

Earn Outs...

These are a commonly used vehicle for managing the respective interests and expectations of vendor and purchaser. Conceptually they are straight forward; practically they are anything but. Here are some issues to be aware of when planning or negotiating them.

First, for what period is the earn out to apply? An earn out period of one year is common; longer than that becomes problematic in light of the restrictions that the vendor will want. Secondly, the vendor may want the financial statements for the earn out period to be audited. The parties will need to agree who is to bear the cost of the audit. In addition, the vendor should take steps to ensure that the audit is limited to an audit of earnings and does not also dictate recognition of a liability that would trigger a warranty claim.

Most important for the vendor will be protections to ensure that the earnings during the earn out period are not reduced on account of activity by the purchaser during the earn out period that may reduce the earn out payment, regardless of any design on the part of the purchaser to do so.

Usual protections sought by a vendor include commitment by the purchaser that the company:

- Will use reasonable endeavours to ensure that key supply or customer arrangements continue;
- Is managed in a prudent manner consistent with the 12 months prior to completion;
- Dedicates adequate resource to actively promote the business;
- Refrains from any act or omission that has a purpose or intention of reducing gross profit or the earn out payment without the consent of the vendor.

These protections can be terribly difficult to negotiate. That is even more so where related party transactions are prevalent. On the other hand if the parties can get past this negotiation hurdle earn outs often greatly pave the way for a sale to proceed where it otherwise might not. That is because they close the gap on price expectations between buyer and seller and if agreement can be reached on price everything else usually falls into line.