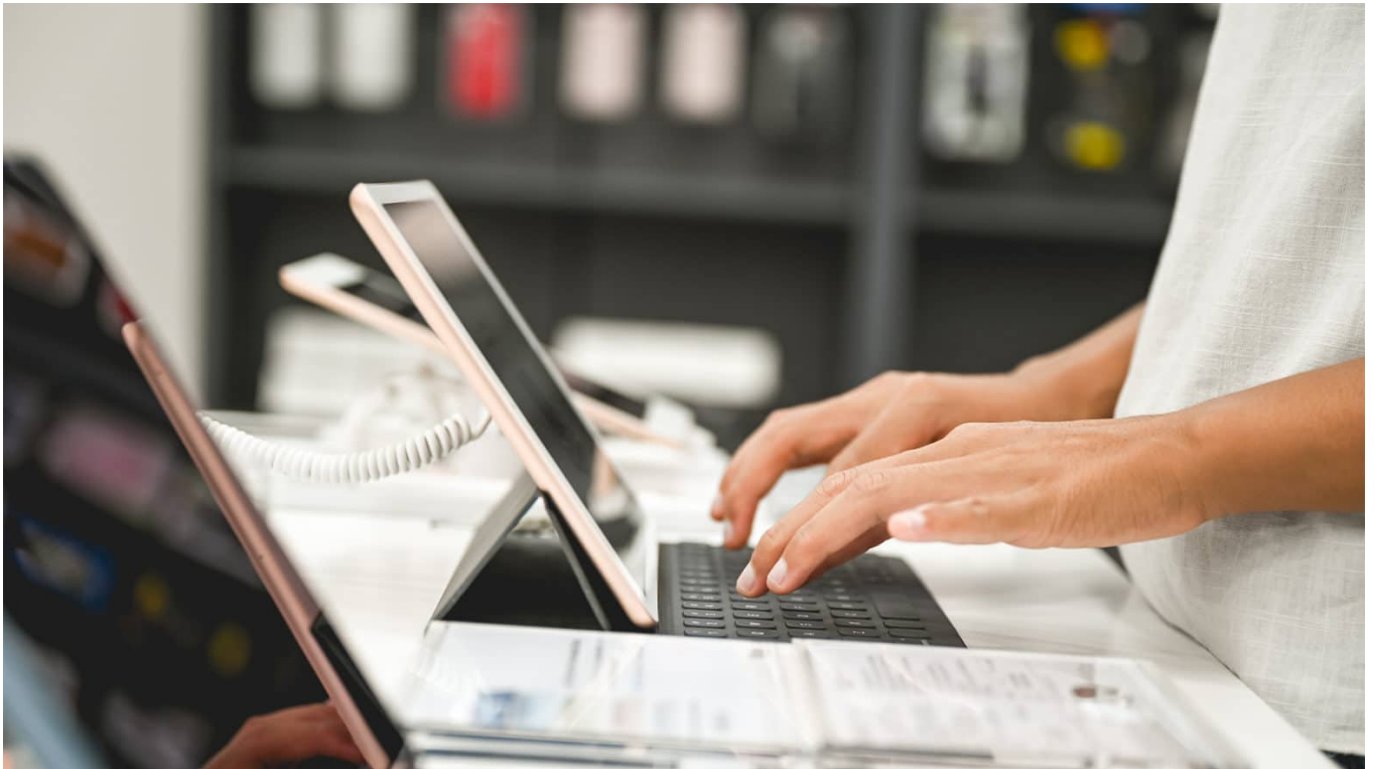


“All reasonable endeavours” – effective protection for a Seller’s earn-outs?



When selling a business (whether through a sale of shares, or a company’s business and assets) it is common for part of the sale price to be deferred, and only payable in pre-determined circumstances following completion of the transaction.

This ‘deferred consideration’ can take many forms; for example, payment might be contingent upon the acquired business achieving certain profitability thresholds (often referred to as an ‘earn-out’), with the payments due being fixed sums, or variable sums depending on the profits achieved.

Deferring part of the purchase price can be beneficial for the buyer: assisting its cashflow position and potentially reducing or eliminating the need for 3rd party financing for the transaction. But for the seller it can also introduce the risk of not being paid a significant portion of the purchase price.

What can be done?

There are ways in which the seller’s risk of not being paid can be mitigated. For example, it might be possible to bring a 3rd party into the transaction to guarantee the buyer’s payment obligations. This will most obviously be of benefit where the deferred consideration takes the form of pre-determined payment instalments which do not depend upon the acquired business achieving profitability thresholds, and/or where the buyer’s financial health is in doubt. But what can be done to reduce the seller’s risk where payment depends entirely on the acquired business meeting financial targets?

In one sense, this might be regarded as low risk. After all, the seller will know the business well and will be unlikely



to entertain deferred consideration tied to profit if the required threshold is unrealistic. Also, it will normally also be in the buyer's interests for its new acquisition to perform well.

However, there can be problems. A buyer may not necessarily have the same level of expertise in the business or sector as the seller. This can lead to the acquired business being run in a way that the seller does not agree with – something that can also happen even where the buyer does have considerable expertise. A buyer might also have plans for the acquired business which benefits the buyer's own business, or even the acquired business in the long term, but does not necessarily assist the acquired business's short term profitability; for example, capital expenditure which will ultimately increase profitability in the long term, but only after the deferred consideration reference period has ended.

“All reasonable endeavours”

Protection for the seller against such risks often takes the form of a contractual obligation requiring the buyer to ensure that it maximises the net profits of the subject company for a given period following completion of the transaction. A typical obligation, which requires a buyer to use “all reasonable endeavours” to achieve this end, might be worded as follows:

“The Buyer undertakes to the Seller that during the period between completion and expiry of the deferred consideration reference period it shall use all reasonable endeavours to maximise the net profits generated by the subject business”.

Rather than being an absolute obligation to maximise net profits, in which case a failure to maximise net profits would be a breach of contract (which most buyers will therefore not agree to), a requirement to use ‘all reasonable endeavours’ means that the buyer is only required to try to maximise the business's net profits, rather than committing to it absolutely.

This begs the question: how hard must the buyer try?

A requirement to use ‘all reasonable endeavours’ sits broadly in the middle of a spectrum of commonly used ‘endeavours’ obligations. At the lower (not particularly onerous) end of the scale is a requirement to use ‘reasonable endeavours’, whilst at the higher (often very onerous) end is an obligation to use ‘best endeavours’.

What ‘all reasonable endeavours’ means in practice varies depending on the circumstances, and in particular, on the contract in which it is found. What one business needs to do in order to maximise its net profits might be quite different from another. However, the courts have on many occasions been tasked with deciding what the endeavours obligations mean in a variety of contexts, from which some guidance as to what ‘all reasonable endeavours’ means can be taken:

- it will normally require all reasonable paths or actions to be exhausted;
- a reasonable path or action may include any path or action that has a significant or substantial chance of achieving the desired result;
- it may require expenditure;
- it can sometimes (but will not always) involve taking steps that are contrary to the party's own commercial or financial interests;
- it is unlikely to mean the party under obligation acting completely against its own commercial interests.

Conclusion

With the above in mind, it is clear that an obligation to use all reasonable endeavours to maximise net profits of an acquired business involves a significant obligation on the part of a buyer.



That said, sellers should also be aware that because the precise nature of the obligation varies, clear and inarguable breaches are likely to be rare, meaning that there is often room for argument by the parties.

Consequently, whilst the obligation may ultimately provide a seller with valuable protection as far as its entitlement to receive deferred consideration is concerned, it may not provide a quick and straightforward solution, and will sometimes require the involvement of the courts.

How we can help

If you would like advice on any of the issues covered in this article, please do not hesitate to contact our [commercial dispute resolution team](#).



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