Earnouts: Advantages, Disadvantages and How to Structure Them

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Abstract
Mergers and acquisitions professionals often disagree on whether the use of earnouts is advisable for completing business acquisitions. Although earnouts can certainly help the parties complete a deal, experience has shown that they may be detrimental in the long run. If not adequately used or structured, earnouts can not only damage the performance of the acquired business, but they can also turn the expectation of a successful deal into the disappointment of a bitter and costly legal dispute. In this paper, the author first explains the notion of earnouts and presents his views on its advantages and disadvantages from the perspective of both the seller and the buyer. He then goes through various issues that should be taken into consideration when structuring earnouts and provides insights on how to deal with them. The author finally concludes this paper by providing six main takeaways that should be remembered when structuring earnouts.

1. Introduction to earnouts

The purchase price of a business\(^1\) is determined by several factors. One of such factors is the future cash flow of the business\(^2\), a topic that is often the subject of disagreement between the seller and the buyer.

Indeed, when negotiating the purchase price of a business, sellers and buyers often reach an impasse due to a gap in their expectations about the future cash flow of the business. While the seller expects the price to reflect his projections on the potential future revenues, the buyer is usually reluctant to agree to this when (in his view) these projections do not seem realistic enough.

An earnout can help the parties bridge this gap and close the deal. An earnout is a portion of the purchase price of a business that, rather than being paid on the completion date of the acquisition, is paid at a later date contingent upon the acquired business achieving certain agreed performance targets. Basically, the buyer agrees to pay on the completion date the price that it is prepared to pay, with the commitment that it will pay an additional compensation (the earnout) to the seller if the acquired business achieves the future revenues that the seller claimed it was going to achieve.\(^3\)

Although they are an excellent tool for bridging the gap between the parties’ expectations, earnouts have become a controversial concept due to its potential for future

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\(^1\) An earnout can be used in the purchase of shares of a company or the purchase of the business assets of a company, hence the use of the word ‘business’.

\(^2\) To avoid confusion, to refer to a business that will be acquired we will use the term ‘business’, and to refer to a business that has been already acquired we will use the term ‘acquired business’.

\(^3\) There is also a type of earnout called a ‘reverse earnout’. When the parties agree to a reverse earnout, the buyer pays the full purchase price (including the contingent payments) but the seller agrees to repay to the buyer certain amounts (the earnout payments) if certain agreed performance targets are not achieved. In practice, however, there is not much difference between a standard earnout and a reverse earnout (except for tax considerations) because typically in both cases the earnout payments will be deposited in an escrow fund managed by a third party.
disputes. Indeed, there have been various court cases in connection with earnouts, and many M&A practitioners and analysts question whether they are ultimately good for a deal. Vice Chancellor Travis Laster of the Delaware Chancery Court famously observed in the Airborne Health case: "An earnout often converts today’s disagreement over price into tomorrow’s litigation over outcome."4

In this paper, we will examine the advantages and disadvantages of earnouts and what one needs to take into consideration to structure earnouts adequately.

2. Advantages and disadvantages of earnouts

2.1 Advantages

For a buyer, the advantages of using earnouts are hard to challenge. Firstly and foremost, by deferring payment of a portion of the purchase price and making it conditional to the achievement of certain performance targets, the buyer is actually transferring the risk of the uncertainty of future revenues to the seller. For a buyer, this is the most valuable benefit of an earnout, as it will only pay for those potential revenues when they have effectively realized.

This transfer of risk works as follows. Typically, the acquisition agreement would provide for the buyer to put the earnout amount into an escrow fund managed by a third party agent (an “escrow agent”) during the earnout period. If the earnout targets are achieved, the escrow agent will release the funds (plus any accrued interests) to the seller; conversely, if the targets are not achieved, those funds will be released back to the buyer.

In some atypical cases, especially in connection with the acquisition of small businesses, the acquisition agreement may not require the buyer to deposit the earnout amount with an escrow agent, but to provide other forms of guarantee, such as a bank guarantee (when the purchaser is a well-reputed multinational even a parent company guarantee may suffice). This would allow the buyer to use the earnout amount for other corporate purposes during the earnout period, which could be of great benefit considering that earnout periods would typically last for an average of three years.5

Earnouts could also be a tool for a buyer to protect itself against a misrepresentation or a breach of covenants by the seller. If at some point during the earnout period the buyer makes a claim against the seller for misrepresentation, breach of covenants or otherwise, the buyer may have a chance (depending on what the acquisition agreement provides for) to deduct the amount of its indemnity claim from any earnout payments that are due to the seller.

Earnouts can also help the buyer retain key employees. For instance, when the seller is also the CEO of the business (a “seller-CEO”), having an earnout would encourage him to remain in his position post-completion as this will give him more control over the acquired business and, ultimately, his earnout.6 Thus, by structuring an earnout, the buyer ensures that the seller-CEO will have a strong personal incentive in staying in the management of the acquired business after the completion.

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5 This could also work in the benefit of the seller if the parties have agreed to a reverse earnout (see footnote 2). If the earnout amount is not going to be deposited into an escrow account managed by a third party (not the usual situation), then the seller would have the full purchase price at his disposal n the completion date.

6 In this case, earnouts operate in the same way as employment performance bonuses except that, legally, earnouts are part of the purchase price of a business and considered as such for all legal purposes.
2.2 Disadvantages

Whilst agreeing to earnouts has numerous advantages for a buyer, deferring payment of a portion of the consideration and making it conditional on the achievement of performance targets is not something the seller would typically be enthusiastic about. However, an earnout can also be rewarding for a seller if the value of the earnout payments is negotiated to meet the seller’s expectations.\(^7\)

The disadvantages of earnouts are mostly common to both parties and relate to the complex nature of earnouts. Perhaps the biggest disadvantage is the risk of post-completion disputes over the ability of the management of the acquired business to achieve the earnout performance targets.

There have been several court cases where a seller has sued a buyer claiming that the acquired business did not achieve the agreed performance targets because the buyer took certain decisions (at a shareholder level - such as policy decisions or investment decisions) that prevented the acquired business from achieving those targets, or that the buyer did not let the acquired business to be managed in the same way it was managed before the acquisition.

A good example of such disputes is the case of *Horizon Holdings, LLC v. Genmar Holdings, Inc.*, where the court found that Genmar Holdings, buyer of the Horizon boat manufacturing business, acted in bad faith by taking actions that restricted the ability of the sellers to earn their earnout payments. Such actions included the decision of Genmar Holdings to prioritize the production of brands of boats other than the recently acquired Horizon brand, which brought down gross revenues of the Horizon business, thus preventing the sellers from earning their earnout payments.\(^8\)

Another substantial disadvantage is the difficulty of structuring an earnout. Agreeing on the monetary value of the earnout payments is not always an easy task\(^9\) and it is very difficult to anticipate every possible situation that may have an impact on whether the financial targets are achieved (take for instance, changes in general economic conditions of a country, the decline of the business’s industry, or the dismissal or even the death of a key member of the management team).

Although the risk of such earnout disputes is difficult to eliminate, the scenario of a seller-CEO staying as CEO of the acquired business post-completion mitigates considerably the likelihood of future disputes. This is mainly because (i) there is very little uncertainty about how the company will be managed after the completion, (ii) the risk of disputes based on the seller’s lack of control over the company is reduced and, finally (iii) the seller will be rewarded for its own performance rather than for the performance of a new management team appointed by the buyer. This is why earnouts are mostly used in cases where the seller-CEO is staying as CEO of the acquired business.

Another consideration to bear in mind is that not all acquisitions are similar and therefore there is not one earnout structure fitting all possible scenarios. Earnout agreements should therefore be negotiated and drafted by experienced attorneys with a good understanding of the underlying business considerations behind the acquisition.

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\(^7\) In consideration for agreeing to an earnout (i.e. the deferring the payment of a portion of the purchase price), the seller may request from the buyer an additional compensation or premium.

\(^8\) See, *HORIZON HOLDINGS, L.L.C. f/k/a Horizon Marine L.C.; Geoffrey Pepper; Cassandra O’Tool; and John O’Tool; Plaintiffs, v. GENMAR HOLDINGS, INC.; Genmar Industries, Inc.; and Genmar Manufacturing of Kansas, L.L.C; Defendants; No. 01-2193-JWL; United States District Court, D. Kansas; available at http://caselaw.findlaw.com/us-10th-circuit/1458956.html

\(^9\) Indeed, there is no guarantee that the parties will not reach a bottleneck when negotiating an earnout of the earnout payments. However, the gap between the parties’ expectations becomes much shorter.
3. Points to consider when structuring an earnout

Although there is not a one-fits-all formula, it is useful to outline some of the topics that commonly need to be addressed when structuring an earnout.

3.1 Parties to an earnout become partners.

The moment the seller and buyer agree on an earnout structure they have a common interest that will benefit both of them: the achievement of the earnout targets. Thus, upon agreeing to an earnout, the parties turn effectively into business partners until the end of the earnout period. Understanding earnouts as partnerships is, in the view of this writer, the first and most important step for a successful earnout structure.

When there is no earnout component in an acquisition, it is not so important whether the parties trust each other or whether there is empathy between them. On the completion date, the buyer pays the consideration to the seller and the deal is completed. The parties may not have to deal with each other again.

But trust and a good rapport between the seller and the buyer do matter in the context of earnouts. Earnouts last for an average of three years after the completion date and are often the source of disputes between the seller and the buyer. Therefore, earnouts have more chances of being successful when the parties trust each other and have a collaborative approach, as this will help them deal with the difficulties that may arise during the earnout period.

3.2 Performance targets

The parties need to determine whether the targets will be financial (such as gross profit or EBIT\textsuperscript{10}) or commercial (such as the achievement of certain milestones, e.g. the award of a contract, or the launch of a new product). If the targets will be financial, the parties need to clearly define what the financial targets will be and how these will be calculated.

The financial targets can be set at the top of the P&L\textsuperscript{11} (e.g. gross revenues, net revenues) or at the bottom (e.g. EBIT or EBITDA\textsuperscript{12}). Bottom line earning figures are usually preferred by buyers as they reflect the value of the business more accurately than top line figures; however, sellers tend to prefer top line figures especially when they will not have control over the operating expenses. Due to the several line items in a P&L between gross revenues and EBITDA, bottom line figures leave some room for controversies related to the allocation of costs, capital, expenditures, investments, etc.; thus, if bottom line figures will be used, the parties should carefully iron out how these figures will be calculated.

The seller may also want to ensure that he is entitled to \textit{pro rata} earnout payments in case the acquired business’s performance is below or above the financial targets and, conversely, the buyer may want to include \textit{floors} and \textit{caps} to such payments. If these \textit{pro rata} earnout payments are agreed, they should be clearly described in the earnout agreement.

Commercial milestones, such as the award of a customer contract or the completion of a particular project, are commonly used when there is not much financial historical information on the acquired business, such as in the case of start-ups. Commercial milestones tend to be easier to measure than financial targets and less likely to be the source of disputes.

\textsuperscript{10} EBIT means earnings before interest and taxes.
\textsuperscript{11} P&L means profit and loss statement.
\textsuperscript{12} EBITDA means earnings before interest, taxes, depreciation and amortization.
3.3 Accounting standards

In an earnout agreement the parties should also agree on the accounting standards that will be used to measure performance (which most likely the parties will choose based on the jurisdiction of the acquired business).

But choosing a specific set of accounting standards such as US GAAP or IFRS may not be enough. The parties should take into consideration the historical accounting practices of the business and may also need to agree to certain adjustments or exceptions to such accounting principles in view of the accounting practices of the buyer.

Professor Robert F. Brunner of the Darden School of Business, states that “of particular importance is the way the buyer treats interest, goodwill and other intangibles, earnout payments and corporate allocations related to the transaction”\(^{13}\), which he continues – should not be treated as operating expenses of the business to measure performance.

3.4 Control of the acquired business and seller’s involvement

Most of the issues that cause an earnout dispute relate to the control of the acquired business after the completion date. Although the buyer will own the acquired business, when an earnout structure is in place, the seller will also have a financial interest in the acquired business and will therefore want to set certain parameters on how the business is run during the earnout period.

Where the seller-CEO will stay as CEO of the acquired business, his concern will be to ensure that he can continue managing the company with at least the same freedom with which he has been managing it before the acquisition.

But if the seller will not be managing the acquired business after the completion, the seller will want to set certain parameters on how the business is run during the earnout period. For example, the seller may want to restrict the ability of the board of directors to approve investments above a certain limit, prevent the reduction of the sales force below a certain level or ensure the retention of key employees or even ensure that specific undesired events trigger the acceleration of the earnout payment, among others. The seller may even want to have veto rights in connection with certain decisions.

Considering that it is the seller the party that will benefit from the earnout payments, it is extremely important for the seller to ensure that these governance issues are adequately dealt with in the earnout agreement. Failure to do so will increase the likelihood of future disputes over the earnout payments.

3.5 Level of expenses and cost allocation

If the earnout targets are set at the bottom of the P&L, the parties should agree on the level of expenses for upcoming years and how they will be accounted for in the books. When a business is bought and integrated into another company or group of companies, the acquired business may need to incur in new costs that may hinder the ability of the acquired business to achieve the earnout targets.

Take, for example, the case of a small company acquired by a large conglomerate with layers of management at regional and global levels. This may derive in management fees to be charged, sharing costs for regional or global projects or investments for the benefit of the whole group, among others. These new costs would certainly change the rules of the game for the seller and could hamper the ability of the acquired business to achieve the performance targets.

It is therefore in the interest of the seller to understand the acquirer’s policies in connection to internal cost allocation before the entering into an earnout agreement and to ensure that the earnout agreement incorporates adequate safeguards that will enable to achieve the performance targets.

3.6 Conflicts of interest

It is important for a seller to ensure that there will be no conflict of interest affecting the operations of the acquired business after the completion. A conflict of interest may arise when, for example, the buyer sets up a new business or product that competes with that of the acquired business.

Take, for example, the case *Kuchera v. Parexel International Corp.* In this case, Paraxel, following its acquisition of the company IMC, created a parallel organization called PRG that performed essentially the same functions as IMC. With the creation of PRG, Parexel effectively diverted work and revenue from IMC, preventing the sellers from meeting the targets necessary to achieve their earnout payments. The court found that the acquisition agreement did not allow Paraxel to manage the acquired business in any way it saw fit.¹⁴

But a conflict of interest does not necessarily involve the launching of a competing business or product. It can involve a business strategy of the buyer that favours certain businesses of the buyer to the detriment of the acquired business.

This is best illustrated by the case *Fireman v. News America Marketing In Store, Inc.* In this case, the seller sold their marketing business to the buyer for US$ 2.8 million in cash and a 5-year earnout. The acquired business did not meet the performance targets and argued that the buyer breached the acquisition agreement by rebranding the product, failing to promote the product enough and removing key people from the business. Nevertheless, the court found the sellers’ claims to be without merit and held that the buyer was merely following its strategy for the acquired business and that the sellers’ allegations were merely related to disputes over the strategy of the business.¹⁵

The seller should therefore carry out a reasonable due diligence of the buyer’s business plan and strategy, and ensure that adequate safeguards are included in the acquisition agreement. This is a matter that is intimately related to the integration of the acquired business into the buyer, to which we refer in the following section.

3.7 Integration

By agreeing to an earnout, a seller is implicitly representing that if the acquired business continues to be managed in the same way as before the acquisition, the earnout performance targets can be achieved. However, the integration of the acquired business, which usually involves new policies about the allocation of internal costs, sales procedures, investments, among others, could dramatically change the way the business is run and could have a negative impact on the ability of the seller to earn the earnout payments.

This is why it is often said that earnouts are more likely to be successful when the acquired business is not integrated with the buyer (at least during the earnout period) and is left to operate as a separate organization. However, it is not always the case that a

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¹⁴ See, JOANNE KUCHERA, GARY KUCHERA and MARY WILLIAMS, Plaintiffs, v. PAREXEL INTERNATIONAL CORPORATION, Defendant, CA No. 07-10815-NMG, United States District Court, District of Massachusetts; Memorandum & Order available at http://pacer.mad.uscourts.gov/.

¹⁵ See, ROBERT FIREMAN & ANN RAIDER, Plaintiffs, v. NEWS AMERICA MARKETING IN-STORE, INC., Defendant; C.A. No. 05-11740-MLW, United States District Court, District of Massachusetts; Memorandum & Order available at http://pacer.mad.uscourts.gov.
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buyer is willing to postpone the integration of the acquired business for a few years. It would be realistic to assume that in most cases certain level of integration will take place. Therefore, not only the buyer should perform a due diligence on the business, but also the seller should perform a reasonable due diligence on the policies and procedures of the buyer to ensure that a potential integration will not hinder the ability of the acquired business to achieve the performance targets. Following such due diligence, adequate safeguards may need to be included in acquisition agreement.

3.8 External events
Sometimes events outside the control of the acquired business may determine whether or not a seller achieves the agreed earnout targets. For example, depending on how the targets are set, a general financial crisis may affect sales and therefore hinder the ability of the seller to achieve the earnout targets or, conversely, a rise in the price of certain commodities could boost a specific industry and it certainly could assist the acquired business to achieve such targets.

There are two main approaches on how to deal with these events. One is to have a clear definition of what ‘an event outside the control of the acquired business’ (hereinafter, an “external event”) means and make payment of the earnout dependent on the level of influence the external event had in the achievement or failure to achieve the performance targets.

Based on this approach, to the extent that such external event was the decisive factor in the acquired business failing to achieve the performance targets, the earnout will be paid to the seller anyway. By contrast, if such an event was the decisive factor in the acquired business achieving the earnout targets, the seller would not be entitled to receive the earnout payment.

The downside to the aforementioned approach is that it imposes the challenges of first determining whether the event claimed to be an external event was indeed outside the control of the acquired business and, second, determining whether such external event was the decisive factor in the acquired business achieving or failing to achieve the performance targets.

More importantly, in the opinion of this writer, that approach ignores that the point of having an earnout is not to reward performance but to pay a fair market value for the business (and the fair market value of a business is naturally influenced, in part, by those external events such as markets, crises, industry trends, etc.).

The second approach is to let payment of the earnout be determined only by the question of whether the financial targets were achieved. In view of this writer, this approach is more adequate as it recognizes the impact that external events have in the value of the acquired company and, being much more objective that the first approach outlined above, it reduces the likelihood of potential disputes between the parties in connection with external events.

3.9 Termination provisions
A seller may want to be able to claim immediate payment of the earnout amounts in case an adverse event (one that could prevent the acquired business from achieving the performance targets) takes place.

Take for example the case of a change of control of the acquired business. The seller may want to include a provision in the agreement whereby its consent would be required in case the buyer wishes to sell the recently acquired business and, if the buyer proceeds
with the sale without the seller’s consent, then all earnout payments would be immediately due.

The same type of provisions could be included in cases of investment or financing transactions that could put the seller’s earnout payments at risk.

The buyer could also benefit from including certain termination provisions in the earnout agreement. A good example would be the case of a seller-CEO that remains as a CEO after completion but resigns without cause during the earnout period. This could have a negative effect in the business and the buyer may want the earnout agreement to clearly provide for the forfeiture of all earnout payments to the seller should that occur.

Also, sometimes earnout agreements may include the right of the buyer to buy out the seller’s earnout for an agreed discounted price (to be determined by an agreed formula), whether at any point during the earnout period or upon the occurrence of a triggering event agreed by the parties.

4. Conclusions

Without prejudice to the importance of all the points mentioned in the previous sections, there are six key ideas that should be remembered when structuring an earnout:

(i) Earnouts are very useful if used and structured adequately. Not all transactions are suitable for earnouts and earnout structures will differ depending on the particularities of the each business transaction. Structuring earnouts is complicated and there is no one-size-fits-all formula to earnouts.

(ii) Earnouts are most suitable when the seller-CEO will remain in the management of the acquired business after the completion of the acquisition.

(iii) It is essential that the earnout agreement sets out the parameters within which the acquired business is to be managed. These parameters should address cost allocation, accounting policies, investments, the strategy of the acquired business, among others. The more comprehensive and detailed the earnout agreement is in this respect, the lower the chances of future disputes over the earnout.

(iv) The aforementioned parameters are of material importance especially when the seller will not manage the acquired business after the completion of the acquisition. In this case, the seller will want to have certain controls in place to ensure that his ability to earn the earnout is not unfairly hindered.

(v) No matter how well drafted an earnout agreement is, earnouts can still go wrong. The parties should therefore ensure that the earnout agreement has specific termination provisions that allow each party to terminate the earnout under certain material circumstances.

(vi) One should think of earnouts as creating a partnership between seller and buyer. Ensuring that there is trust and a good rapport between the parties increases greatly the chances of a successful earnout.
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