Earn-Outs: Don't Trade a Handshake Today for a Lawsuit Tomorrow

by Robert Adel, Litigation Shareholder, Greenberg Traurig

Earn-outs — provisions giving the seller of a business additional consideration if the business hits certain performance benchmarks — can be a win-win for both business buyers and sellers. Earn-outs can provide a source of funds for business buyers that can save a deal that otherwise couldn't close, and they can provide a method for buyers to share risk with sellers. If a seller predicts great things for the future of his business, an earn-out is a way for the buyer to make the seller "put his money where his mouth is." If the rosy projections prove true, the seller shares the upside and gets a higher price than he would have gotten otherwise. If the business doesn't hit the projections, the seller shares the downside. This helps to keep the seller's projections honest and realistic, can help the parties overcome negotiation hurdles, and provides an incentive for the buyer and seller to work together for the future success of the business. However, earn-outs can serve a different purpose: they can be a crutch when parties can't agree on a purchase price for the business. Too often parties use an earn-out to close a gap where they either should have properly negotiated the price or — if they couldn't agree on the price — should have walked away from the deal. In such situations, instead of aligning the parties' interests and helping them work together, earn-outs mask a disagreement. Deal-makers sometimes say that in these situations the parties traded an agreement on price today for a lawsuit tomorrow. More often than not, the cost of the lawsuit will far outweigh any benefit that may have been obtained from the earn-out. What should deal-makers do to maximize the benefit and minimize the risk of an earn-out? First, they should ensure that the particular deal lends itself to an earn-out. Does the earn-out accomplish legitimate goals? Does it provide needed seller financing thereby enabling the deal to close? Does it create risk-sharing based upon good-faith projections? After the sale, will the business be operated in such a way that the earn-out metrics can be reasonably calculated? If the deal isn't right for an earn-out, or if there is already tension and suspicion between the parties, an earn-out is probably not a good idea.

Second, the parties should make the earn-out calculation as fair and objective as possible. The calculation should be based on an "apples-to-apples" comparison of the business pre- and post-acquisition. Changes based on the deal itself, such as interest on acquisition debt, increased depreciation resulting from an increase in the valuation of purchased assets, buyer's home office or administrative expenses, etc., should be eliminated from the calculation. Accounting is not an exact process and accounting issues arise in nearly every earn-out dispute. Sometimes "creative" accounting is used by a buyer to avoid or reduce earn-out payments. The best way to minimize accounting issues is to minimize the subjective elements that go into the earn-out calculation. The biggest culprit is typically reserves. The Allowance for Doubtful Accounts, Excess and Obsolete Inventory Reserve, and Warranty Reserve are all based in part on subjective estimates. And, not surprisingly, these reserve accounts figure prominently in many earn-out disputes. These and other such accounts are amenable to subjective adjustments based on accounting considerations rather than changes in performance. Thus, adjustments to reserves often lead to disagreements. The parties should agree in advance how these accounts will be valued for purposes of calculating the earn-out. The parties should also agree in advance to any changes in seller's accounting methodology so that the earn-out is based on true performance, not accounting adjustments. It may be worthwhile to negotiate and attach to the contract a detailed summary of the accounting policies and procedures that will govern the earn-out calculation.

Another thing the parties can do is base the earn-out on revenue rather than profit. Revenue is a straightforward determination. EBITDA or profit, on the other hand, is affected by adjustments to the above-mentioned reserves, accruals based on estimates, the accounting treatment for returns, timing considerations, and many other subjective factors. The further down the income statement the earn-out metric goes, the more subjectivity enters into the equation and the more likely there are to be disputes. Third, the parties should make sure the earn-out provides incentives to both the buyer and the seller. The goals should be reasonable and obtainable, and the benefits of hitting those goals should be meaningfully shared between the buyer and the seller. If all or most of the benefit of hitting the target goes to the seller (as is often the case when an earn-out is a substitute for agreeing on the price), then the buyer has no incentive to push to hit those goals and may even have an incentive not to do so or to postpone sales or growth. Conversely, if the benefits go disproportionately to the buyer, then the earn-out probably isn't an important deal component. Finally, any specific issues unique to the particular deal should be considered. The contract should prevent the buyer from defeating the intent of the earn-out or avoiding legitimate payments. For example, if the buyer already owns businesses similar to the business being acquired, the contract should appropriately limit the buyer's ability to transfer sales of the business being sold to other business units it already owns. The contract should also address the possibility of the buyer engaging in a subsequent acquisition or divestiture that affects the purchased business. And if the seller is being retained to operate the business post-close, that may cause issues with the earn-out.

The bottom line is that earn-outs are a great tool in the right circumstance, but should never be used as a proxy for an agreement on price. Earn-outs are notoriously fertile ground for disputes, but that risk can be greatly mitigated by the careful negotiation of the earn-out provision. This might seem like a hassle during deal negotiations, but if it avoids a dispute later, it's probably worth the effort.

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