Earn-Outs On The Sale Of A Business

An Evolution CBS White Paper

Special points of interest:

- *Earn outs explained*
- *Issues to consider*
- *Protection Provisions*
- *Tax implications*

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It is not unusual, particularly in the current economic climate, for a buyer to wish to postpone or defer the payment of some of the purchase price when buying the shares or assets of a company.

One way to defer payment of some of the purchase price is with the use of what is usually known as an earn-out structure.

This is where part of the purchase price is calculated by reference to the performance of the business being bought for a fixed period of time after completion of the purchase.

The classic earn-out is calculated by reference to profits (although earn-outs can be linked to alternative financial measures).

Where the suggestion of an earn-out structure is based on sound commercial reasoning (e.g. not just because the buyer is going to struggle to raise sufficient funds in time for the proposed completion date) they can be beneficial for a seller as they may allow a seller to reap the full benefit of a profitable business. However, there are a number of things that a seller should consider before agreeing to an earn-out structure.

If you are considering accepting an offer where an earn-out structure is proposed you should be aware that there may be some conflict between your own interests and those of the buyer.

You are likely to have a short term view, wanting the immediate profits of the business to be as high as possible, whereas a buyer may want to make changes or invest in the business in a manner which may reduce the initial profits but be conducive to higher long term profits.

Issues to consider

In view of potential conflicts between seller and buyer earn-out protection provisions will be very important to a seller in order to ensure that the deferred amount of the purchase price is protected and, of course, as high as possible.

Issues you might want to give some thought to include restrictions on the buyer during the earn-out period e.g. not to sell off material assets of the company or wind the company up, an obligation on the buyer not to divert business away from the company, and general goodwill obligations.

Your solicitor should advise you on all of the relevant issues.

Protection Provisions

The protection provisions in the purchase agreement are likely to be the subject of much negotiation. Obviously, the larger the part of the purchase price that is represented by the earn-out, the harder you will want to negotiate.

Whilst a seller does not have to remain with the business where earn-out provisions are included, it is usual for them to do so (not least to try and protect their earn-out!) and therefore if you are a seller looking to retire or pursue other ventures then an earn-out structure may not be appropriate for you.

If you are going to remain with the company during the earn-out period (or beyond) you will also want to consider the terms of your employment or consultancy, and how the earn-out will be affected in the event that such employment or consultancy is terminated.

Security and tax implications

Another thing to consider with an earn-out structure, as with any structure where some of the consideration is deferred, is whether you will require security for the deferred part of the consideration.

Security could include a personal guarantee or a charge over assets or shares and may assist you in the event of non-payment by the buyer, although be warned that requests for security are often met with some resistance from the buyer.

Finally, the way in which you structure any sale could have an effect on how much tax you will pay and as well as legal advice on properly structuring any earn-out and ensuring that the necessary protection provisions are included in the legal documentation, you should seek an accountants advice on potential tax repercussions.

About the Author

Peter heads up Clarke & Sons Commercial team and has many years experience in advising a wide range of business clients. He deals with all aspects of business law including the buying and selling of companies and businesses, shareholder and partnership agreements, investor and joint venture agreements, intellectual property matters and issues relating to charities. Peter approaches all issues on a constructive basis with the aim of finding solutions to difficult situations and problems; his objective is to help clients achieve their goals, and to get the deal done.

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