

# **The M&A Source**

## **September 2009 Webinar “Earnouts – A Tool for Dealmakers”**

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Michael S. Roberts is a corporate attorney and one of the founders of the law firm of Connelly Roberts & McGivney LLC in Chicago, Illinois. He is also a certified public accountant. Mr. Roberts has extensive experience in corporate and securities transactions, mergers and acquisitions, venture capital and other financing transactions, and international outsourcing deals. He has represented private and public companies, entrepreneurs, private equity funds, software, technology, manufacturing and retail companies in a wide variety of transactions, including mergers, acquisitions, dispositions, joint ventures, private placements of debt and equity and financings. Mr. Roberts obtained an undergraduate degree in accounting from Northern Illinois University and received his law degree from the DePaul College of Law in 1987. Mr. Roberts is a frequent guest speaker on topics involving corporate transactions.

## A. Definition of an Earnout

1. A performance-based component of the purchase price.
2. A variable pricing mechanism based upon the post-closing realization of certain predetermined parameters.

## B. Parameters

1. Economic Parameters
  - a. Revenues
  - b. Gross Profit
  - c. Net Income/ EBITDA

These four categories start “above the line” (revenues) and move toward “the bottom line” (net income/EBITDA)

## **B. Parameters (con't)**

2. Buyer favored and seller favored
  - a. Sellers favor earnouts based upon the “above the line” earnings figures toward gross revenue
    - i. objectively determined and measured
    - ii. operating expenses (including overhead) and accounting determinations not in Seller’s control
  - b. Buyers favor earnouts based upon “bottom line” earnings figures, toward net income
    - i. Position is that this parameter is the true test of the value of the business
    - ii. Position is that overhead and direct expenses need to be included to measure performance

## B. Parameters (con't)

3. Non-economic Milestones
  - a. New product launches
  - b. New accounts
  - c. Website hits
  - d. Units produced

## B. Parameters (con't)

### 4. Time Frames

- a. Typically between one and three years
- b. Less than one year is not sufficient time to measure the value of the business
  - i. Seller chases revenue; very short-term outlook
  - ii. Lose focus on long term goals, such as credit of the customers and product quality
  - iii. Going through transition

## B. Parameters (con't)

### c. Longer periods

- i. Performance of the acquired entity becomes increasingly dependent upon management of the buyer post-closing rather than pre-closing value
  - If the business becomes fully integrated, not sure of the value of the independent business
  - At some point, post-closing performance as a measurement of pre-closing performance must stop
- ii. Longer earnouts take on the attributes of debt or equity
  - Buyers not afforded the protections you might otherwise have with debt or equity (protective covenants, management involvement, etc.)

## B. Parameters (con't)

5. Sliding scale payments based upon a percentage of milestones achieved
  - a. Sellers benefit from a sliding scale in case targets are not fully met
  - b. Buyer may want “all or none”

## **C. Other Issues to Consider**

1. Seller should perform due diligence of buyer
  - a. financial stability
  - b. management capability
  - c. Risks

## C. Other Issues to Consider (con't)

2. Continued control
  - a. Management role played by seller
    - i. Immediately conflict in earnouts; seller wants significant input on management to make earnout; buyer says it bought the business
    - ii. Key employees in place
  - b. Sellers may be able to negotiate veto rights on major decisions, such as hiring and firing key personnel and acquisitions

## C. Various Issues to Consider (con't)

3. Independent operation of selling company
  - a. More independent, value better measured by performance
  - b. As business is integrated, more difficult to measure performance
  
4. Accounting standards may need to be defined
  - a. "GAAP consistently applied"
  - b. GAAP with adjustments to account for items such as bad debt reserves, inventory write-downs, capitalizations issues, depreciation methods and extraordinary items
  - c. Allocation of overhead from buyer
  
5. Audit rights of seller

## D. Benefits of Earnouts

1. Spreads some risk to the seller as to the true value of the business
2. Creates incentive for seller and key employees to remain in place and commit to the business after the acquisition
3. May help shorten the due diligence period

## E. Shortcomings of Earnouts

1. Prevents post-acquisition integration of the business into buyer
2. Complex definitions; may be difficult to administer
3. May emphasize short-term profits over long-term growth