Earn-Out Agreements: Part 1 – An Overview

Article from Money soft

An earn-out can allow an otherwise willing buyer and seller to bridge the gap in their respective valuation concepts for the business in order to complete a sale. In periods of economic and political uncertainty, earn-outs seem especially attractive because they can help get deals done in a difficult business climate.

Recently, one adviser gave his audience this advice: Keep your cash. If you're going to buy a business in this uncertain economy, do it with an earn-out. This may or may not be sound advice, but it certainly reflects an increased interest in earn-outs.

In a typical earn-out scenario, a seller may have a more optimistic view of the future earnings of the business, characterized by a conviction that their investment and labor in the business is about to bear an abundance of fruit. The buyer may understand the basis for the seller's optimism, but is not convinced that results will materialize and doesn't want to plunk down hard cash for what is essentially a riskier tranche of projected earnings. So, in certain cases, an earn-out agreement can be structured to bridge the value gap and to allow the buyer and seller to reach a meeting of the minds.

An earn-out can be used as an acquisition currency and as an incentive to encourage the seller who remains with the business after the sale to achieve the mutually agreed upon performance targets. Since the payment is only due upon attainment of the performance target, the advantages to a buyer include:

1. Conservation of cash.
2. Reduction of leverage (which is helpful in a tight credit market with typically lower advance rates).
3. An incentive for the seller to make the transition in ownership a success.
4. An overall reduction of risk.

From the seller's vantage point, an earn-out represents an opportunity. If performance targets are hit, the seller receives additional value from the sale. If the company exceeds the performance targets, the seller may actually net more dollars in the long run. However, an earn-out is a risky proposition for a seller with the worst-case scenario being a complete failure to achieve the performance targets and not receiving a dime. In effect, risk is shifted by the buyer to the seller.

A Closer Look at the Definition of an Earn-Out Agreement:

An earn-out is a type of contingent payment. It is paid by a business buyer to the seller upon the attainment of certain predefined post-closing events (performance targets). An earn-out is one form of a contingency payment. While an earn-out is a contingent payment, it is not a Purchase Price Adjustment such as the ones made to reflect the actual values of balance sheet items as of the closing date.

The performance targets can be financial metrics (i.e., Net Revenues, Gross Margin, Net Operating Income, EBITDA, EBIT, EBT or NAT). A performance target can also be established in operational or project-based terms such as the completion of a research project, getting a production line or facility online, or closing of a specific sale.

Payments become due and payable when the contractually defined performance targets have been achieved. Payments can be made based upon a percentage of the performance target or as a lump sum. If performance targets are missed, then the amount payable to the seller is reduced according to the formula defined in the agreement.

The payments received by the seller under an earn-out are additional consideration and can be paid with cash or stock. If the payments are made in stock and an interest rate is not built into the agreement, it is possible that the IRS may impute interest.

A “reverse earn-out” is a variation on the concept. Under this arrangement, the buyer is paid an agreed upon amount or percentage of the performance target. The payment is reduced if the target is missed.

From a psychological perspective, in a reverse earn-out, a seller is working to “keep” the earn-out amount by achieving the performance target and will be “penalized” for missing the mark. In a normal earn-out, the seller is working toward a target so that he will “be in the money.” It is human nature to work harder to keep what we have rather than achieve something we don’t.

The higher an earn-out (as a percentage of the total consideration), the more committed the seller may be to seeing a payday. In addition, the larger the earn-out (as a percent of the total consideration), the higher the litigation risk in the event the seller feels that they were “shorted” by the buyer.

Earn-outs are not magic bullets. One-size-fits-all and cookie-cutter agreements are an invitation to disaster. Diligent and careful negotiations are necessary to resolve the stress points to reach an agreement that will hold together after the closing.

An earn-out presents additional risks and costs to the buyer and seller. It takes time to negotiate, draft, and implement an earn-out. There is also the risk of litigation. An earn-out can impose additional accounting and audit costs on the buyer.

An earn-out can reduce a buyer’s initial investment, bridge the value gap and provide an incentive for the seller. For the value-oriented negotiator, the primary objective of an earn-out is the maximization of value for both the buyer and the seller.

Earn-outs are commonly used when the buyer and seller are both interested in consummating a deal and need to bridge the value gap such as in the following instances:

1. Businesses in the development or entrepreneurial stage with limited operating history.
2. Companies that have introduced a new product line or technology that do not have a track record as of the date of negotiations.

3. Turnaround situations in which the future existence of a business is in question. The focus is on survival and the business may not be generating positive cash flow.
4. Markets or industry sectors that are experiencing growing valuation multiples that may be reaching a peak.
5. As an incentive to keep the seller involved in the operations after the deal closes and the buyer wants the seller to have some "skin in the game."
6. Privately owned businesses where the owner's concept of value is based upon projections that are more optimistic than the projections made by the buyer.
7. A "value buyer" wants to acquire a business but is unable or unwilling to pay the entire price in hard money. This is especially helpful when negotiating with a seller that is under some pressure to sell.

Summary

Conceptually (but not legally), an earn-out is very much like either a bonus or a dividend. It is an incentive to meet a target. If the seller is going to have hands-on authority to hit the performance targets, it is more like a performance bonus. On the other hand, if the seller is going to have a passive or subordinate role, the earn-out payment is much like a dividend.

What looks like a "win-win" solution can turn into a litigious nightmare if the earn-out agreement is poorly drafted or implemented. An earn-out is not monopoly money. And, what looks like a marriage made in heaven, can quickly turn into a legal controversy. Then again, a carefully constructed and diligently drafted earn-out agreement can create value for both the buyer and seller while mitigating the risks.

The best advice for anyone considering an earn-out is to retain the services of an attorney with extensive earn-out experience. They will be able to guide you past the landmines and structure an agreement that supports your business intent and personal motivations.

Earn-Outs Agreements: Part 2 – Possible Outcomes

Note to the Reader: This is the second in a series of articles that explore the definition, application and issues of including earn-outs in negotiated M&A transactions.

An earn-out is an opportunity for both buyer and seller to maximize their respective post-acquisition returns on investment, but it doesn't always play out that way. Generally, there are eight possible outcomes when an earn-out is included in an M&A transaction. This article provides an overview of the spectrum of possible outcomes and the significance to the buyer and seller:

1. **Success**: The seller hits all or most of the performance targets and receives the payment as expected—on-time in accordance with the terms and spirit of the earn-out agreement.

In addition, the hitting of the performance targets creates additional value and cash flow for the buyer. This is the most desired outcome, one that you can call successful.

2. **Partial Success**: The seller can hit a portion of the performance targets and receives a payment that is disappointingly lower, but both buyer and seller believe that the earn-out was implemented faithfully and that each party gave an honest best effort. While this is not the optimal outcome, it is still successful.
3. **No Success, but No Foul**: The seller misses the performance targets and doesn't receive any payment, but both the buyer and seller believe that the game was played fairly on a level field. There is no cause for celebration. The players feel that they faithfully tried to adhere to the letter and spirit of the agreement and both parties walk away amiably, but disappointed.
4. **Mid-Flight Change**: There are a number of business events that can present themselves during the term of an earn-out agreement that can create problems. Examples include termination of the seller's employment (if employed), the sale, assignment or transfer of the business unit or company, and termination of the buyer's management team. To the extent that these issues have been diligently addressed in the earn-out agreement, the change can be smooth. If not, then we move to the next two possible outcomes, a controversy or a fight.
5. **Controversy**: The seller doesn't earn a payment or earns one that is lower than expected and feels that the agreement was implemented in bad faith. The seller may believe that his or her ability to earn the payment was thwarted by the actions of the buyer. It is also possible that the seller earned a payment but it was withheld or used to offset a charge arising from the provisions of another transaction agreement. In this outcome, the earn-out results in a controversy that can mushroom into a full-fledged fight. In both instances the buyer and his or her legal team need to get into conflict-resolution mode to contain the situation. This is a poor outcome and the only question is: will it be contained.
6. **Failure and a Fight**: When there is a controversy that can't be amiably resolved, the conflict can escalate into a legal action. This is the worst outcome and one that will cost the parties a considerable amount of stress, time and money. This risk can be mitigated by building a conflict resolution process into the agreement.
7. **The Wrong Target Gets Hit**: It is possible that the seller successfully hits all or part of the performance targets and it doesn't create additional cash flow or value for the buyer. This could be due to the selection of the wrong performance targets or a malformed agreement. In this case, the seller is being paid directly out of the buyer's pocket, which is a big disappointment because the buyer was assuming that the seller would only be paid if the deal was successful.
8. **The Big Surprise—the Unknowable Unknown**: Life doesn't fit into a projection and it doesn't much pay attention to statistics and bell curves. Unexpected random events can lay waste to the best formed plans. Nassim Taleb's Black Swans are in some invisible or ignored corner of our Universe doing push-ups. There are positive surprises and then there are surprises that bring misfortune. As a buyer, it never hurts to spend some time trying to imagine the unimaginable.

Negotiating a careful and comprehensive earn-out agreement is time intensive and incurs legal, tax and accounting fees for both buyer and seller. So, before a buyer embarks upon the path of including an earn-out as part of a buy-out, be sure that it is really a good idea.

Earn-Out Agreements: Part 3 – Buy-Side Considerations

Note to the Reader: This is the third in a series of articles that explore the definition, application and issues of including earn-outs in negotiated M&A transactions.

An earn-out can reduce a buyer's initial investment, bridge the value gap and provide an incentive for the seller. For the value-oriented negotiator, the primary objective of an earn-out is the maximization of value for both buyer and seller.

Threshold questions include: In the specific instance, is an earn-out really a good idea? And if it is, how do you create a foundation for successfully including one in a transaction?

This article is written from the buyer's point of view.

When considering an earn-out, a buyer should address the following foundational points before getting into the nitty-gritty detail of negotiations:

1. Clarify the intent and purpose of the earn-out. An earn-out can be structured to bridge the value gap and/or can also provide an incentive for the seller to hit predefined targets after the transaction closes. As a buyer, you want to be clear about what you are trying to accomplish with an earn-out because that intention will shape the discussions and negotiations with the seller.
    - Bridge the value gap: If the earn-out is intended to bridge the value gap, then the amount of the earn-out is a component of the purchase price. Depending upon the terms of the earn-out agreement, the earn-out amount is a portion of the price that is conditioned upon the attainment of the performance targets.
    - Provide a performance-based incentive: If the earn-out is intended as an incentive only, then any earn-out payments are over and above the purchase price. In this case, earn-out payments are much like a bonus or similar incentive plan, and are not a component of the purchase price.
2. Determine the amount of the value gap. You need to quantify the value gap before you can begin to bridge it. The value gap is caused by a mismatch between the buyer's and seller's expectations and projections for the future. The value gap is the difference between your concept of value and your best guess of the price the seller would be inclined to accept in a transaction without an earn-out, which is not necessarily the seller's asking price.
3. Discover the facts and assumptions that account for the value gap. Simply quantifying the value gap does not provide you with sufficient information to craft an earn-out that meets the objective of maximizing buyer and seller value.
    - Dig into the facts and assumptions upon which the seller's projections are based. You want to fully understand the story behind the projections: the goals, strategies and action-steps that form the seller's future vision and business plan.

Understanding the seller’s assumptions doesn’t imply that you are in agreement with them—it just means you comprehend them.

- Determine if the seller’s assumptions and projections are “reasonably” achievable. The seller’s business plan and projections can be based upon a pipe-dream or can be both realistic and fundamentally sound. If you think the facts and logic behind the seller’s assumptions are specious or unrealistic, then going any further with the earn-out is an invitation for future conflict.
- Consider whether the seller’s direction is one that you want to pursue as a new owner. It is possible that the seller’s plans are feasible, but not a direction you want to pursue. In this case, pursing an earn-out can be a set-up for future conflict and friction.
- Determine the additional risks associated with the seller’s assumptions and if they increase the enterprise risk. When discounting future earnings or cash flows (income streams), the key variables are the income stream and the discount (risk) rate. You want to compare the relative risk between the two business plans and, if necessary, work the additional risk into the overall discount rate and value concept.
- Consider how much the company would be worth if you used the seller’s more optimistic projections (with the same valuation metrics you applied to your projections). By determining the additional earnings and discount rate of the business based upon the seller’s projections, you can create a “what if…?” value. By deducting the value based upon your projections and the seller’s “what if…?” projections, you have a number to work with in setting the earn-out performance targets and payout rates.

4. Consider whether the company will be operated as a standalone business, closely integrated into an existing business unit, or merged into another business. When negotiating an earn-out, it is important to define the “business.” Such a definition is clearer when the company will be operated on a standalone basis. However, isolating the various performance targets becomes increasing more difficult when the acquired business is merged, tightly integrated or completely assimilated by the parent. It is also requires additional accounting and reporting to distill the performance target from the overall entity. Despite the difficulty, if an earn-out makes sense, these issues can be addressed during the negotiation process.
5. Share your vision for the company’s future and the detail of your business plan with the seller, and determine if the seller is aligned with them. If a transaction closes, you are going to have an on-going relationship with the seller. The seller is going to be a stakeholder in the company’s future and might even have an active role in the management and operation of the business. Incongruent visions will result in conflict, especially if the seller is a strong alpha personality.
6. Consider the role you want the seller to play in the company’s post-acquisition future. So, assuming that you and the seller are congruent with the vision of the future, the next issue is to define the seller’s future role, if any, in the business. The seller may or may not want to have a continuing role. And, you may or may not want the seller to be active.
   - If the seller is going to have an active role in the management of the company, consider whether the seller’s management style is consistent with yours. If the seller is not someone you would want on your management team, then you

obviously don’t want to go down that road. If you hire the seller and then feel obliged to terminate employment, there is going to be hard feelings and, depending upon the terms of the agreement, possibly a payment to be made to the seller.

    - Consider the degree of control and authority you’re comfortable giving a seller over operations, accounting and capital budgeting matters. When it comes time to negotiate the actual details of the earn-out, control is going to be a big issue. The seller is going to want to do everything possible to protect their earn-out payment. On the other hand, as a buyer, you want to retain all of the rights and authority necessary to protect your investment.

7. Think about your chances of reaching a clear understanding with the seller on your major post-acquisition operational, accounting and fiscal policies. A lack of clarity on these issues is a breeding ground for disagreement. If you can’t discuss these issues and reach a good understanding with the seller, then negotiations can reach an impasse or, even worse, you will set yourself up for trouble by glossing over these points in favor of just getting the deal done.
8. Quantify the financial impact of the seller meeting the performance targets. If project-based targets are to be included in an earn-out, you want to quantify the financial contribution that these projects will add to the bottom line and cash flow. In addition, you want to thoroughly understand any expenditures and additional investments that might be necessary to complete the project. You want to factor these items into your projections and discounted cash flow calculations to make sure that the additional risk and amount paid meet your hurdle or threshold rate for ROI on the additional investment.

The above steps provide a framework for evaluating whether an earn-out makes sense in a particular situation and lay a foundation for negotiating one that will maximize value for you and the seller.

In many ways, an earn-out negotiation is like an employment interview in which both parties do much better when they focus their discussions and questions on the job’s requirements and abilities of the candidate to successfully perform his or her duties. After the parties are comfortable with each other and want to pursue a relationship, then issues like compensation and benefits naturally come into play. Trying to negotiate a “dumb number” without reaching a meeting of the minds about the underlying assumptions is putting the cart before the horse and may not get you where you want to go.

Earn-Out Agreements: Part 4 – Sell-Side Considerations

In the last installment of this series, we explored the buyer’s considerations when deciding whether to propose an earn-out agreement to a seller. In this article, we will look at the issues a seller needs to face before getting involved with the complex, time-consuming and expense-incurring formal negotiation process.

An earn-out is frequently proposed by the buyer, who is concerned about conserving cash, reducing the need for debt, mitigating risk and incentivizing the seller by making a portion of the purchase price contingent upon the attainment of pre-defined performance targets.

While the advantages to the buyer are clear, an earn-out proposal runs counter to a seller's general financial objectives which are to get the highest possible price, with the most cash up-front and, in many instances, as little future risk as possible. Plus, even if a seller has been active in the management of the business, he or she may be motivated to sell in order to retire. This tension between a seller's and buyer's objectives, sets the stage for negotiations.

Within the context of the negotiation, it is reasonable to assume that the buyer is evaluating several investment opportunities and uses for its funds (i.e., other acquisitions candidates, projects providing organic growth or dividend distribution). On the other hand, it's equally likely that the seller is going to be evaluating proposals from several prospective purchasers.

So, from a sell-side perspective, an offer containing an earn-out may be one of several different offers a seller will entertain, and they will possibly be entertained simultaneously. Just like the buyer who decides which investment opportunity among several is the optimal blend of risk, reward and strategic congruence, the seller may have to decide which buyer proposal is ultimately going to be accepted and pursued.

Sell-Side Situations that Suggest an Earn-Out

If a business falls into any of the four groups listed below, it should not surprise a seller if a buyer(s) wants to add the element of an earn-out into the deal. That doesn't mean that a seller should necessarily announce that they are seeking an earn-out, it just means that the conditions suggest the subject may be raised.

1. Businesses in the development or entrepreneurial stage with limited operating history.
2. Companies that have introduced (or plan to introduce) a new product line or technology that does not have a track record as of the date of negotiations.
3. Turnaround situations in which the future existence of a business is in question. The focus is on survival and the business may not be generating positive cash flow.
4. Markets or industry sectors that are experiencing growing valuation multiples that may be reaching a peak (and buyers are indicating resistance).

Putting an Earn-Out on the Table

A buyer can introduce the idea of an earn-out in of one of two ways: the buyer can bring it up during discussions (a trial balloon) or present it as a component of a written proposal (offer or letter of intent).

1. The Trial Balloon: The buyer can float a trial balloon during discussions by either asking the seller outright if they are open to an earn-out or by indicating that they are interested in making an offer as long as it includes an earn-out provision. The buyer is attempting to position you toward an idea without committing to anything.So how do you respond to

the trial balloon? The seller can dismiss the idea or indicate interest. My response is to neither embrace nor reject the idea, but rather indicate something to the effect that: "we are interested in all serious proposals and will look forward to your proposal." My reasoning is based upon two points. First, never negotiate with yourself. Secondly, until you see a written proposal, you have no idea what kind of total purchase price package the buyer is going to offer. So, conceding an earn-out without knowing the specifics of the other deal terms, is giving ground for nothing in return.

2. The Written Proposal: Sometimes a buyer introduces the concept of an earn-out by including one in the terms of the written letter of intent. The LOI provides something concrete for you to discuss. It will provide the terms of the overall purchase price package along with the general terms of the earn-out. A written proposal indicates serious interest on the part of the buyer.

Possible Reactions to an Earn-Out Proposal

The general question of whether an earn-out is something of interest to a seller brings into consideration the objectives of the seller, the seller's concept of value and the seller's relative bargaining power. An offer with an earn-out provision should be objectively discussed with the seller and his or her advisors. In essence, this discussion boils down to: does the seller want to consider an earn-out and, perhaps more importantly, does the seller need to consider an earn-out in order to get the right deal, or for that matter, any deal?

So, imagine that the business is on the market, buyers are kicking the tires and one such buyer is interested enough to introduce the topic of an earn-out into the discussions. The seller can react several ways:

1. Dismiss the idea and give it no further thought on the grounds that they are "just not interested in an earn-out. I don't want one and talking about one is a sign that we are wobbly on price."
2. Look at the top-side of the number and enthusiastically lock into that number because it is close or possibly exceeds the seller's aspirational price.For example, the owner is looking for a number of $5,000,000 and the buyer offers $5,000,000 to be paid 50% cash and the balance contingent upon the attainment of a financial metric (that was pulled from the seller's own projections).
3. Study the idea with objective detachment to determine if the seller wants to have an earn-out relationship with that particular buyer and approach discussions accordingly.

When a serious and capable buyer broaches the topic of an earn-out, we recommend that a seller take an objective look at the proposal. A seller can reject the idea, but the rejection should be based upon a rational examination of the facts and not on the basis of emotions—positive or negative. So, our vote is for option 3—pause and reflect before deciding.

The Right Deal, Wrong Buyer: It is conceivable that an earn-out may make sense as a way to enhance the overall valuation, but that it is not a good idea with a specific buyer. The reverse may also apply. A seller may be averse toward earn-outs in general, however, when an earn-out is introduced as a component of a purchase price package by a specific buyer, it may make a great deal of sense.

An Earn-Out is More than an Agreement. It's a Relationship.

The various terms and conditions of an earn-out are set forth in an agreement. However, an earn-out is more than an agreement. An earn-out is a relationship between the buyer and the seller. The terms and language of the agreement should be carefully and diligently drawn. However, the terms are not the relationship although they do define the boundaries. The earn-out agreement defines the rules of the game. Assuming that those rules were negotiated in good faith, it's up to the players to work with those rules so that their common purpose—the performance targets—can be achieved so that both parties increase the long-term value of the transaction.

Threshold Issues for a Seller to Consider.

Before dismissing the idea or embracing an earn-out proposal, do some fact-finding about the buyer's assumptions. The following list is written from a seller's point of view and systematically addresses the threshold issues of whether or not to enter into active negotiations over the details of an earn-out.

1. Discover the buyer's assumptions that account for the value gap. When the buyer presents an offer with an earn-out component, you now have several important pieces of information:
    - Your concept of value as a seller.
    - The total price of the buyer's offer (all forms of consideration including the earn-out component).
    - The portion of the offer that is made up of cash, notes, and stocks. You want the buyer to be financially committed to the acquisition. As a seller, you don't want to be promised "monopoly money" in exchange for the keys to the business (unless you are under a compulsion to do a deal—any deal).
    - The portion of the total offer attributable to the earn-out. The larger the percentage of earn-out, the greater your risk.
2. Discover the buyer's stated reasons for including an earn-out into the deal structure. There are a number of reasons why a buyer would gravitate toward an earn-out. As stated earlier, an earn-out conserves cash, reduces debt, provides an incentive to the seller and lowers the buyer's risk. A buyer can also be offering an earn-out because they are short on cash or debt capacity and that is the only way they can get the deal financed. In either case, it is helpful to understand the buyer's intentions and the implications.
3. Find out how the buyer established the earn-out amount and key terms. At the letter of intent stage, the key metrics of an earn-out are the performance target, the payout formula and any minimum or caps on the payment. As a seller, you want to understand how the buyer arrived as these items. Do you agree with the buyer's thinking? Based upon your understanding of the business as it is currently being operated, are these metrics attainable?

4. Your role, if any, in the management of the company after the transaction closes. When you accept an earn-out, a potentially significant portion of the purchase is contingent upon hitting the performance targets. This amount is at risk. The management of the business after it is acquired is going to determine whether the targets are hit or missed and whether you get paid or not.
5. So, to the degree that you can exert influence over the success of the venture, you can minimize risk. The key questions are: do you have the ability to meet the earn-out targets? Do you actually want to be involved in the management after the deal? Can you see yourself working for the buyer? In some cases, an owner was passive before the sale or is motivated by retirement to pursue the sale. So, would you (or should you) now become active with the company for the sake of realizing the potential of an earn-out?
6. Learn as much as possible about the buyer's vision and plans for the future of the company. If the deal happens to close, you will have an entirely new relationship with your former business. Instead of having control of the business as an owner, you will become what is effectively an investor in the post-deal business. The control over operations, policies and treasury will pass to the buyer. Do you think the buyer has the commitment and ability to attain the performance targets? If you're going to have an active role in post-acquisition management, do you think the performance targets are realistic and, more importantly, what degree of support do you think you can expect from the buyer to do what is necessary to hit the targets? You will be hitching your wagon to the buyer. So, be sure that the buyer has what it takes to get you where you want to go once the transaction closes.
7. The degree of integration of the seller's business into the buyer's business. After the acquisition, your company can be operated as a standalone business, provide the buyer with a platform for growth, or rolled-up or merged into another business. It is very important to understand the actual business and the targets upon which your earn-out payment will be dependent.
8. Merging or combining your business with another can be attractive for the buyer. However, it will require careful negotiation and definition of the earn-out formula along with the issues of control, accounting and financial reporting.

Now there are other points to consider and discuss in the process of arriving at a definitive earn-out agreement, however understanding the buyer's assumptions will help the seller decide if the earn-out proposal is something they really want to pursue with the particular buyer.

Keep Your Objectives in Mind

As a seller, your objective is to maximize your chances of meeting the earn-out performance targets and earning the contingent portion of the purchase price without getting into a head-knocking contest with the buyer or its representatives. You can't reduce the risk to zero, but you can minimize it by understanding the implications of an earn-out and having experienced professionals on your team. Negotiating a sound agreement is essential, but your primary objective is to get paid.

One closing thought; this series of articles is intended to stimulate thought about earn-outs from a businessperson's point of view. Earn-outs can be fickle creatures. ALWAYS have legal, tax, accounting and deal professionals with previous earn-out experience on your team to handle the complexly delicate aspects of negotiating and codifying an earn-out agreement.

Earn-Out Agreements: Part 5 – Key Negotiating Points

When a buyer and seller approach the negotiation of an earn-out, they have a common goal of arriving at an agreement that meets their respective needs. It is reasonable that both buyer and seller will want to negotiate a deal that meets their respective financial objectives.

While the buyer and seller may have different negotiating strengths, weaknesses and skills, each party wants a bargain that minimizes their risk by shifting as much of it as possible to the opposing party. This sets up the dynamic tension in which negotiations take place.

This article is written from the buyer's point of view. It examines the key terms of an earn-out that will need to be ironed out. In addition, this article assumes that the buyer and seller have:

- Identified the value gap along with its reasons.
- Decided that an earn-out is something worth pursuing.
- Defined the business activities that are associated with the earn-out.
- Reached a tentative understanding of the seller's post-closing obligations.

As a buyer approaches the details of negotiating an earn-out, there are two questions to keep in the back of his or her mind:

1. What are the buyer's business objectives? In general terms, an earn-out is a way to bridge the value gap between buyer and seller. It can also serve as a form of acquisition currency. An earn-out can help maximize the value of the buyer's investment. These are generalities. As a buyer, you want to drill down into the specific objectives of what you want to accomplish through the earn-out.
2. What specific behaviors do you want from the seller? An earn-out can be structured so that the seller has an active or passive role in the business after the date of closing. An earn-out can provide an incentive for the seller to assume a predefined role in the operation of the business in order to achieve the agreed-upon performance target. The desired behaviors will define the future duties and responsibilities of the seller going forward.

In order to achieve maximum value from the earn-out, it behooves a buyer to negotiate a structure that aligns the buyer's business objectives with the incentives provided to the seller. As you work your way through the business terms of an earn-out, you want to make sure that objectives and incentives are in full alignment. You want objectives and incentives to be congruent. Failure to align objectives with incentives can harm future value and create conflicts that can become distracting and expensive to resolve.

While there are many points that will need to be addressed in order to finalize a definitive earn-out agreement, its economic core consists of the following key elements that we call the "earn-out package":

1. Type of Agreement
2. Performance Target.
3. Term of the Earn-Out.
4. Earn-Out Formula.
5. Distribution of Earn-Out Payments.
6. Method or Form of Payment.

Because of the complexity and dynamics of an earn-out agreement, it is essential that both buyer and seller obtain the advice of legal, accounting and tax professionals that are experienced with earn-out transactions. As a business buyer (individual, financial or corporate) or advisor, there are a number of fundamental issues that frame the negotiations of an earn-out package:

1. **Type of Agreement**: In a business acquisition, an earn-out is the part of the consideration paid to the Seller that is contingent upon the attainment of a performance target or event. An earn-out can be included as a clause in the Purchase Agreement or set forth in a separate agreement.There are different ways to form an earn-out including:
    - An earn-out clause and related terms in an Asset or Stock Purchase Agreement that makes a portion of the purchase price contingent upon meeting the performance target.
    - License Agreement and/or Royalty Agreement can provide deferred and conditional consideration to the seller that is derived from the use of specified intellectual property.
    - Commission Agreement that provides a percentage of sales revenues generated from specific product lines or customers.
    - Bonus clause in an Employment Agreement that provides for a lump sum or percentage of a performance metric upon attainment a predefined objective.
    - The type of agreement is important because it can have a significant tax impact for both the buyer and seller:
    - Depending upon how the earn-out is structured, payments made by the buyer might be expensed, amortized or treated as part of the buyer's basis.
    - From the seller's perspective, the structure of the earn-out could result in ordinary income or capital gains. This is an area that requires the expertise of experienced legal, accounting and tax professionals.
2. **Performance Target**: The performance target sets forth the metric that needs to be achieved in order for the earn-out to be "earned." The performance target can be tied to revenues, margins or profits. In some cases, the target can be defined as the completion of a project or attainment of a business objective.From a business perspective, there are four things to keep in mind when establishing a performance target:
    - It needs to be specifically aligned with the buyer's return on investment objectives. The appropriate metric is the one that works for both buyer and seller. For example, an earn-out based upon sales revenues may be desirable for the

seller, but if the increase in revenues doesn't correlate to an increase in earnings, the earn-out payment may be dilutive.
    - The performance target should be clear and understandable.
    - The greater the degree of complexity or variables involved in the calculation of the performance target, the greater the potential for misunderstanding.
    - It is possible to have multiple performance targets, each associated with a different payout formula and rate.
3. **Term of the Earn-Out**: There is a beginning and ending date to the seller's eligibility to make their earn-out. The length of that period should be reasonably sufficient for the seller to reach the performance objective and allow the buyer to achieve the anticipated return on investment.A long-term agreement means that the seller and buyer are going to have a long-term relationship. A buyer needs to ask himself if this is something he wants.
4. **Earn-Out Formula**: When the performance target is hit, the earn-out payment becomes "earned" and payable subject to the earn-out formula. The earn-out formula can include a:
    - Lump-sum amount.
    - Percentage of the performance target.
    - Minimum amount plus a percentage of the performance target.
    - Ceiling or cap on the amount earned during any one period.
    - Ceiling or cap of the total amount earned over the term of the agreement.

    The Earn-Out Formula sets forth the conditions and amount of the earn-out for any given period of time. The fact that a seller has successfully achieved their earn-out for a given period does not necessarily imply that a payment will be distributed. The agreement will guide the timing of payments and the manner in which specific payments are calculated.

5. **Distribution of Earn-Out Payments**: There can be one formula for determining the amount of an earn-out that has been earned and another that directs how the earn-out is distributed. Depending upon the type of earn-out agreement, payments can be made monthly, quarterly, or annually. In addition, payments can be made at the end of the agreement's term along with periodic payments. The information required to calculate the earn-out based upon the formula needs to be available. Therefore, the buyer will need a reasonable amount of time to gather the necessary data.An earn-out agreement can provide for simple periodic payments without recourse. Another option is to create an earn-out pool. This pool is more or less a cumulative account showing the amounts earned, distributions in a given period and a running total of payments.As an added protection, a buyer may negotiate a right to set-off losses against any future earn-out payments. In this way, losses in one year can be used to reduce the balance of the pool and the net amount paid to the seller over the term of the earn-out. (This right to set-off can also apply to deficiencies or breach of the agreement by the seller.)
6. **Method or Form of Payment**: Since the seller has already deferred the earn-out payment and shouldered the risk of not meeting the performance target, earn-outs are often payable in cash. However, there may be occasions when the earn-out payment is distributed as a note payable or in stock.Using stock (or rights to equity) as well as note(s) as a currency for earn-out payments raises a number of potentially gnarly issues. The buyer's legal counsel will want to make certain that any stock transferred conforms

to applicable State or Federal Securities Laws and Regulations. In addition, there are the problems of the valuation and shareholder rights pertaining to such stock or equity, especially in a privately held company.While not particularly interesting to most sellers, paying an earn-out by issuing a note sounds very attractive to a buyer. Not only would the future payment to the seller be contingent upon a definition of success (performance target), but then after the payment is earned, the seller finances the payment. Outside of special situations, some sellers might respond to such an offer as an insult and as an indication that the buyer isn't serious.

Closing Thoughts

The above six points address the aspects of an earn-out package that impact return on investment. There are other issues that will need to be address by the legal team of the buyer and seller such as accounting definitions, inspection and audit of buyer's books, conflict resolution, remedies in the event of breach, and other essential points that the advisors will want to cover.

As negotiations with the seller unfold, the buyer will want to input the key assumptions into their financial model to make certain that the net impact is neutral or favorable to the bottom line and return on investment. The type of agreement, performance target, earn-out term, earn-out formula, distribution and form of payment will all impact the amount, timing and tax consequence of the anticipated future cash flows. The amount and timing of cash flows will determine the return on investment and whether the Internal Rate of Return meets the buyer's threshold or hurdle rate given the specific risk of the acquisition.