Flexibility in Structuring M&A Transactions – the Earnout Provision

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M&A transactions are often complete on the deal's closing date. The seller and buyer agree on the value of the business and on the closing date the buyer pays the agreed price to the seller. In many situations, though, buyers and sellers may have divergent opinions on the target company's value. Because of informational asymmetries, the cognitive bias known as endowment effect and other factors, a seller is likely to ascribe a higher value to her company, while a buyer – which does not have an intimate knowledge of the business (even after a well conducted due diligence) – usually takes a more conservative approach in establishing the company's value. To bridge this gap in price, sellers and buyers often take a compromise approach: on the closing date the buyer pays to the seller a lower price, but commits to additional payments contingent upon the occurrence of future financial or operating goals. This risk-allocation mechanism widely used in M&A transactions is known as earnout.

The following scenario illustrates the mechanism. A seller believes that her company will greatly increase its annual profits over the next few years and thus puts it up for sale at USD 100 million. The potential buyer assents that the company would be worth USD 100 million if the incremental profits were to be confirmed but, sceptical of the forecasted high-growth rate, appraises it at USD 60 million based on current earnings. Meeting halfway, the parties agree on an initial fixed price of USD 60 million to be paid on the closing date, and an earnout under which the buyer will pay to the seller an additional price of up to USD 40 million conditioned on the business' outcome over the following 5-year period.

Most earnout provisions are tied to the acquired company's performance and are usually measured by financial targets such as revenue, net income or EBITDA within a time frame of 5 years. In businesses with a short operating history (such as the early stage, high-potential companies sought after by venture capitalists) the appropriate performance metrics include the number of products sold or launched, the expansion of the client base (or, if an internet company, the number of users), or product development milestones.

Sellers that have specific knowledge or are key to the company's operation will often be retained as managers or top-tier employees and continue to run the company. In these cases, the earnout provision can also be used to motivate sellers to achieve the performance level set forth by the earnout provision.

Earnouts can also be a useful tool to adjust a price linked to the occurrence of future events. Take the example of a company that at the time of the M&A transaction is in an ongoing and still uncertain negotiation of a major supply agreement that, when and if executed, will likely more than double its annual profits. The parties can establish an earnout payment contingent upon the successful execution of such an agreement.

The upside of the earnout usually benefits only the sellers. However, in transactions involving the subscription of shares (in lieu or in parallel to the purchase of shares), earnouts can also be structured to benefit the invested company. In this case, the acquiring party commits to paying to the company an additional subscription price upon the occurrence of certain events.

Post-closing disputes over earnouts are not uncommon. They usually revolve around whether the earnout amounts were calculated correctly and if a party took actions that negatively impacted the achievement of the earnout milestones.

To avoid disputes, special attention should be given to the drafting of the earnout provision. In earnouts linked to financial metrics, the parties should agree on specific accounting rules and methods for measuring performance. They may also consider imposing limitations on how the acquired business will be operated to prevent the buyer from taking actions that could have a negative impact and reduce the amount to be paid to the seller under the earnout provision. In an event-based earnout, the agreement should clearly describe the triggering event for the additional payment and the roles, if any, of each party in trying to attain such event. When the earnout is linked to a subscription agreement and will be reverted to the target company, the public documents available to the company's shareholders and creditors (subscription bulletins, etc.) should expressly state that the additional payments are subject to the occurrence of certain metrics or events.

The earnout provision should also address other lateral – albeit relevant – issues, such as force majeure and the buyer's decision to sell his shares of the company before the expiration of the earnout provision.

Properly used and well crafted, earnouts can be a useful and flexible method to help sellers obtain a fair price, while providing buyers with the comfort that they will not overpay for an underperforming company.