Using an "Earnout" to Bridge the Gap on Purchase Price in a Sale of a Company

In any sale of a business transaction, the buyer and seller may not be able to reach an agreed upon purchase price. One method that is sometimes used to bridge this gap is an "earnout." An earnout is a contingent payment obligation of the buyer provided certain agreed upon financial or non-financial milestones are met after closing.

For example, if the business being acquired achieves a certain level of revenues for the first few years after closing, then the buyer would pay the seller a certain agreed upon amount (which might be a percentage of the revenues). An earnout can provide some security to a buyer who has concerns over the business's future profitability, and it can also be a way for a seller to achieve a higher price for its business. Although an earnout may bridge a gap between the buyer's and the seller's view of the value of the assets, constructing an earnout raises many issues that need to be carefully considered. The key for both buyer and seller in using an earnout is to make sure the provisions are clearly defined and written. An earnout provision that has not been carefully considered or is ambiguous can only lead to disputes and frustration. The following are a few important considerations:

1. *Clearly Define the Performance Milestones*. Sometimes, the milestones that need to be met are non-financial, such as the development of a product or obtaining a specific number of subscribers for a website or app. More often, the milestones are financial, such as the achievement of a certain level of revenues or net income. Sellers will generally want to use revenues or gross sales because sales are generally more objective and less open to manipulation by the buyer. On the other hand, the buyer might want to use net income because it is a better gauge on how profitable the acquired business is for the buyer. One possible compromise is to use EBITDA (Earnings before interest, taxes, depreciation/amortization). If the purchase price for the business was a multiple of EBITDA, then EBITDA might be a logical metric to use for the earnout.

2. *Clearly Define the Business Segment that is Subject to the Earnout*. Measuring the earnout will become difficult if the acquired business is integrated into the buyer's existing business, so the parties will need to find a way to segregate the business that is subject to the earnout. Separate accounting and financial statements will need to be put in place to be able to accurately measure the results of the business.

3. *Clearly Define the Accounting Measurements That Will Be Used*. Just mentioning GAAP will generally not be sufficient. The seller will want to state that it is GAAP consistent with the seller's past practices, and the buyer will want GAAP consistent with the buyer's practices. Thus, the parties should develop and specify a set of accounting principles that will specifically govern the calculation of the earnout, which should cover such matters as: the timing of revenue and expense recognition; the treatment of expenses or payments resulting from the acquisition (such as retention bonuses); and the treatment of intercompany expenses.

4. *Clearly Define How the Business will be Operated*. The seller will want to make sure the business is operated in substantially the same manner as it was operated when the seller owned it. The seller will want to prevent the buyer from making significant changes during the earnout

period that could affect the earnout, such as reducing the sales force, discontinuing services or products, or shifting products or customers to any of the buyer's other business segments.

5. *Clearly Define the Earnout Period and Events that Might Affect the Earnout.* Typically, an earnout period is anywhere from 1 to 5 years. A buyer would generally prefer to have a shorter time period so that it can be finished with any restraints on its business. If the earnout has multiple time periods (say, 3 years instead of 1), then the seller would want there to be an aggregate milestone to be reached for all 3 years combined. That would allow the earnout to "catch up" if a subsequent year is better than the first year. A seller will also want to provide for the triggering of an immediate payment upon the happening of certain events that would negatively impact the earnout, such as the buyer's sale of the business or change of control, or if the seller's employment is terminated without cause.

6. *Seller Will Want Periodic Reports on the Earnout.* The seller will also want to be updated periodically on the status of achieving the underlying milestone. For example, if the earnout is based on the revenues for the 1 year after closing, then the seller will want monthly or quarterly financial reports on the revenues so that it can track the revenues and, if need be, discuss any concerns it has with the buyer earlier rather than later.

We hope this newsletter has been helpful. If you are thinking about selling your business or buying a business, we can provide the experienced mergers and acquisition assistance you need.