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Earnouts: A Deal Making Tool In A Tough Economy

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Has the difficult economy of the last few years forced you to re-think your plans for selling your business? Probably.

Should you wait for a full-blown economic recovery before seriously considering selling your business? Not necessarily.

Is there a mechanism that can help bridge the gap between the purchase price you were hoping to receive for your business and the lower purchase price you are likely to receive? Absolutely!

An earnout can help you bridge the gap between a buyer's concerns about your business and asking price, on the one hand, and your own certainty about the future performance of your business, on the other.

So, how does it work? An earnout is a contractual obligation that provides a seller with a higher purchase price - over a designated time period after the closing - provided the seller achieves certain agreed upon targets. In other words, an earnout can enable you to achieve a higher price on the sale of your business because the final purchase price is based, to an extent agreed by the parties, on the future performance of your business. Properly designed, an earnout will cause a buyer to pay a higher purchase price at a level the buyer is comfortable paying and at performance levels the seller believes are reasonably attainable.

In order for an earnout to work, it must be carefully tailored to the seller's business and to meet the expectations of both parties. A seller must have realistic guidelines in mind and understand how each piece of an earnout will be calculated post-closing. A good suggestion is to keep the earnout as simple as possible. Sellers are well advised to keep earnout percentages low (i.e., maximize up-front cash) and the length of time short. The longer the earnout period, the more performance becomes a reflection of new management and less a valuation as of the closing. Many earnouts are in the range of one to three years, with some running as long as five years.

Sellers must understand that earnouts are fully negotiable. While a buyer may desire an all-or-nothing provision, a seller can often successfully argue for a sliding scale of payments dependent on the level of achievement. It is perfectly logical to argue that if you achieve only 90% of Target X, you should still get *something* for your efforts instead of being shut out completely. A seller should also argue for catch-up provisions that take into account the possibility of a bad fiscal quarter and allow the seller to counter the effects of a bad quarter with the results of a good one. In addition, for lengthier earnouts, payments to the seller should be made throughout the earnout period. In certain instances, earnout payments should be accelerated and become immediately due and payable in full - for example, if the buyer breaches a significant post-closing covenant, terminates the seller's employment contract without cause, or sells the target company (or substantially all of its assets).

Sellers should ensure that the earnout provision expressly requires that the seller will oversee the division or group that will be responsible for achieving the earnout targets. A seller would not want to put his earnout in the hands of people who have no vested interest in meeting the milestones required for achievement of the earnout. (Note of caution: some prospective buyers are turned off by the idea of earnouts because sellers become too focused on achieving the milestones instead of focusing on what may be best for the overall health of the business.)

Earnout requirements and methods of calculations must be precisely defined to avoid confusion. Earnouts can be based on a variety of targets including gross revenue, EBITDA, new clients generated or anything else on which the parties can agree. The amount of the earnout payment can be a flat amount, a percentage or multiple of the target, or some other formula-based calculation. It is imperative that a seller understands that an earnout will require seller to work for someone else post-closing; however, the seller should still negotiate for some measure of post-closing control over the entity.

An earnout should require a seller to work to achieve the earnout goals while also minimizing the ways in which a buyer could manipulate the numbers involved in the earnout calculations. As a result, specific limits must be placed on a buyer's operations. For example, while a buyer may wish to integrate a portion of the business it just bought, a seller may rightfully argue that the earnout cannot be properly determined if such integration occurs. Accounting issues must be analyzed pre-closing as companies often adopt generally accepted accounting principles (GAAP) without considering the ambiguities within GAAP. To protect against undesirable maneuvering by a buyer, a seller should insist on audit rights in connection with the earnout calculation, which allow a seller representative or an independent third party to review the numbers before they are deemed final.

Parties considering the use of an earnout must proceed with caution. There are various aspects of earnouts that can lead to disputes between the parties, including mismanagement by a buyer, partial achievement of goals by a seller, accounting issues and a host of other potential problems. For these reasons, it is important to have as much clarity as possible in the design and implementation of the earnout provision. Also, as a result, it is important for parties to consider an appropriate methodology for dispute resolution.

In order to properly structure an earnout that recognizes the needs of both parties, and maximizes the outcome, the buyer and seller must fully understand the business being sold, the parameters of the earnout, and the accounting issues involved. The terms of the earnout must be clearly defined and carefully negotiated by skilled professionals, with all ambiguities settled before the closing. Under these circumstances, an earnout can become a useful tool for bridging of the gap between a buyer and seller in a difficult economic climate.

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