# Negotiating Price:
# All Earnouts Are Not Created Equal

By Seth I. Rubin

Picture this scenario: you've worked your entire adult life building up the value of your business and you're ready to execute your exit strategy – a sale to another company that will enable you to retire comfortably. But, there's a catch in the deal. The buyer is expressing doubts about the projected earnings of your company despite all of your charts showing a clear upward path in earnings well into the future. How can you bridge the gap between the buyer's concerns and your own total certainty about the future performance of your business? Simple, the buyer says, let's use an earnout.

An earnout provision provides a seller with a higher purchase price – over a designated period of time – provided the seller achieves certain agreed upon targets. An earnout is designed to alleviate a buyer's concern about overpaying for a business and a seller's reasonable desire to be paid for the anticipated (but, as yet, unrealized) future value of the company being sold. As a result, an earnout can be useful in effectively bridging the gap between a willing buyer and a willing seller who have a disagreement as to the true value of the business being sold. It is attractive to the buyer because it spreads some of the risk of the acquisition to the seller while also allowing the seller to receive increased compensation for the sale if the triggering points of the earnout are achieved. While these are noble goals, sellers need to carefully assess the parameters of the proposed earnout: all earnouts are not created equal.

So, how can a seller protect himself with an earnout and still have the opportunity to maximize his sale price? First, 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 simple and measurable. While earnouts can represent up to 25% of the purchase price and last for several years, sellers are well-advised to keep earnout percentages low (i.e., maximize the amount of cash in the deal) and the length of time short (i.e., allow yourself to "move on" after you've sold your business). As time passes after the closing of the acquisition, the performance of the acquired company becomes more a reflection of the new management and less a valuation as of the closing and, therefore, a short earnout period is justified.

Second, understand that earnouts are fully negotiable. While a buyer may argue for an all-or-nothing provision, a seller can often successfully argue for a sliding scale of payments depending on the level of achievement. It is perfectly logical to argue that if you achieve 90% of target X, you should 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 provide an opportunity to the seller to counter the effects of a bad quarter with the results of a good one. At the end of the day, 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. It is imperative that a seller understands that an earnout will require lots of work post-closing and will require the seller to work for another company or group of people. Although the seller should negotiate control over the entity being sold post-closing (i.e., a management position), the seller must recognize that she will no longer have absolute control over the company. If you are the type of person who is looking to sell your business and ride off into the sunset, or, if you will have difficulty working for someone else, an earnout is not for you.

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 that are 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. Allocation of certain internal and administrative costs and expenses (e.g. legal, insurance and accounting costs) can also negatively impact a seller's ability to achieve earnout goals. Accounting issues must be analyzed pre-closing as companies often adopt generally accepted accounting principles (GAAP) without considering the ambiguities and options 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 earnout numbers before they are deemed final.

Parties considering the use of an earnout must proceed with caution. In order to properly structure an earnout that recognizes the needs of both parties, the buyer and seller must have a full understanding of the business being sold, as well as the accounting issues involved. The terms of the earnout must be clearly defined and carefully negotiated, with all ambiguities settled before closing. Only then can the earnout be used as a tool for a fair bridging of the gap between a willing buyer and a willing seller.

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