VedderPrice

Earnouts Back on the Rise in M&A Transactions: What Purchasers, Sellers and Lenders Need to Know

By Michael A. Nemeroff, Joseph H. Kye and Austin Young

April 19, 2024

The pace of earnouts accelerates in M&A transactions whenever market conditions create a value gap between seller price expectations and buyer confidence levels. Earnouts are most common when the volume of merger and acquisition activity falls, whether due to a recession (e.g., the 2008–2010 recession) or other external factors like the current increase in interest rates coupled with tight credit markets. In some cases, earnouts are solutions to the underlying recent performance of the target company coupled with a lack of going-forward visibility. In all cases, the value gap was too wide between what a buyer was willing to pay and what a seller was willing to accept.

Today, M&A professionals expect credit to remain tight and performance visibility to remain uncertain through the remainder of 2024.[1] As parties strive to get deals done amid these issues, an earnout is an effective technique to fill the gap in the capital structure and close the gap between a seller's value expectations and a buyer's price point. This article summarizes key elements in designing an earnout and addresses important considerations from the perspective of various deal constituents.

Designing an Earnout

When considering an earnout, both parties need to first agree upon the key value drivers in the transaction. These drivers should both measure the value of the target company and motivate the target management to perform for the buyer. In many cases, value drivers include EBITDA, sales, net income, customers, product development, research or intellectual property. Generally, a buyer would prefer to have the earnout structure based as far down the income statement as possible (e.g., measuring the earnout on net income or EBITDA). However, the seller would prefer that the earnout be tested at the top of the income statement or at the gross sales line. This is because the gross sales test is a more objective measurement. As long as the seller company has separate reporting during the earnout period, there are fewer post-closing actions or inactions that can impact earning or measuring the earnout. However, buyers typically resist gross sales measurements since they do not want to encourage sales at low margins.

In contrast, in a net income-based earnout, post-closing actions that a seller cannot control (even if good for the business) could have the effect of reducing the earnout. For example, post-closing increases in marketing or management expenses that do not result in higher sales volumes could reduce the earnout. Nevertheless, we most often see EBITDA as the key metric for earnouts because EBITDA correlates more specifically to valuation of the seller's business as well as the company's credit agreement and buyer expectations going forward.

The parties should agree upon the metrics, methodologies and timing of the calculation of the earnout. In many cases, we recommend attaching detailed accounting principles and sample calculations to the contract, similar to the mechanics of a thorough working capital adjustment process. Similar specificity in drafting the rules that apply to the calculation of the earnout and dispute resolution procedures will also help to avoid disagreements, or to resolve them efficiently and effectively.

[1] *See* KPMG M&A DEAL MARKET STUDY, KPMG LLP 8-9 (December 2023).

Once the parties agree on how the earnout will be calculated, the next consideration is how the earnout gets paid out or the "payout formula." Buyers generally prefer an "all-or-nothing" approach whereby a lump sum is paid out upon the achievement of the target threshold (e.g., EBITDA is greater than or equal to X). However, sellers advocate for a "graduated" approach by which the seller receives a specific percentage of the target threshold as it is achieved (e.g., X% of EBITDA). We typically see two common compromises on this issue: (1) a graduated approach with a minimum threshold (e.g., X% of EBITDA above $Y); and (2) an all-or-nothing approach with multiple periods/installments whereby the seller gets multiple bites at the apple throughout the full earnout period. The parties may also consider an appropriate cap and/or floor for the earnout. Ultimately, the parties should balance their desire for a tailored approach to their specific deal with a preference for simplicity as additional complexity often leads to a higher risk of future disputes.

There are several additional structural trends to consider depending on the size and context of a transaction. One key trend that we have observed includes acceleration or early payment provisions upon a change of control. Sellers ask for these provisions to protect themselves from post-closing changes that may hinder achieving the earnout. For example, acceleration may apply if certain key members of the management team are terminated or if there is a material change in the manner of operation of the business. However, such provisions only appear in approximately 30% of earnouts.[2] Another key trend to consider in structuring an earnout is the length of earnout periods. We most often see earnout periods between one and three years, but it is increasingly common to see earnout periods of less than one year. Longer earnouts layer in macro risks to the economy as a whole which neither the buyer nor seller can control and may impact flexibility in managing the business for a longer period than desired post-closing. Generally, the earnout period should be long enough to adequately assess the performance of the business, but short enough to efficiently attain the goals of the parties—payment for the seller and control for the buyer.

Key Considerations for Sellers

In general, the seller should understand that postponing payment increases the risk that external factors could have an adverse effect on the purchase price. One example is that earnout payments might be subordinated to and subject to being blocked in a default by the senior credit agreement of the applicable company.

The seller should also be confident that there is a clear standard for valuing the earnout such that the outcome can be managed based on the metrics. This reduces the opportunity for disputes or for potential skewing of results.

The seller further needs to give consideration to what, if any, restrictions it would like to or can impose on the buyer's management of the company during the earnout period (e.g., overhead cost allocations, management fees, timing of capital expenditures, leaving the company intact, etc.). However, the seller should also consider the extent to which financial or operational support from the buyer may be required to hit the performance thresholds.

Moreover, the seller needs to understand how and when it will get paid when the earnout is, in fact, earned. Part of that equation is specifying if the earnout will be the obligation of the target operating as a subsidiary or the buyer itself, and if the buyer is willing to provide any credit enhancement or guarantees. Having the target operating company as the payor of the earnout is further complicated if the seller is also a rollover investor in such target company (i.e., the rollover investor is entitled to distributable profits and is arguably partially paying itself).

Although the form of consideration for earnouts is often cash, some buyers may offer debt or equity instead. Sellers should consider the additional risks and issues that arise in these cases. In the case of debt, the buyer's credit risk and ability to make payments are the key concerns, as are the terms of any subordination required by a senior lender. In the case of equity, it should be clear which date is applicable for determining the valuation of such equity (or seeking to have the equity issued at closing subject to cancellation for not making the earnout target). Moreover, sellers should consider the risk of dilution, restrictions on transfer, tag-along rights, drag-along rights and any other customary provisions that may be attached to the equity.

Lastly, a key trend has been the use of earnouts to secure the seller's indemnification obligations. In today's market, a majority of earnouts include an indemnity setoff right for the buyer.[3]

[2] *See* 2023 M&A Deal Terms Study, SRS Acquiom 26 (May 25, 2023).
[3] *See* 2023 M&A Deal Terms Study, SRS Acquiom 26 (May 25, 2023).

Typically, the best practical protection for the seller with respect to earnouts is alignment with the post-closing management team, particularly if management represents all or a portion of the seller group.

Key Considerations for the Buyers

The earnout needs to be tied to what the buyer believes are the key value drivers upon which it is basing the transaction and upon which it will operate the business throughout the earnout period, all in view of its long-term goals. The buyer should consider that value drivers may gain or lose relevance over time. If the test is financial, then the earnout needs to be structured accordingly. If the test is tied to customers, product development or intellectual property (e.g., attainment of FDA approval in a biotech or pharmaceutical deal), each of those matters need to be given careful consideration and woven into the earnout methodology.

Further, while the seller will try to impose restrictions on the purchaser's operation of the business so as not to interfere with achieving its earnout payments, the buyer also needs to make sure it has retained sufficient flexibility to effectively run the business and maximize its value without impeding its long-term goals. One compromise often agreed to in this context is for the buyer to agree not to take any action designed to frustrate the achievement of the earnout.

Also, when establishing a performance threshold, the buyer should consider any benefit the seller may receive from synergies with the buyer's operation.

Lastly, the buyer needs to make sure it has built into its future cash flows and financing structures the ability to make the earnout payments when they become due. As noted above, setoff rights for indemnifiable damages against earnout payments are increasingly typical.

Lenders' Considerations

A key consideration for lenders is whether an earnout should be characterized as indebtedness, as it has many debt-like features. Accordingly, a buyer's lenders may often treat earnouts as "restricted debt" (i.e., debt that cannot be repaid or prepaid unless certain conditions or covenants are satisfied first). This allows lenders to control the amount and structure of earnouts, while monitoring the overall leverage and liquidity of the buyer. Finally, lenders often insist on a formal subordination agreement between the seller and the lender that blocks earnout payments upon specified events so the failure to pay will not be actionable by the seller for an agreed-upon time period.

Tax Considerations

There are a variety of tax considerations that have to be addressed when structuring an earnout, and tax advisors play a critical role in the process. The parties should agree on how the earnout payments will be allocated. In many cases, earnout payments will be considered "goodwill" payments since they are not adjustments to balance sheet items. Another tax consideration is the installment sale reporting requirements. Under the installment method, a seller reports its taxable gain ratably with each payment it receives, rather than reporting all of the gain in the year of disposition. Thus, the installment sale method can have the effect of deferring the seller's tax obligations or gains from the sale, with a number of exceptions and limitations. Further, whether there will be imputed interest income to the seller and related interest deductions to the buyer must be considered and addressed. Lastly, the parties should consider whether the IRS is likely to characterize the earnout consideration as purchase price or compensation for services, as such characterization can have significant tax consequences. The risk of such characterization increases if the earnout is tied to the continued employment or services of specific post-closing management members.

Conclusion

Earnouts can be useful tools in filling in the capital structure and bridging the gap between a seller's value expectations and what a buyer is willing to pay for a business. Earnout provisions need to be carefully structured to (i) capture the key value drivers, (ii) allocate control over business operations, and (iii) mitigate future disputes. Given the current uncertainty in the market, we expect more M&A transactions to include earnouts as key parts of the consideration.

If you have any questions about this article, please contact **Michael A. Nemeroff** at mnemeroff@vedderprice.com, **Joseph H. Kye** at jkye@vedderprice.com, **Austin Young** at ayoung@vedderprice.com or any other Vedder Price attorney with whom you have worked.