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Features in the use of Earn-out Clauses in Japan

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I. Introduction

This article introduces and explores the main features of an earn-out clause in M&A transactions, primarily in the context of target companies incorporated in Japan.

An earn-out clause is a provision under which the buyer pays the seller an additional amount of money or any other type of assets (the “Earn-out Consideration”) as part of the acquisition consideration if the acquired company or business achieves a specific goal within a certain period after the closing of the M&A transaction. Such Earn-out Consideration can take the form of a fixed amount or an amount calculated by a predetermined formula.

An earn-out clause is mainly used to: (1) bridge the gap in valuations of the target company/business between the seller and the buyer and (2) incentivize the seller to cooperate with the transition of the target’s operation and management, and maximize the enterprise value of such target after the closing by itself or making someone remain in the target company/business. Therefore, the use of earn-out clause is often considered in acquisition deals of start-up companies or companies undergoing turnaround, where it is difficult to estimate the corporate value.

II. Mechanisms and Functions of Earn-out Clauses

When establishing an earn-out clause, the buyer and the seller generally need to discuss the following matters:

(1) Earn-out conditions
- The indicators triggering payment of Earn-out Consideration
- The period during which the indicators are measured for the Earn-out Consideration

- The amount and maximum limit of the payment
- Timing of payment of the Earn-out Consideration

(2) Definition of deemed fulfillment of the conditions of the earn-out and forfeiture of the benefit of time

(3) Buy-out options that allow the buyer to sell the target company during the earn-out period

(4) Earn-out covenants

- The obligations of the buyer to conduct the business operations of the target company in order to achieve the conditions of the earn-out
- The obligations of the seller in case the seller is involved in the business operations of the target company during the earn-out period

The first step for establishing an earn-out clause is to agree on the indicators that trigger the payment of the Earn-out Consideration. While financial indicators such as sales, net income, and EBITDA are often used as earn-out indicators, non-financial indicators, such as obtaining permits and approvals for new drugs or entering into contracts with certain business partners, have also been used in some recent transactions in Japan, as we will discuss below. In addition to the indicators, the buyer and the seller need to agree on the periods during which the indicators are measured. Such periods are generally set at several months to a few years. Earn-out covenants are also important because the Earn-out Consideration received by the seller depends on the post-closing business performance of the target company that the buyer controls. The seller often asks for some degree of control over the daily operations of the business during the earn-out period. The seller can retain rights over key strategic decisions that need to be made, control over accounting practices, or access to financial information. Conversely, without this control, the buyer could manipulate the business to minimize the amount of the earn-out payments.

Earn-outs have not yet been widely used in Japan. The reasons for this are the complexity of structuring the earn-out mechanism and the possibility of disputes arising if the buyer and the seller disagree on the fulfillment of the earn-out conditions. However, given that the availability of permits and approvals has had a significant impact on corporate value when acquiring recent fintech and drug discovery ventures, we think that the use of earn-outs is becoming more actively considered for such deals.

III. Examples of Earn-out Clauses in Japan

According to publicly available research in the U.S., earn-out clauses were used in approximately 20% of M&A transactions for target companies related to industries other than the Life Sciences sector

over the last three years. In the Life Sciences sector, from mid-2021 to mid-2023, they were used in 59% of M&A transactions in the Devices area, 47% in the Dx/Research area, and 91% in the Biotech/Pharma area. (SRS ACQUIOM 2023 M&A Deal Terms Study, 2023 Life Sciences M&A Study).

In contrast, although there is no widely distributed statistical information in Japan, the use of earn-outs is estimated to be very low (i.e., less than 5%), considering the number of disclosed cases and other factors. As shown in the following disclosed cases, some cases are used in the Life Sciences sector, but there are not enough transactions of this kind to identify a clear trend.

The table below shows some of the recent M&A transactions using earn-outs by Japanese listed companies.

Company	Date	Earn-Out Indicator	Period	Ratio of Earn-out Consideration to the total consideration
(A) Target: 3Minute Inc. Buyer: GREE, Inc.	Feb. 2017	Business performance	3 years	Not disclosed
(B) Target: This Place Limited Buyer: Asteria Corporation	Apr. 2017	EBIT	5 years	Not disclosed
(C) Target: Coincheck, Inc. Buyer: Monex Group, Inc.	Apr. 2018	Business performance	3 years	Up to 50%
(D) Target: Quartz Media LLC Buyer: Uzabase, Inc.	Jul. 2018(*)	Percentage of business performance achieved (sales and number of paying users)	FY 2018	Up to 47%
(E) Target: MEJ Inc. Buyer: Euglena Co., Ltd.	Jun. 2019	Issuance of stock acquisition rights subject to the achievement of the following conditions: (i) Net sales of at least 2 billion	3 years	Not disclosed

		yen and operating income of at least 120 million yen in the fiscal year ended September 2020 or September 2021; or (ii) net sales of at least 3.5 billion yen and operating income of at least 350 million yen in the fiscal year ended in either September 2020, September 2021 or September 2022.		
(F) Target: NS ASSET MANAGEMENT INC. and its subsidiaries Buyer: Asia Gate Holdings Co., Ltd.	Jul. 2020	Business performance	-	Not disclosed
(G) Target: Itabashi Trading Co. Ltd. Buyer: Menicon Co., Ltd.	Dec. 2020	Payments depending on average operating income	Fiscal years ending March 31, 2025, and March 31, 2026	Up to 43% but later amended to 185%
(H) Target: Artham Therapeutics Inc. Buyer: KAKEN PHARMACEUTICAL CO., LTD.	Nov. 2021	Non-financial Indicators: Progress in research and development of new drugs	-	Up to 131%

(*) Uzabase, Inc. exited Quartz Media LLC in November 2020.

In the case of (F), there were unique factual circumstances as follows:

- The indicator of the earn-out was the “prospect of achieving” a certain level of future business performance (instead of “achieving” as in most cases).
- However, if the “actual performance” of the target company during the three years following the transfer of the business fell considerably short of the business plan, the sellers in this deal would be obligated to refund the amount of the Earn-out Consideration proportional to the shortfall to the buyer, Asia Gate Holdings Co., Ltd.

- While the buyer once announced that it planned to pay the Earn-out Consideration because there was a “prospect of achieving” a certain level of future business performance, the buyer shortly thereafter realized that it was “highly likely” for the target company to fail to achieve the business plan, and thus a refund of the Earn-out Consideration would be triggered.
- Therefore, the buyer reconsidered and withheld the payment of the Earn-out Consideration.
- The buyer believed that the target company’s poor performance was due to the directors’ (the former individual shareholders of the target company) negligence in performing their duties.
- Subsequently, the buyer and the sellers reached a settlement that the buyer would pay a part of the Earn-out Consideration to the sellers.

The structure is relatively unique in that: (i) the mere “prospect of achieving” a certain level of future business performance was agreed upon as a trigger of payment of the Earn-out Consideration, (ii) refunding the Earn-out Consideration after its payment could be required, subject to certain conditions. It should also be noted that the buyer withheld the payment on the basis that it was highly likely that a future refund obligation would arise. This case (F) illustrates the importance of defining the earn-out terms rigorously and precisely enough to produce the desired legal effects or conclusions without leaving room for interpretation.

Case (H) also has unique factual circumstances. At the time of closing, some of the class shares held by the seller were not transferred, which led to these class shares being converted into non-voting shares. This conversion resulted in 100% ownership of voting shares of the buyer upon the closing. Then, such non-voting shares and stock acquisition rights held by the seller are planned to be acquired for an Earn-out Consideration or for no consideration, depending on the achievement of the earn-out indicators.

IV. Tax and Accounting issues with Earn-out Clauses in Japan

1. Tax

One key issue involving earn-out clauses is the tax treatment in Japan. For an individual seller in an M&A transaction where the consideration, whether for listed or non-listed shares, is to be paid at the closing and not subject to any conditions, the income for the consideration is generally classified as capital gains and taxed separately at a rate of 20.315% (including special income tax for reconstruction and local tax) (Articles 37-10-1 and 37-11-1 of the Act on Special Measures Concerning Taxation, Articles 9 and 13 of the Financial Reconstruction Act, Article 71-49 of the Local Tax Act). In contrast, if the seller and the buyer agree on an earn-out mechanism, the income for the Earn-out

Consideration that depends on the achievement of an indicator as earn-out can be classified as either (i) capital gains or (ii) miscellaneous income (if a seller is a non-resident individual, before considering the above, whether his/her income is taxable as domestic source income and whether tax treaties are applicable to him/her should also be considered). According to the internal records of the National Tax Agency, the amount equivalent to the Earn-out Consideration paid by a buyer is generally considered as miscellaneous income for the year in which the payment of the consideration is finalized, since the payment is not finalized at the time of the closing. Miscellaneous income is subject to tax on aggregate income, with a maximum tax rate of approximately 55%.

If the seller is any entity such as corporation, income classification cannot be an issue because there is no such concept under the Corporation Tax Act (if a seller is a foreign entity, whether its income is taxable as domestic source income and whether tax treaties are applicable to it would be also considered). On the other hand, if the buyer is an entity, the question is whether the amount equivalent to the Earn-out Consideration paid by the buyer should be added to the purchase price of the shares or whether it should be treated as an expense and deducted in the tax year in which the Earn-out Consideration is paid. The latter is consistent with the National Tax Agency's view that it is miscellaneous income for the seller, which is also advantageous for the buyer.

Please note that the above treatments depend on the terms of the earn-out, so it is recommended that you consult a tax advisor when designing the earn-out mechanism.

2. Accounting

Earn-out Consideration is basically treated as acquisition cost for accounting purposes, but it should be noted that the accounting treatment differs between IFRS and Japanese GAAP.

Under IFRS, the contingent consideration is measured at fair value on the acquisition date, included in the acquisition cost and recorded as a liability (IFRS 3.39). The difference between the total acquisition cost and the fair market value of the acquired assets and debts will be goodwill. Under IFRS, the fair market value of the contingent consideration is evaluated at the end of every accounting period and evaluation loss or profit is recognized and once it becomes certain to deliver Earn-out Consideration whose amount is different from the recorded amount of the liability, it is considered not to be a change in the amount of goodwill, but to be a change in the market value of liability and such amount of change is treated as loss or profit in the period. In contrast, under Japanese GAAP, when additional consideration is delivered, the consideration paid shall be additionally recognized as acquisition cost, and goodwill shall be additionally recognized or negative goodwill shall be reduced

when the delivery of the conditional consideration becomes certain and its fair value is reasonably determinable (ASBJ Statement No. 21, Accounting Standard for Business Combinations, paragraph 27). Therefore, the goodwill recognized on the date of the business combination is larger under IFRS than under Japanese GAAP by the market value of the contingent consideration.

Regarding the amortization of the goodwill, under IFRS, goodwill is not amortized, but tested for impairment at least once in the same period each fiscal year (IAS38.107, 108, IAS36.10, 96). Conversely, under Japanese GAAP, goodwill is recognized as an asset and amortized regularly on a straight-line basis or other reasonable method over the period of its effect, up to 20 years (ASBJ Statement No. 21, Accounting Standard for Business Combinations, paragraph 32).

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