A CLEAN EXIT

UNDERSTANDING EARNOUTS IN A BUSINESS TRANSACTION

by **Phil** Josephson

"If you don't want to work you have to work to earn enough money so that you won't have to work." - Ogden Nash

Structuring an Earnout	
Issues for Consideration	
• Accounting	• Earnout Amount
• Availability of Capital	• Earnout Period
• Management	• Performance Goals
• Change in Control	• Payment Schedule
• Tax Impact	• Operational Integration

An earnout agreement is useful between a buyer and a seller of a closely held business, particularly when the seller and the buyer have different views on the price of the business or when used as a financing device to consummate a transaction. An earnout agreement is a portion of the selling price which is made contingent upon attainment of identified thresholds. While useful, earnouts have downsides and are inherent with litigation risk.

Drafting an earnout can be difficult, especially when anticipating all possible future scenarios. As a result, earnout language may be ambiguous, and those that do not draft adequately may invite and encourage future litigation. Loosely drafted earnouts may lead to litigation issues such as implied covenants to use reasonable efforts to develop and promote the acquired business, making representations that buyer can make earnout payments, revenues of another target acquired during the earnout period applied to the earnout, integration of the acquired business as a trigger to an acceleration of the earnout due to a merger, or misrepresentations by the seller that lead to skewed earnout payments.

Another issue arises when trying to enforce an earnout. In such cases, courts have had trouble proving or calculating damages.

But earnouts do not need to be invitations to litigation. Parties should pay close attention to the accounting, tax, securities, financial and non-financial consequences of each aspect of the earnout agreement. They should specify in detail the nature of the threshold giving rise to the earnout obligation, the methods that will be used in ascertaining whether the earnout has been achieved, the inclusions and exclusions from the earnout calculation, and who will determine whether the earnout threshold had been met. Careful planning and consideration of all possible scenarios at the initial drafting will, in the future, minimize risk, avoid conflict and help resolve any disputes.

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In the earnout agreement, the identified thresholds used may be fixed or variable, and they may be non-financial or financial, or a combination of all. Non-financial thresholds may include reaching certain milestones or achieving other identifiable goals.

Financial thresholds also may vary in their composition. Revenue-based thresholds are more attractive to sellers, since they will not be affected by operating expenses or acquisitions. Buyers generally favor net income thresholds on the ground that they are the best indicator of the target's success. When net income, EBIT or EBITDA are used as the performance measures, the seller should ascertain what administrative or general overhead expenses the buyer will allocate to the target after closing and determine how those expense will impact the post-closing figures.

Other areas for drafting consideration include whether the seller will require that the buyer adequately fund the target during the earnout period so that it will be able to capitalize on opportunities, or whether the seller will request a provision that prevents the buyer from making subsequent acquisitions that would affect the acquired business, or whether the target or a portion of it may be sold to a third party during the earnout period and the effect of such a sale should it happen, or whether anything happens if a third party acquires the buyer during the earnout. If the acquired business will be fully integrated into the buyer's business or when the business lines of the buyer and the target are essentially the same, it may be harder to measure the financial performance of the acquired business accurately. Therefore, the buyer may want to consider including a provision whereby the seller acknowledges that the buyer has the right to control the acquired business in its sole discretion and the seller waives certain duties. Also, knowing that conflict may be inevitable, the parties should also consider how they want to resolve any possible future disputes, whether by accountants, lawyers, business valuators, the courts, arbitration or otherwise.

Earnout periods vary and risk shifts as the length of time extends, therefore, the parties must consider the impact on the business over this time. In addition, the parties should consider events that may terminate the earnout. That could include a buyer wanting the right to terminate the earnout and paying the seller a predetermined amount if the buyer, for example, finds that the earnout would interfere with an acquisition or reorganization it would like to accomplish. A seller may want to terminate an earnout if the buyer subsequently has a change in control that could jeopardize the relationship or payments. Also, an equity raise, an IPO, a recapitalization or other change in resources, management or line of business may be used as a trigger to terminate or accelerate an earnout.

Earnout agreements are an often used and effective vehicle in the sale of a business. Each earnout is unique and has nuances. Therefore for each earnout, it is important to consider future scenarios, make the language clear, confer with advisors and draft accordingly.

Philip Josephson is the founder of Sterling Business Law, which focuses on providing general counsel and strategic planning services to business leaders and business owners. Josephson earned a bachelor of business administration degree in finance from the University of Miami, a juris doctorate from the University of Miami School of Law, and a master's degree in business administration from Columbia Business School. He is a member of the Florida Bar, the Arizona Bar and the Federal Communications Bar. Phil can be reached at 305.443.3444 or josephson@sterlingbusinesslaw.com