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Earnouts: When and How to Use Them

In privately held company M&A transactions, earnouts are frequent components of the deal structure. Why? - Because an earnout is an excellent mechanism for bridging the gap between the buyer and seller. Most private company transactions are negotiated transactions. The buyer starts out with a position, and likewise, the seller starts out with a position. The following provides earnout perspectives.

The negotiations gap tends to center on specific issues including:

- Value of the company today.
- Value of the company in the future.
- Risk related to departure of the owner.
- Risk associated with representations and intentions.
- Value and risk associated with expected future events, products, customers, or services coming to fruition.

Practically speaking, what are some examples of the negotiations gaps?

- When the seller believes his company is worth more even though the weather caused a downturn the previous year.

- When the major work on the new website or product development should pay off bigtime in the next few months.

- When the seller's attitude may change if his post-closing bank account swells yet his continuing with the company is important to the acquirer. The seller may have the majority of the institutional memory about customers, the market, company mistakes, industry missteps, employee capabilities, new or ongoing technology, or competitor vulnerabilities.

- When a strategic acquirer will intend to combine his product offerings with those of the newly acquired company but needs the seller to stay on board to make it happen.

- When the acquirer is an industry player or could buy a competitive operation.

- When new major customers are going to significantly increase the company's pretax earnings.

The earnout may be structured in many forms.

- It can be in the form of commission or bonus, not unlike other incentive compensation plans for a senior level employee.
- Or, the earnout may be in the form of additional price paid for the stock or assets.
- Or, the initial transaction may be a price paid for the option to acquire the stock at a price based on a formula
- Or, a put may be used based on formula or earnout criteria.

There can be many variations depending on the circumstances of the company, the acquirer and the seller. In one case familiar to this writer, the seller was owed a substantial debt by his company and the earnout was based on benchmarks that caused that debt to be paid - or not.

Some would argue that an earnout, itself, could be risky. There certainly can be risk in an earnout if the results related to the earnout criteria do not prove out. But, an earnout that is well conceived and well crafted should not be any more risky than any other future payment plans such as a seller note.

So what is the most effective way to structure an earnout?

- The acquirer is buying earnings and earnings streams that show a return on the investment. As such, the acquirer is often going to argue for the earnout to be based on pretax earnings.

- The seller, on the other hand, knows that the acquirer may operate the company differently than he did and may possibly spend more on general and administrative expenses than would he, thereby decreasing pretax profits. Because he cannot control operating expenses in a company he no longer owns, the seller then likes to have the earnout based on gross revenues.

This writer is of the strong belief that the best conceived earnouts are based on the gross profit line of the P&L Statement. Gross profit tends to not change significantly as a percentage of sales over time. Additionally, by using gross profit, the acquirer can invest in people or other items that hit the general and administrative expenses without impacting the earnout calculation results. That said, we have seen effective earnouts based on units sold in defined time frames. The objectives here are fairness, simplicity and easy measurability. A fair deal tends to reduce the potential for disputes.

Disputes are best handled first by the parties. Then, if agreement cannot be reached, the next step should be arbitration by a professional business arbiter who is experienced in these types of matters. Arbitration is a superior method to court. Settlement in court could take years, be much more costly; all while the parties are still dealing with one another related to the business.

So in the spirit of avoiding disputes, it is important for the parties to include certain things in the definitive agreement regarding the earnout.

- Specifically, the respective and joint objectives and intentions of the earnout among the parties should be made clear.

- The method of measuring the criteria going into the earnout calculation should be carefully and thoroughly defined.
- All definitions of the method must also be clearly spelled out.
- The accounting approach to be used must be described such as GAAP or some other methodology.

Pragmatism should prevail in an earnout and that also applies to its duration. At some point the value will be reached or the seller will be assured that payment, or whatever the gap in negotiations is reasonable and differences can be resolved. So, longer duration earnouts do not make better earnouts. Five years should be the maximum. Medium term is better – say three years.

Term periods that are too short can allow gaming the system. Gaming occurs when two or more participants attempt to reach conflicting objectives or goals. If the term is too short then too much focus on the earnout itself at the expense of good business principles and judgment can negatively influence a good business decision. Companies change. If something happens, i.e. the company is again sold; the earnout usually would be accelerated. The earnout document language should accommodate any such eventualities.

Certain related "what-ifs" should also be considered and their impact defined such as new product announcements and releases, discontinuing products, restructuring services or product packages, or pricing decisions. A well-conceived earnout structure will not be an impediment to the ongoing business; rather it should be supportive of the company's success.

Are there situations where an earnout should not be used? Absolutely! An earnout is only one possible way to bridge the gap between the parties. Frankly, it is better to not have an earnout. And, there are situations that just do not lend themselves to an earnout structure such as when the combined companies are integrating operations and newco's operations, channels or combined product offerings are not distinguishable going forward.

A well-conceived, well-structured earnout can provide excellent benefit for both acquirer and seller. The beauty of an earnout is:

- That it provides for the value of the company to become the value paid.
- It can cause the seller to reach the full value that is consistent with his expectation.
- It can cause the acquirer to structure a transaction so that all parties are pulling in the same direction toward higher returns-on-investment goals that motivated the acquisition in the first place.

Because earnouts are increasingly common components of deal structures, attorneys have become more familiar and comfortable in drafting them. Before the point of drafting documents though is the negotiation process. This negotiation is where the principals are well served to have a savvy and experienced investment banker on their side of the table who can discuss the nuances of an earnout that is effective, efficient and fair.

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