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Client Alert: Another $300 Million for *Guitar Hero* Purchase; When is a Statement Final?

By Ezra Doner*

Eager buyers often overpay for entertainment assets. Add a problematic earn-out[1] and the possibility of overpayment increases.

In the latest *Guitar Hero* case[2], the problem was that an earn-out statement became final against Viacom, the purchaser of videogame company Harmonix Music Systems, notwithstanding a sudden, rapid decline in the value of Harmonix's game inventory.

If you're in the position of Viacom, ideally, your earn-out and participation statements will not be final until you say they're final. In fact, even if your earn-out statement is final vis-à-vis Harmonix, you don't want it to be final for you. As the accounting party, you want the opportunity to revise, revisit, rethink and recalculate your statements.

In the arbitration underlying this latest *Guitar Hero* case, an earn-out statement was held to be final against Viacom in part because it was final against the selling shareholders of Harmonix. In the case itself, the reviewing court affirmed an arbitration award to the selling shareholders of close to $300 million.

The Initial Transaction

Harmonix is one of the companies behind such videogame franchises as *Guitar Hero* and *Rock Band*, iconic properties of the first decade of this century. Viacom wanted to be in that space and, in September 2006, it bought Harmonix for $175 million in cash plus an earn-out for the years 2007 and 2008. For each of those years, the earn-out formula was gross sales of Harmonix's games, less manufacturing and sales costs, less a flat $45 million; then 3.5 times the remainder[3].

The 2007 Earn-Out

In September 2008, Viacom paid $150 million as the earn-out for 2007, the first earn-out year. In calculating the first year earn-out, Viacom did not deduct the costs of goods that were unsold at year-end. At the time of this earn-out payment, Viacom, per evidence in the case, was

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[1] An earn-out is future compensation to the seller of a business, based on the business' post-sale performance.
[2] *Viacom Int'l v. Winshall*, 2012 WL 3249620 (Del.Ch. Aug. 09, 2012), affirmed 76 A.3d 808 (2013)
[3] The court's decision does not explain the rationale behind this formula.

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"delighted to have Harmonix 'in the family' and thrilled with the progress of the *Rock Band* franchise." But that same month, Lehman Bros. filed for bankruptcy. Soon, the economy was in a tailspin. Had Viacom overpaid?

The 2008 Earn-Out

In March 2010, Viacom delivered to Harmonix a final earn-out statement for 2008 which, despite some $768 million in sales, showed no earn-out due. In preparing this statement, Viacom deducted not only cost of goods sold, but also the cost of unsold goods at year-end 2008.

The Earn-Out Formula and Inventory Cost

The Harmonix earn-out formula apparently did not permit deduction of costs of unsold goods. If it were otherwise, a purchaser like Viacom could load up on inventory during the earn-out period, burdening the selling shareholders with excessive inventory cost. Then, after the earn-out period, Viacom, having recovered the cost of goods, could sell free and clear of the earn-out participation.

The Arbitration

Harmonix objected to the 2007 and 2008 earn-out calculations, and the parties, pursuant to their underlying agreement, proceeded to arbitration. In the arbitration, Viacom not only argued for deduction of costs of unsold year-end inventory but, in a variant of that position, argued that it was entitled to deduct an inventory write-down for 2008. Viacom pointed to an inventory write-down in its corporate financial statements, and claimed the right to make a parallel write-down in the earn-out statement.

In a December 2011 award, the arbitrators, siding with Harmonix, rejected both arguments, and determined the 2008 earn-out to be $298.8 million. In another part of the arbitrators' decision which wasn't challenged in court, the arbitrators added $84.4 million to the $150 million earn-out previously paid for 2007.

The Reviewing Court's Decision

The arbitrators' decision meant that Viacom couldn't charge either the cost of unsold goods, or a write-down for their lost inventory value, to the earn-out. Viacom re-raised both arguments in the judicial review, but the reviewing court rejected them, affirming the arbitrators' award of $298.8 million for the 2008 earn-out.

What This Case Means For You

If the Harmonix earn-out provision had been more sensitive to inventory risk, Viacom might have been in a better position to respond to the sudden and rapid decline in inventory value. Moreover, in participation agreements (if not earn-outs), the incontestability provision frequently makes statements final against the participant but not necessarily against the accounting party, and a provision along these lines might have provided more leeway to Viacom to revise the Harmonix earn-out statements.

Of course, this is hindsight, and since the text of the earn-out provision is not part of the reviewing court's decision, we don't know the precise state of play. From all appearances, the selling shareholders were able to negotiate highly favorable earn-out terms.

More generally, since inventory risk exists in every entertainment "hard goods" distribution arrangement, whether for DVDs, CDs, merchandise, physical books, and so on, it should be carefully considered in revenue participation agreements of all kind.

Coda

The total price Viacom paid for Harmonix, including upfront cash and earn-outs, was over $708 million. There may have been other costs as well.

Yes, Viacom apparently overpaid. The earn-out was cranked up to eleven! (See *This is Spinal Tap!*) Within a few years of the sale, *Guitar Hero* and *Rock Band* were (excuse the puns) played out, and Viacom ultimately sold the company back to the founders, reportedly for a song . . . plus a spot of sympathy from the Taxman[4].

[4] News outlets have reported that the sale yielded substantial tax benefits to Viacom. One of Harmonix's top games was *The Beatles: Rock Band*; hence the *Taxman* reference.