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### Earn-out Models for Mergers and Acquisitions

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Buyers and sellers often have different views on how much a target is worth and how its value should best be determined. Normally, the valuation of a company is based on both its past performance and its projected future performance. While the seller may be confident of the company's future growth, the buyer may be reluctant to assume the risk of the company failing to perform as expected by paying the seller the whole purchase price upfront. In some cases this problem can be mitigated by the parties agreeing on the introduction of an earn-out provision into the transaction, thus spreading the risk between the seller and buyer.

**Earn-out Models and Specific Considerations**

An earn-out can be described as a deferred portion of the purchase price which is conditional on the target's achievement of certain predetermined operational or financial goals within a specified timeframe. Earn-outs can be structured according to various models in order to base these goals on different parameters. In most cases financial parameters such as net income, gross revenue, earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation and amortization (EBITDA) are used. However, other parameters relating to new customers or other business-specific operating parameters may also be used.

Parameters which are easily measurable are used in order to ensure that earn-out models are simple and transparent. Even so, the buyer and the seller often struggle to agree on how the earn-out is to be calculated. For example, a buyer will often argue that the earn-out should be based on EBITDA, while the seller would prefer it to be based on revenue. From the seller's perspective, using revenue as the basis for an earn-out is often seen as advantageous, since a company's revenue cannot be manipulated by the buyer. On the other hand, the EBITDA could be manipulated - for example, by incurring costs which are not in line with past practice. On the other hand, from the buyer's perspective, using EBITDA or net income is preferable since these parameters say more about the company's performance.

In this light, the buyer and the seller sometimes agree on a code of conduct during the earn-out period. According to such codes, the buyer, although now the legal owner of the company, must adhere to certain provisions when operating the company. Irrespective of how the earn-out is structured, it requires the seller to be involved, to some extent, in the company's business during the earn-out period. This is not always disadvantageous for the buyer and the seller's continued engagement with the company may improve future performance. Often, the valuation of a company is based on the seller's continued engagement or reinvestment, and thus the seller's continued involvement may be prerequisite of an earn-out. In such cases, in order to avoid future disputes, the buyer and the seller must have agreed on a clearly defined role for the seller within the company and on how the seller's work is to affect the earn-out.

In cases where the buyer and seller agree on an earn-out model based solely on financial parameters, the seller will require that the buyer keep it informed of the development of the company. As a consequence, the seller will normally also require that the buyer undertake not to take any measures to manipulate the financial results of the company which would reduce the earn-out. For example, if the earn-out is based on EBITDA, the seller and the buyer can agree that the buyer be prohibited from incurring any extraordinary costs or that such costs are be excluded from the calculation of the earn-out. In addition, the seller and the buyer can agree on a budget during the earn-out period, to which the buyer is obliged to adhere for the purposes of the earn-out calculation, thus preventing the buyer from reducing the earn-out by such means. From a seller's perspective, it may also be important to control an eventual transfer of the company or its business during the earn-out period. For instance, should the buyer decide to sell or merge the company with another company within the buyer's group of companies, such a transfer is likely to make it difficult for the company to reach the EBITDA targets required for the earn-out. However, the seller can prevent this problem and allow, for example, an intra-group transfer, provided that the buyer undertakes to keep the company's accounts separate during the earn-out period so that the earn-out may be calculated accurately.

Following the earn-out period, the buyer must allow the seller to verify the buyer's calculation of the earn-out and let the seller make its own calculation of the earn-out. This is rarely contentious. However, problems may arise when the seller and the buyer cannot agree on the calculation of the earn-out. To prevent such disagreements from escalating into full-blown disputes, both parties can benefit from the inclusion of a settlement provision in the earn-out model. Typically, such settlement provisions stipulate that the earn-out calculations are to be finally determined by an independent auditor appointed by the seller and the buyer. The cost of this auditor can be split between the buyer and the seller or borne by either party, depending on what has been negotiated.

**Other Considerations**

The seller and the buyer may agree that the seller's continued engagement in the company is a requirement for the seller to receive an earn-out. Depending on the circumstances, this may lead to tax consequences for both the seller and the company (and thus the buyer). This factor should be borne in mind by the parties when negotiating an earn-out model. Further, and depending on the structure of the deal, an excessively stringent code of conduct for the buyer (effectivey a veto for the seller) may have competition law implications.

**Comment**

Earn-out provisions can be an effective tool for taking negotiations forward when a seller and a buyer have difficulties in agreeing on the valuation of a company. However, the parameters on which the financial or operational goals are based should be chosen carefully by both the seller and the buyer if the model is to spread the risk between the buyer and the seller in a fair and effective manner.

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