be consistent with the terms of the share purchase agreement and the escrow agreement.

For an example of a letter of instruction from the escrow agent to the escrow bank, see Standard Document, Escrow Account: Instructions to Escrow Bank: Cross-Border.

Security for Non-Cash Consideration

Where all or part of the consideration is paid in a form other than cash (such as shares or other securities), the buyer may retain the non-cash consideration by way of a holdback or escrow arrangement to secure the seller's obligations under the share purchase agreement. If the consideration shares are to be issued by the buyer, the buyer may either retain the consideration shares as authorised but unissued shares, or deposit the consideration shares into a securities escrow account, which otherwise operates in the same way as a cash escrow account (see Escrow Accounts and Arrangements). If the non-cash consideration is made up by other physical assets, the buyer may consider taking a charge over the assets as security.