The Earn-Out: A Complex Issue Sometimes Requires a Complex Solution

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You have built a successful business, are ready to sell it, and have found a potential purchaser. However, you and the purchaser cannot agree on a price. All is not lost. A properly negotiated and drafted earn-out agreement may be the difference between closing the purchase and losing the sale.

It Sounds Good…But What Is It?

An "earn-out" is an agreement by the purchaser of a business to pay additional consideration to the seller if the business meets or exceeds certain post-closing goals. The earn-out generally is contained within an Asset or Stock Purchase Agreement and often is used to smooth over any differences between the purchaser and the seller as to the perceived value and, thus, the purchase price of the business. The amount of any additional consideration paid under the earn-out will be based on an agreed-upon formula which takes into account certain financial or non-financial measurements.

The existence of an earn-out allows the purchaser to pay at closing an amount that more closely resembles what the purchaser believes the business to be worth, while also allowing the seller to receive additional money after the closing if the value of the business, based upon its post-closing performance, more closely resembles the value perceived by the seller. It sounds like the best of both worlds. However, the seeming simplicity of the idea hides numerous traps for the unwary. An earn-out adds a great deal of complexity to the sale of a business and must be drafted carefully in order to accomplish the goals of both the purchaser and the seller, while avoiding future litigation between the parties.

What are the Ideal Circumstances for Using an Earn-Out?

An earn-out is more appropriate when the business will be operated after closing as a stand-alone business, rather than being integrated into the purchaser's existing business. Keeping the business as a separate operating unit after closing, at least for the period of the earn-out, makes it much easier to measure its post-closing performance. Differences in accounting policies between the purchaser and the seller, which may include allocations of income and expense items between the purchaser's existing business and the seller's business, may pose problems in the earn-out computation if the businesses are integrated shortly after closing. In addition, the seller should play a management role in the business post-closing. From the seller's perspective, having a management role will enable the seller to ensure that the business meets or exceeds the performance criteria necessary to receive the full payment under the earn-out. Of course, the purchaser may be concerned that allowing the seller to have a management role in the business after closing will enable the seller to engage in activities to maximize the earn-out payment at the expense of long-term profitability. These potential issues must be addressed in the earn-out through careful drafting of each party's expectations, rights, and obligations.

Advantages of an Earn-Out to Both the Purchaser and the Seller

Some advantages to the purchaser of agreeing to an earn-out are:

- Limiting the risk that the purchaser is overpaying for the business;
- Providing an incentive for sellers to remain as management-level employees with the business in order to grow the business and ensure that it is successful after closing; and,

- Allowing the purchaser to pay later and to use funds earned by the business to make the payment.

Some advantages to the seller of agreeing to an earn-out are:

- Allowing the seller to receive a potentially higher price for the business;
- Indicating to the purchaser that the seller is confident in the business and its upside, and therefore making the purchaser feel more confident in the deal; and,
- Allowing the sale to move forward despite differences over the perceived value of the business.

Some Common Performance Measurements

Earn-outs can be based on any number of financial or non-financial measures, including gross sales; earnings before interest, tax, depreciation, and amortization (often referred to as "EBITDA"); net income; obtaining regulatory approval of a product; obtaining patent protection for an invention; or the number of sales of a pre-closing product line. Using gross sales as a measure of the seller's performance following closing is advantageous to the seller because gross sales are easy to measure and hard to manipulate. However, gross sales are not impossible to manipulate, and the purchaser and the seller should be careful to draft the earn-out to avoid any inadvertent or intentional manipulation (for example, hindering of the seller following closing, including the re-direction of purchase orders from the seller's customers to the buyer's existing business in order to decrease gross sales figures attributable to the purchased business).

Probably the most frequently used performance measurement is EBITDA. EBITDA essentially is net income with interest, taxes, depreciation, and amortization added back. It is an easy way to compare the profitability of two companies because it eliminates the effects of financing and accounting decisions.

One key to the successful negotiation of an earn-out is to ensure that the accounting methods used to determine the pre-closing performance baseline are defined clearly in the earn-out so that the identical accounting methods are used to determine the post-closing measurement. In other words, it's important to compare apples to apples, not apples to oranges. It may surprise some to realize how often the accounting policies used by a seller and a purchaser for certain items differ, even though both are using generally accepted accounting principles. Any difference could be very important, particularly if the earn-out requires a measurement of pre-closing versus post-closing accounts receivable or other items that may be recognized and characterized differently by the seller and the purchaser.

Similar care must be taken when EBITDA is used as the earn-out measurement. An earn-out may provide that the purchaser will pay to the seller additional consideration in an amount equal to a multiple of the amount by which EBITDA exceeds a particular amount. However, a company is free to determine what is and is not included in the calculation of EBITDA. Therefore, care should be taken to define how EBITDA will be computed so that a fair comparison is made.

Conclusion

An earn-out can be a useful addition to a purchase agreement when there are differences between a seller and a purchaser regarding the purchase price for a business. The concept is simple, but the actual details of the earn-out require careful negotiation and drafting to ensure that each party's goals are met and future litigation is avoided. The earn-out should address details such as the performance measures that are applicable, the specific accounting methods and policies to be used, how much control the seller will have over the business after closing, the time frame for the earn-out, as well as issues such as what effect the purchaser's sale of the business during the earn-out period or the discontinuance of a product line of the seller will have on the computation. Disputes with respect to earn-outs are fairly common, but with the right amount of thought and drafting up front, it may be the key to salvaging a deal.

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For further information regarding the issues described above, please contact Richard J. Crow.

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