BUSINESS ACQUISITION EARNOUTS: BRIDGING THE BUYER-SELLER VALUATION GAP

by Peter Papagianakis

In light of the economic turmoil in 2007 and 2008 that has resulted in the proverbial credit crunch, the volume and dollar value of mergers and acquisitions has essentially come to an abrupt halt. Enter the business acquisition earnout.

Earnouts - General Definition

Generally, an earnout in the context of a sale/acquisition of a business means that postclosing an additional purchase price payment will be made by the Buyer to the Seller if certain milestones are achieved.

Although they have been used by public companies, earnouts are more common in sale/acquisition of a private company. Accordingly, this article will not outline any issues relating to earnouts as they apply to public companies.

Earnouts - General Purpose

Generally, the purpose of the earnout is to bridge the valuation gap that occurs when the Seller believes that its business is worth more than the Buyer is willing to pay for the business. For example, the Seller and the Buyer may agree on a purchase price of $20 million to be paid at closing and an additional $5 million to be paid within a certain time period after the closing - if their agreed upon milestones are achieved.

Because businesses generally are valued based on their likelihood of generating a certain amount revenues in the future, and because of our current economic situation, the future is more uncertain than other times. Buyers are discounting the revenue-generating capacity of businesses much more than they otherwise would. Accordingly, in light of the valuation gap that is likely to exist in our current economic situation, the earnout might be poised to be the equivalent of an economic stimulus package for the sale/acquisition of businesses.

On its surface, an earnout seems to have built-in incentives for both the Seller and the Buyer to achieve their objectives such that the earnout winds up creating a win-win situation for both of them. For example, from the Buyer's perspective an earnout allows it to (i) purchase the Seller's business with lower initial cash payment, which in turn (a) decreases the debt financing that might otherwise be necessary and (b) mitigates the risk of overpaying for the business and (ii) potentially pay the earnout with revenues generated from the acquired business (rather than out of pocket, as the initial cash payment is made). From the Seller's perspective, an earnout allows it to (i) potentially receive a higher price for its business and (ii) signal to the Buyer that the Seller is confident in the future prospects of its business.

Earnouts - No panacea

Despite the superficial appeal of earnouts as an antidote to the credit crunch that has plagued the mergers and acquisitions industry, earnouts are still viewed with consternation by both Buyers and Sellers (as well as their respective advisers).

The primary reason for their respective consternation is that post-closing - their interests automatically begin to diverge. From the Seller's perspective, its primary concern is that the business be operated in a manner that maximizes the likelihood that the earnout milestones will be achieved and, perhaps, exceeded, in order to ensure Seller's right to receive the additional payment - which makes the Seller focus on short-term and myopic goals. The Buyer's primary concern, on the other hand, is to integrate the newly-acquired business into its existing business and commence its operation in a manner that achieves its long-term and more general goals. To illustrate the post-closing divergent interests of the Buyer and the Seller, the Buyer may decide to discontinue or slowly phase out certain products that are duplicative or closely resemble other, pre-existing products of the Buyer (which might also be more profitable, either because of the nature of the Buyer's customer base or because of the Buyer's credit terms to its customers). Notwithstanding the legitimate reasons for the Buyer's discontinuance of the sale of certain products previously sold by the Seller, such action will likely prevent the earnout from being achieved.

In an effort to balance the potential negative aspects of an earnout, the earnout in a sale/acquisition agreement should be crafted very precisely and carefully. However, as with other clauses in negotiated transactions, it is practically impossible to craft the final earnout clause in the sale/acquisition agreement in the manner that fully satisfies either the Buyer or the Seller because the earnout clause ultimately is a smorgasbord of language that is the result of numerous revisions and compromises by the Buyer and the Seller (and their respective advisers).

Despite the potential pitfall of having to accept compromised language, there are several threshold issues that should be set forth in the earnout clause and each of those threshold issues should be drafted precisely and should be capable of being measured/determined in an objective manner.

The following is a list of some threshold issues that should be addressed in an earnout provision:

- the standards and metrics on which the earnout milestones will be based, whether financial (e.g., revenues, EBITDA, or net income) or nonfinancial (e.g., product development);
- the time-frame for achieving the milestones;
- a hypothetical descriptive example of how the standards will be applied and the metrics calculated; and
- the restrictions and/or changes, if any, on the post-closing operation of the Seller's business.

Tax and Accounting Issues

In addition to the threshold issues for implementing the earnout, there are threshold tax and accounting issues that should be considered.

From a tax perspective, earnouts may qualify for the installment sale taxation, which defers the taxation on the Seller's gains until the payments are actually received. However, the IRS could re-characterize a portion of the earnout payment as interest (analogous to a Seller receiving a promissory note for a portion of the purchase price).

From an accounting perspective, earnouts now generally are recorded at their fair value as of the closing date rather than delaying the recognition of the earnout payment until it is reasonably assured.

Conclusion

An earnout is a very useful tool for bridging the gap in the Seller and the Buyer's valuation of a business. In light of the lack of confidence in future results (which is caused by our current economic climate), the earnout could be the tool that revives private company mergers and acquisitions activity.

Despite, their appeal, however, earnouts could create litigation fodder because of the wide array of issues that need to be addressed in the sale/purchase agreement and the importance of crafting precise contractual language for such issues.

INSTITUTE OF MANAGEMENT ACCOUNTANTS

Advancing the Profession™

LONG ISLAND CHAPTER

MAY 2009

Institute of Management Accountants, Long Island Chapter proudly presents the prestigious

2009 Milton Zipper Financial Executive of the Year Award to:

This Year's Recipient:

Howard S. Weitzman
Nassau County Comptroller

Special Guest Speaker:

Arthur A. Gianelli
President & CEO
Nassau Health Care Corporation

RESERVATIONS REQUIRED

Tuesday evening, May 5, 2009
6:00 p.m. - Social Hour
7:00 p.m. - Dinner is Served
The Cottage, Milleridge Inn, Jericho, NY

For reservations, send payment and attendee names to:

Adrienne Sinnott
234 Chestnut Avenue
East Meadow, NY 11554

For additional information please call Adrienne Sinnott (516) 528-2474

Tariff	*$50.00/Member*	*$75.00/Non-Member*
	Tables of 10	*$600*
	At Door	*$75*
	(subject to availability)	

Thank You To Our FEY Sponsors

AVZ Financial Services • Grassi & Co., CPAs, P.C.
Madison Davis Professional Services, LLC
OST Group, Inc. • PBI Payroll
State Bank of Long Island