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# Earnouts: Love 'em or Leave 'em

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The use of "earnouts" as part of the purchase price for privately held businesses -- especially in this difficult economy and for those with high growth projections -- has become almost standard. In an earnout, a portion of the purchase price is paid only if and when the business achieves certain performance targets during a specified period following the closing. The performance targets are often based on the seller's projections for the business.

In theory, an earnout should result in a "win-win" for both parties: the buyer will only need to pay the seller for the business' actual -- rather than projected -- performance, and the seller will receive payment when the business performs as expected. In practice, the results of earnout arrangements often disappoint one or both parties. Below you will find some of the key factors that anyone involved in the purchase or sale of a business should consider before deciding to include an earnout in a transaction and, if one is to be used, how to make it work.

## Money, money, money . . .

The foremost financial consideration is: What are the appropriate performance targets that will be the hurdles for the earnout? The challenge for the seller is getting comfortable with targets that can be realistically achieved in light of the business' track record and resources, and the competitive environment and market conditions that the business is likely to encounter during the earnout period. The seller also needs to consider the fact that he or she will not be in control of the business during the earnout period. A seller not keen on leaving the success of the business in the hands of someone else should negotiate an increase in the upfront purchase price in lieu of a bigger potential payment on the back end.

The buyer will want to make sure the earnout payments and performance targets are aligned in such a manner that fairly compensates the seller for the business' performance while retaining for the buyer the lion's share of the upside. In addition, the buyer should consider whether it is appropriate to give the seller credit for what the buyer brings to the table, including synergies from combining their businesses or the impact of acquisitions or product add-ons of the business during the earnout period. The seller, on the other hand, may believe that he or she is entitled to a piece of the business' growth during this period, regardless of how it is achieved.

The parties will need to agree upon the performance metrics. A seller will likely favor a revenue-based metric since it is subject to less variables -- and less manipulation by the buyer. The buyer may want an earnings-based metric, since earnings is the true measure of a business' value.

If the seller accepts an earnings-based metric, a number of safeguards may be negotiated to mitigate the pitfalls associated with such metrics:

- an EBITDA standard will be used (i.e., earnings will be determining before reduction for income taxes, depreciation and amortization);
- all transactions between the buyer and its other businesses and the purchased business (the "target") are to be accounted for as having been effected on a basis no less favorable to the target than would be the case if that transaction had been at arms-length with an unrelated third party;
- the allocation of overhead from the buyer or its other businesses to the target business will be included as an expense only to the extent that the allocation actually reduces the costs the target would otherwise have had to incur; and
- costs of a type not contemplated by the projections on which the earnout is based will not be included as expenses.

Regardless of what metric is used, the seller will want to be compensated on a sliding scale to the extent that the business does not achieve the performance targets. This means the seller wants "collars" around the targets as opposed to "cliffs." In addition, it will be in both parties' interests for the purchase agreement to set forth clear rules on how the earnout is determined (e.g., "in accordance with GAAP as historically applied by the business") and how disputes will be resolved (e.g., by a neutral accounting firm).

## But how does it work on the real world?

In evaluating the ability of the business to achieve the performance targets and thus whether to agree to an earnout, the seller needs to appreciate that he or she will not be given free reign of the business during the earnout period -- even if he or she is retained by the buyer and holds a senior managerial position. Keep in mind the seller may not even remain with the business after a sale or only for a relatively short period of time after closing. In either case, the seller can request a number of protections to gain a greater measure of comfort. Customary examples include requiring the buyer to:

operate the target substantially in accordance with an agreed-upon business plan and/or past practice;

provide adequate capital to the target;

not terminate the employment of the seller or other key employees of the target without "cause" during the earn-out period;

maintain the target as a division or entity separate from the buyer's other businesses; and

not divert clients or business opportunities of target to the buyer's other businesses.

The last item can be perhaps the most difficult for the buyer to agree on -- particularly in the case of a strategic buyer that has other businesses that compete for the same customers as the purchased business. Likewise, a strategic buyer that hopes to use the acquisition as a means of achieving synergies with its other operations may well look askance at a prohibition on rolling up the target with its other businesses. Achieving an appropriate and fair balance of interests in these cases may be difficult -- if not impossible.

## Tax (gulp) thoughts

An earnout can qualify for the installment method, which generally means that tax is not paid on the earnout payments until the payments are actually received. However, a portion of each earnout payment may be re-characterized as interest, using interest rates set by the IRS.

In determining the amount of gain reported on the installment method, the tax basis of the property sold must be allocated among the payments received at closing and the various payments due under the earnout. In general, tax basis is allocated according to the maximum amount of consideration payable; thus, for example, tax basis would generally be allocated equally between a closing payment of $50X and an earnout that could potentially pay as much as $50X. If the seller does not fully recover the tax basis through the receipt of earnout payments, a capital loss may result. If the total installment obligations held by the seller (including the value of the earnout) is in excess of $5 million, the seller may be required to pay interest on the deferred tax liability.

Gain recognized in a future year under an earnout will be subject to the tax rates then in effect. The current 15 percent federal capital gains rate is scheduled to increase to 20 percent after 2010. Depending upon the results of the 2008 election, new legislation (both at the federal and state level) could be enacted imposing an even higher tax rate. A seller can elect out of the installment method, and pay tax on the earnout using today's low capital gains rates, but electing out of installment sale treatment may not be all that attractive. To determine the tax payable on the earnout, the seller would have to value the earnout. If the seller overvalues the earnout, the seller may be left with a capital loss for the difference; but if the seller undervalues the earnout, then the difference may constitute interest income (taxed at ordinary income tax rates).

Additional issues and complications arise if the seller is selling stock in an S corporation pursuant to a "Section 338(h)(10) election" or if the seller is an S corporation that subsequently liquidates.

## Look before you leap

Reaching agreement on the issues highlighted above, as well as others that may arise in negotiating an earnout, will take patience and perseverance on the part of the buyer, the seller and their advisers. There will have to be compromises by all parties. The legal and accounting costs that both parties will incur in negotiating, documenting and implementing the earnout can be substantial.

Beyond these tangible costs are "emotional" costs that the parties need to weigh. As in any long-term arrangement, the parties need to consider whether they are willing to continue dealing with each other for years following the closing of the purchase and sale. The buyer needs to understand that even if the seller does not have a continuing role with the business, the seller will be looking over the buyer's shoulders to make sure that the seller is living up to any agreed upon obligations. Disagreements on this, as well as whether the business' results were properly calculated, can lead to litigation.

For the seller -- especially in the case of an entrepreneur -- an earnout means a lack of closure for years on the sale of a business. Waiting to see if the performance targets will be hit can make for an anxiety-filled post-closing period.

However, if the buyer and seller consider and confront all the issues, an earnout can be used to allow a buyer to pay a "fair" price for the business while allowing the seller to achieve the value he or she so richly deserves.

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