CORPORATE MATTERS:
EARNOUTS

Author
Simon H. Prisk

Tags
Corporate Law
Earnout
Sale

Typically, when a client is involved in an acquisition, the purchase price is paid in cash, stock of the buyer, a promissory note, or a combination thereof. Factors that lead to one form of payment being used over another include (i) the seller's willingness to be involved in the business post-closing, (ii) the buyer's ability to fund an all-cash purchase, (iii) the various tax implications, and (iv) the type of transaction – all stock, asset acquisition, or merger. In addition, determining the amount of the purchase price can be a complex process and a wide gulf may exist between the views of the buyer and those of the seller. The gulf is often bridged through the adoption of an earnout clause in the contract. This article provides an introduction to earnout clauses and their application.

WHAT IS AN EARNOUT?

An earnout provision in a contract makes a portion of the purchase price contingent upon the target company achieving certain milestones during a period of time following the closing. The milestones are commonly based on financial benchmarks, which often include revenue, net income, or E.B.I.T.D.A. (earnings before interest, taxes, depreciation, and amortization) targets. Non-financial benchmarks, such as the number of contracted sales or improvement of manufacturing efficiencies, can be appropriate with respect to some businesses.

An earnout is not a purchase price adjustment. A purchase price adjustment is used where there is a fundamental agreement as to the purchase price but a long period of time between that agreement and the closing of the acquisition. The adjustment is to reflect changes in the value of the target from the date of signing an acquisition agreement to the date of the closing.

WHEN ARE EARNOUTS USED?

An earnout is used when the seller and buyer cannot agree on the purchase price, such as in the case of a disagreement about the expected growth and future performance of the target entity, or when the buyer is unable to pay the full purchase price at closing. In the former situation, the seller has often built the business over a number of years and believes that it is well-positioned for future sales growth, while the buyer is typically less optimistic. When disagreements arise over projected earnings or other indicia of value, earnouts can be useful. Earnouts are also useful when a buyer is buying a business which has earnings that are generated by a new product and whose valuations are based on projected sales that are based on limited experience. An earnout may also be appropriate if the seller is going to continue in a management role after closing or if the target will continue to operate as a stand-alone business.

An earnout may make the seller as interested in the identity of the buyer as with the amount of money offered for the purchase. The seller will want the buyer to be capable of running the business in a way that ensures that the agreed-upon milestones are reached and payments made promptly thereafter. The buyer's track record with other sellers will also be important. If the seller is reluctant to agree to an earnout, the buyer will want to demonstrate that he or she is up to the task of running the business and that the seller should accept a lower amount at closing, with the expectation of perhaps achieving a higher purchase price over time, in order to make the sale happen.

EARNOUT TERM

It is important that the earnout term not be too long. Typically, the buyer's exercise of discretion in integrating the target business is limited, as the seller correctly wants wide latitude in making business decisions. The seller also has an interest in limiting intercompany charges from the acquiring group. An earnout term is fixed, and a period of one, two, or three years is common. Anything longer puts a chill on the buyer's ability to run the business as it sees fit. A period longer than three years also potentially exposes the seller to greater risk, as external factors not existing at the time of sale – a general economic downturn, for example – may impact the buyer's ability to reach long-term milestones. In comparison, the buyer is interested in integrating the business in order to realize the benefits of the acquisition.

FINANCIAL METRICS

Earnout payments are predicated upon the achievement of certain milestones over a fixed period after closing. If a milestone is achieved, the seller is entitled to either a fixed or computed payment. Sellers typically propose milestones related to a higher level of financial reporting, such as sales or gross income, which are less affected by the buyer's operational decisions. They buyer, on the other hand, will often argue for milestones based on a number from which all expenses of the business have been deducted. Use of E.B.I.T.D.A. for the financial target is a common compromise in an earnout.

Non-financial milestones that are important to the parties, such as product approval by a regulatory body, may also be used.

DISPUTES

Where there is a fundamental dispute as to the purchase price prior to closing, that disagreement often carries over into the post-closing period. In difficult circumstances, such disputes may eventually manifest themselves in the form of litigation. Courts have observed that "[e]arnouts all too often transform current disagreements over price into future litigation over outcome."[1]

From the seller's point of view, disputes often arise with respect to the operation of the business by the buyer post-closing. In cases where the seller has less leverage, the buyer operates the business without input from the seller and this can lead to

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[1] *Airborne Health, Inc. v. Squid Shop*, LP, 984 A.2d 126 (Del. Ch. 2009).

allegations that the business is being intentionally operated in a way to minimize earnout payments. Earnout provisions in an acquisition agreement will generally attempt to address this issue by including language with respect to the continued operation of the business, but these clauses are difficult to nail down and hard to enforce. Sellers and buyers can look at the same set of facts regarding continuation of the business and reach opposing conclusions.

To overcome these types of disputes, it is sometimes agreed that the seller will stay on in the business as an advisor or even continue to run the business during a transitional period. This too, though, may lead to a dispute, as the buyer may allege that the business is being managed in such a way as to increase short-term gain while harming the company long term.

CONCLUSION

Earnout provisions can be a useful way to prevent a deal from falling through when the parties genuinely cannot agree on price. Their main utility is in cases where a seller has encountered difficulty in finding an acceptable buyer and the acceptable company cannot come up with the total purchase price. Otherwise, earnouts often lead to disputes. Nonetheless, when properly drafted in the right set of circumstances, some sellers have been very happy with the results.

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