Earnouts

By Fredric Tannenbaum, Partner

Parties to a sale or business transaction sometimes utilize earnouts or contingent purchase price provisions to solve valuation gaps. The buyer may only be willing to meet the seller's price if the seller's business performs after the closing at or above the level promised or hoped for. The seller, on the other hand, may be more willing to accept a lower nominal purchase price if it is confident that the business can attain specified post-closing performance goals.

While the theoretical rationale for earnouts is laudatory, their practical implementation sometimes is wrought with peril and invites post-closing uncertainty. This brief article highlights several of the key structural elements of earnouts and suggests means to protect both parties to minimize cost and controversy.

Metric for Determination. Will the seller share in some percentage of the post-closing increase or overall EBITDA level? Or will the earnout be tied to gross profit margins or some other metric? The determining metric is key from the standpoint of both valuation as well as integrity. From a valuation standpoint, a buyer may prefer an EBITDA threshold because that is strategic and long term oriented. A seller, in contrast, may only care about short term sales and therefore prefer gross revenues or gross profit as the benchmark. However, EBITDA is easily manipu-lated since the "e" component can be padded with extraordinary or simply elevated expenses which the seller would not have incurred when it controlled the business. While gross profit is not as easily subject to manipulation, many clever but justifiable means exist to deflate this figure as well. Parties need to devise elaborate adjustments to their formulas to increase earnings or revenues by unusual expenses or discounting. Further, the parties need to separate any extraneous buyer operations or overhead from the earnout calculation. Metric determination provisions are therefore the subject of intense negotiating. Precise and careful drafting is key to minimizing if not eliminating disputes.

Security for Payment. A buyer may have already leveraged the assets of the business to finance the purchase price and a seller may not receive sufficient comfort with a second security interest in the collateral. Further, a senior lender will frequently restrict payments to a junior lender and certainly prohibit them if there is a default. Moreover, situations often arise where the appropriate targets are met and earnout exceeded, yet the buyer has insufficient cash flow, whether due to taxes, bank restrictions, working capital timing or re-investment. Therefore, sellers often insist on third party guarantees and other collateral to assure the integrity of the payment of the earnout.

Events for Acceleration. The period in which the earnout may be made is of limited duration. However, if the buyer's business is sold prior to the ending point for determining earnouts or the seller is unjustifiably terminated (assuming the seller has remained as a key employee of the buyer), the seller will be deprived of an opportunity to actually earn the earnout. The buyer, on the other hand, might claim that the earnout would not likely have been met or that it terminated the seller since he or she was not performing. Therefore, the parties need to anticipate some form of acceleration of the earnout to deal with these contingencies.

Events for Withholding Payment. A buyer will occasionally refuse to pay amounts due under an earnout and insist on an offset due to a good faith belief that seller has breached one or more of its representations and warranties under the purchase agreement or seller owes some amount under another agreement such as a lease or supply agreement. The parties should negotiate an appropriate means to assure the buyer that it is not needlessly paying such sums while at the same time preventing mischief. Paying the earnout to a third party escrow pending resolution of the dispute is one means to assure the integrity of the process.

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Earnouts
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Dispute Resolution. Carefully drafted dispute resolution provisions are key to minimizing cost and time as well as preventing extraneous issues from polarizing the parties or needlessly harming the business or its relationship with key employees, customers, vendors, and financing sources. While independent accounting firms often serve as the arbiter of these disputes, the accountants must be carefully guided to enable them to accurately and clearly implement the parties' intent. Can the accountant offer a figure not proposed by a party? Can the accountant use a different methodology? Will the accountant understand some of the terms it is being asked to judge? If the person resolving the dispute is not pre-selected and therefore able to read and accept the contract language in advance, the parties need to involve their accountants at the drafting stage to obtain their imprimatur.

In conclusion, earnouts often solve valuation differences but, at the same time, cook up a recipe for further confrontation. If parties feel they really need an earnout, they need to carefully address these critical areas.

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