Considering Earn-Out Provision

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An earn-out provision is language in a purchase and sale agreement that commits the buyer to make payments to the seller if the business achieves agreed-upon financial targets following the sale. Earnouts also may be referred to as payouts or contingent payments.

Earn-outs are often useful when buyers and sellers can't agree on a price or when the transaction is only possible if the seller finances a portion of the purchase price. The seller may believe the business has good financial prospects and merits a higher sale price, but the buyer is unwilling, or unable, to pay it.

To break the deadlock, the seller agrees to accept a lower payment at closing with a held interest and the promise of additional remuneration if the business meets certain financial milestones. The seller releases held interests as these remunerations are paid and may maintain rights to assets of the company if the buyer fails to meet a specified schedule.

Earn-out provisions have several components. A quantitative formula typically determines how much is to be paid as a financial target is reached. For example, a buyer might agree to pay the seller 20% of annual earnings that exceed the prior year's earnings by a certain amount. A target also might be based on annual cash flow, sales, or other metrics. A payout provision also specifics when and how many payments are to be made.

The term covered by the earn-out provision generally runs no longer than three years. Longer periods can subject the seller to additional risk because they increase the possibility of adverse business events beyond the seller's control. So if a longer period is envisaged, sellers should consider financing in the form of a loan or preferred stock in the company both of which offer remedies in the event the business is mismanaged and the buyer can't meet the financial obligations.

Earn-out provisions also address contingencies that could affect the business's ability to reach agreed upon milestones. Say, for example, an acquired company must achieve certain levels of earnings. After the sale, the new owner decides to write down the value of a large asset or invest in expensive new equipment that boosts depreciation expenses. The resulting changes could significantly lower earnings, and the seller could lose out on one or more earn-out payments.

Such developments aren't uncommon, so earn-out provisions should state how contingencies are allowed to affect payouts. Should accounting changes be allowed to reduce payouts? Should large capital improvements be allowed to distort expenses? The seller may require regular open-book access to accounting reports and other proof of financial operability to ensure accurate earn-outs.

Acts of God, the receipt of insurance proceeds, the early sale of the business, and arbitration procedures in case of disputes are other details to address. Finally, to avoid future disagreements, both parties should specify how each contingency will affect earn-outs.

Earn-out provisions are useful tools for helping buyers and sellers that are having trouble bridging a price gap. But because a comprehensive provision is better than one that leaves many contingencies unaccounted for, both parties should have experienced legal counsel draft the agreement and be involved in the negotiation process.

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