CONSIDERING EARN-OUT PROVISION

By Peter C. King, CEO VR Business Sales / Mergers & Acquisitions

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An earn-out provision is a clause in a purchase and sale agreement that commits the buyer to make additional payments to the seller if the business achieves specified financial targets after the sale. These provisions, also known as payouts or contingent payments, are often used to bridge valuation gaps between buyers and sellers or when the seller finances part of the purchase price.

KEY COMPONENTS OF EARN-OUT PROVISIONS

1. **Purpose and Use Cases:**
   A. Valuation Disagreements: Earn-outs are useful when buyers and sellers cannot agree on a price. The seller may believe the business has strong financial prospects and deserves a higher price, while the buyer may be unwilling or unable to pay that amount upfront.
   B. Seller Financing: When the seller finances a portion of the purchase price, an earn-out can provide additional security and potential upside based on the business's future performance.
2. **Structure and Mechanics:**
   A. Initial Payment: The seller agrees to a lower initial payment at closing.
   B. Contingent Payments: Additional payments are made if the business meets certain financial milestones. These payments are typically based on a quantitative formula, such as a percentage of earnings, cash flow, or sales that exceed a specified threshold.
   C. Payment Schedule: The earn-out provision specifies when and how many payments are to be made.
3. **Duration:**
   A. Typical Term: Earn-out provisions usually cover a period of up to three years. Longer periods increase the risk for the seller due to potential adverse business events beyond their control.
   B. Alternative Financing: For longer periods, sellers might consider financing options like loans or preferred stock, which offer remedies if the business is mismanaged.
4. **Contingencies and Adjustments:**
   A. Accounting Changes: Provisions should address how accounting changes, such as asset write-downs or capital investments, affect payouts. These changes can significantly impact earnings and, consequently, the earn-out payments.
   B. Open-Book Access: Sellers may require regular access to accounting reports and other financial documents to ensure accurate earn-outs.
   C. Acts of God and Other Events: Provisions should specify how events like natural disasters, insurance proceeds, early sale of the business, and arbitration procedures in case of disputes will affect earn-outs.
5. **Legal and Negotiation Considerations:**
   A. Comprehensive Drafting: A well-drafted earn-out provision should account for various contingencies to avoid future disagreements.
   B. Legal Counsel: Both parties should involve experienced legal counsel in drafting and negotiating the earn-out provision to ensure it is comprehensive and fair.

VALUED REPRESENTATION

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EXAMPLE SCENARIO

Imagine a company being sold with an earn-out provision that stipulates the seller will receive 20% of annual earnings that exceed the prior year's earnings by $1 million. If the business achieves this target, the seller receives additional payments. However, if the new owner makes significant capital investments that increase depreciation expenses, the earnings might be lower, affecting the seller's earn-out payments. To mitigate such risks, the earn-out provision should clearly define how these expenses are treated.

CONCLUSION

Earn-out provisions are valuable tools for facilitating business sales when there are price disagreements or when seller financing is involved. A comprehensive and well-negotiated earn-out provision can protect both parties' interests and ensure a smoother transaction.

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