



M&A EARN-OUTS: THE DEVIL IS IN THE UNCERTAINTY

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Mergers and acquisitions (M&A) are inherently complex transactions that involve balancing the interests, expectations and risk tolerances of buyers and sellers. One mechanism frequently used to bridge differences in valuation and to manage uncertainty in deals is the earn-out provision. An earn-out allows part of the purchase price to be contingent on the future performance of the acquired business, effectively aligning incentives of the parties and deferring part of the financial commitment of the buyer. While earn-outs offer significant benefits, they also bring potential pitfalls in

terms of complexity, conflict, and administrative considerations. This article explores both the positives and negatives of earn-out provisions in M&A transactions, highlighting their strategic value and the challenges they present.

EARN-OUT PROVISIONS' UPSIDES

One of the most compelling advantages of an earn-out provision is its ability to bridge valuation gaps between the buyer and the seller. When there is uncertainty about the future performance of the business, whether due to volatile market con-

ditions, an unproven product, or a lack of historical financial data, buyers and sellers often struggle to agree on a fair purchase price. An earn-out provides a compromise: The seller receives an initial payment up front and may earn additional payments if the business achieves certain performance targets post-closing. This structure enables deals to move forward that might otherwise stall over valuation disputes.

Earn-outs also help align the interests of both parties. Sellers, especially those who stay on with the company post-closing in a management role, are directly motivated to

drive the business toward the agreed-upon performance metrics. This alignment can foster a smoother transition and more committed post-sale management, leading to better results for the buyer and higher payouts for the seller. For the buyer, retaining a motivated seller can help preserve institutional knowledge, key customer relationships and operational continuity.

From the buyer's perspective, earn-outs help mitigate the risk of overpaying for a business whose future is uncertain. By deferring a portion of the purchase price until certain benchmarks are met, the buyer limits their initial exposure. If the acquired business underperforms, the buyer has already protected themselves by tying part of the payment to performance. This is particularly important in industries where future success depends heavily on innovation, regulatory approval or market expansion—areas prone to unpredictability.

For sellers, an earn-out structure offers the potential to maximize the overall sale proceeds if the business performs well after the transaction. Sellers who are confident in their business's growth prospects may be more willing to accept an earn-out, knowing they could ultimately receive more than the buyer's initial offer. This arrangement rewards sellers not only for the company's past performance but also for its post-sale trajectory, which they may still influence if they remain involved operationally.

Another benefit of earn-out provisions is that they can improve the buyer's cash flow management. By deferring a portion of the purchase price, buyers preserve cash that can be deployed for integration costs, growth investments, or working capital needs in the early stages of ownership. This delayed payment schedule can be especially beneficial for private equity firms or other buyers operating within tight capital structures.

Earn-outs are highly customizable. They can be structured around various performance metrics such as revenue, EBITDA, customer retention or other operational goals, depending on what makes most sense for the business and the parties involved. This flexibility enables earn-outs to be tailored to the unique dynamics of each transaction, increasing their utility across different industries and deal types.

EARN-OUT PROVISIONS' DOWNSIDES

Despite their many advantages, earn-outs are not without significant drawbacks, particularly to sellers. Parties must carefully weigh these risks and challenges to ensure the earn-out serves its intended purpose and does not leave the party in a disadvantaged position.

On the front end, earn-out provisions are inherently complicated to structure. They require detailed negotiations around performance metrics, timeframes, calculation methods and payment schedules. This added complexity can lead to protracted negotiations, delay the closing of the transaction, and increase legal and advisory costs. Both parties need to consider a wide range of scenarios and plan for contingencies, which can bog down the deal-making process.

One of the most common issues with earn-outs is the potential for disputes over whether performance targets were met. Even when both parties act in good faith, disagreements can arise over how metrics are calculated, which accounting standards are applied, or whether certain external events (e.g., economic downturns or industry disruptions) should impact the outcome. Vague or poorly drafted earn-out terms can lead to litigation or strained relationships between buyer and seller.

In some cases, the buyer may be incentivized to manipulate the performance of a business in a way that prevents earn-out payments from being triggered. For example, a buyer could delay investments, alter operational practices, or change accounting methods in a way that reduces reported earnings or revenue. While such action may not necessarily be illegal or directly violate the purchase agreement, it can undermine the spirit of the earn-out agreement and leave sellers feeling cheated. Parties should consider these potential pitfalls when drafting the purchase agreement, particularly the earn-out provision.

Although earn-outs are designed to align interests, they can also create post-closing tensions. For instance, the buyer may want to focus on long-term strategic initiatives or cost-cutting measures, while the seller (now an employee or advisor) may prioritize short-term performance to maximize their earn-out payout. These conflicting goals can lead to disputes, reduced collaboration and challenges in day-to-day decision-making.

Earn-outs involve a significant administrative burden, especially if they are tied to complex metrics or span multiple years. Buyers must implement systems to track performance accurately, produce regular reports and sometimes engage third-party auditors to validate results. This ongoing oversight can be time-consuming and costly, particularly for smaller companies without a robust financial infrastructure.

Finally, earn-outs can introduce tax and legal complexities. Depending on how the earn-out is structured, payments may be treated as purchase price or as compensa-

tion, each with different tax consequences for both buyer and seller. Additionally, if disputes arise, the legal costs of resolving them can be substantial, regardless of whether the purchase agreement contains an arbitration provision. Sellers should also be aware of the impact of earn-outs on capital gains treatment and any withholding requirements.

CONCLUSION

Earn-out provisions in M&A transactions are helpful tools for balancing the interests of buyers and sellers, especially in cases where future business performance is uncertain. They offer numerous benefits: helping bridge valuation gaps, aligning post-closing interests, reducing buyer risk, and providing sellers with upside potential. When thoughtfully designed, they can facilitate deals that might not otherwise be possible and set the stage for a more collaborative transition period.

However, the benefits of earn-outs must be weighed against their considerable drawbacks. Structuring an effective earn-out requires careful negotiation, clear and enforceable performance metrics and ongoing administrative diligence. There is also the risk of disputes, misaligned incentives and financial manipulation. For these reasons, earn-outs are best used in situations where the parties have a high level of trust, transparency and collaboration, and where both sides are willing to invest the time and resources needed to manage the arrangement properly.

Ultimately, whether an earn-out is appropriate depends on the specifics of the deal, the nature of the business and the goals of the parties involved. For buyers and sellers alike, understanding the advantages and risks of earn-outs is essential to crafting agreements that are fair, flexible, and financially sound.



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