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# Should you fear earnouts in M&A deals?

By Tom McLain

The Corporate Dealmaker section of The Deal.com (the online version of The Deal magazine) recently asked the question: Who's Afraid of Earnouts? The occasion for the question was a study of the deal making philosophy of Jim McCann, founder and CEO of 1-800-Flowers.com Inc., whom Kenneth Klee, writing for The Deal on June 19, 2009, dubbed the "Entrepreneurial acquirer." Mr. McCann says that his company uses earnouts in every acquisition of a company. The counter-argument to the use of earnouts is found in Klee's June 5, 2009 article, Arguments postponed. So we have Mr. McCann extolling the virtues of an earnout and other experts saying that earnouts usually wind up being nothing more than a postponement of an argument. The point behind this article is to weigh in on the question of "Who's afraid of Earnouts?"

Like any good attorney, I'll start by reframing the question before I answer it. The question that is probably a little more appropriate is: "Who's very cautious about using earnouts in an acquisition?" Answer: I am. Perhaps the primary reason for my caution is that, in my experience, a significant number of earnouts creep into deals when buyers and sellers disagree over the value of a business. Since many of these disagreements are based on a different view of the future (the seller claims to see explosive growth and the buyer claims to see conservative growth or even contraction), an earnout serves as a compromise between the optimism of the seller and the pessimism of the buyer. These types of earnouts are usually tied in some way to the revenues (either gross or net) of the business after it has been acquired: if the revenue thresholds are met, the seller will receive some additional compensation. Lets call these "business performance earnouts."

One of the first cautions in connection with earnouts, in general, and business performance earnouts, in particular, is the tendency for both sides to believe that their assumptions will be borne out. This is usually a bigger problem for sellers because they may count the additional compensation embodied in the earnout as “money in the bank.” So, if a seller accepts a deal

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that only works economically if earnout is paid, there is a significant risk of disappointment. Not only is the earnout dependent on how the business does as a unit of the acquiring company, but the earnout can also be influenced by overall economic conditions. It is quite easy to imagine that a significant number of performance-based earnout thresholds have been missed over the last 18 months due in large measure to the overall economic malaise. However there are other reasons to be cautious about earnouts.

Business performance earnouts can be quite tricky to define. Picking an appropriate performance criteria can be much more difficult to do that it may seem. It is not unusual for one of the parties to discover after the fact that the measurement rewards behavior that would not otherwise be desired. So, a lot of careful thought needs to be done by the financial and business due diligence teams before signing off on an earnout formula. The due diligence done in support of developing an earnout formula should include many things, including, without limitation, analysis of historical trends in the business, validation of the sales efforts, determination of the sensitivity of the business to adverse economics or increased competition, careful modeling, understanding the metrics of the business and determining how best to measure its success. Even when all the homework has been done, it is not unusual for me to caution sellers to assume that they will never see a dime of the earnout and to caution buyers to assume that they will wind up paying the entire earnout irrespective of whether either side feels like the performance thresholds have been met or missed. This is because there are often ways to "game" the formula and there are many unpredictable and uncontrollable influences on the formula. In other words, in this regard, I tend to fall into the camp that says that earnouts are merely a way to delay arguments until later.

However, the most difficult part of business performance earnouts can be the way in which they impact the integration the purchased business operations into the acquiring business. This is less of a concern with financial buyer than with strategic buyers, since much less business integration is required in the case of financial buyers. The fundamental obstruction to effective integration is that the former owners of the acquired business tend to want to continue running the business in the same manner as they have always run it in order to make sure they get their earnout. Thus, it is quite easy to have the old owners become quite obstructive to change because of their desire to protect their earnout. Again, this can be controlled to a degree in the manner in which the business performance earnouts formula is designed, but the argument that can often be raised somewhere along the way by the seller is "the buyer's actions prevented me from earning my earnout." The bottom line is that the impediments to business integration that are created by business performance earnouts need to be very carefully considered.

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In other cases, the earnout may be more directly related to retention of the seller for a long period of time after the acquisition. Let's call these "retention earnouts." From reading Klee's article about Mr. McCann, this seems to be the primary reason for the earnouts that 1800 Flowers uses. Mr. McCann explains that "about 60% of the company's executive team has joined through deals." If you want to retain the seller's expertise, the challenge is keeping them motivated after they have received a big payday. Thus, retention earnouts are typically less results oriented and more oriented to service longevity and quality. They can simply take the form of requiring the seller to continue to work for a period of time in order to receive the full deal consideration. More often, retention earnouts combine longevity components and revenue components and, as in the case of 1800 Flowers, there may be complimentary programs providing employment incentives. The tension in retention earnouts is not so much over whether there will be problems with integration but over whether the seller will actually remain in productive service. Needless to say, retention earnouts be difficult to design but, since they are not serving as a bridge over a dispute, they can be a little easier to create.

Earnouts have been and will continue to be part of mergers and acquisitions. Earnouts that are created primarily as a way to resolve a current dispute in the future by making payments based on thresholds that are tied solely to company performance are the ones that are least likely to work as intended and the most likely to create future problems. It may be the case that, in these uncertain economic times, there may be an upswing in the use of business performance earnouts to fill in valuation gaps. In contrast, earnouts that are designed to encourage specific behaviors like the retention of services tend to be a little more likely to operate as intended. In summary, there is no need to be afraid of earnouts, but there is every need to be cautious in implementing an earnout.

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