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How To Survive An Earnout

The good news: You've sold your company. The bad news: If you leave early, you could be giving up a big chunk of cash

Five years ago accountant Ira Feldman sold his two Phoenix businesses to RSM McGladrey, a division of H&R Block ([HRB](#)), for about \$16 million. But Feldman still hasn't seen all his money, nor is he likely to. That's not for the reasons you might suspect -- a falling out between his 10 partners, say, or the inability of the buyer to get financing. None of that happened. Instead, Feldman came up short because he agreed to an earnout. He got 80% of his money up front. The remainder -- called an earnout because it would be awarded only if Feldman's companies reached agreed-upon targets, and if Feldman stayed on board until they did -- was to be paid to Feldman and his partners over the next five years.

At first, Feldman wasn't worried. The accounting and software businesses he had built were now backed by a major company. But things started going south soon after the deal closed, says Feldman. Under the new owners, he says, the partners stopped working directly with clients, and longtime customers took their business elsewhere. Deborah Ely-Lawrence, a spokeswoman for RSM McGladrey, says that the acquisitions represent "a very successful operating office for our firm." Two years into his five-year contract, Feldman left to set up his own accounting practice, forfeiting his balance. "My advice is to limit your earnout to the amount you're willing to lose," he says.

Unfortunately, Feldman's situation is quite common. As many as half of all small business acquisitions involve earnouts, which generally last from two to four years and range from 15% to 30% of the purchase price (though 50% is not unheard of). Earnouts are particularly common in acquisitions of high-growth companies and those with unproven products. Takeovers of service businesses, in which the entrepreneur's relationships with clients are crucial, are also likely candidates for earnouts.

As private-equity investment surges, the chances of an entrepreneur being asked to accept an earnout are increasing. "A private-equity fund is more likely to keep management around, as opposed to a strategic buyer who isn't buying the company for management but for the product or customers," says Robert S. Matlin, co-chair of the private-equity practice at Thelen Reid & Priest in New York. Private-equity buyers typically don't have expertise in a specific industry, making them dependent on the former owner -- at least initially -- to guide them.

For entrepreneurs, working for a boss at a bigger company can feel like purgatory. "The reality is you lose control the day you sell," says John Arensmeyer, who sold ACI Interactive, a \$3 million Sausalito (Calif.) online-financial-services company, in 1999 in a three-year earnout agreement. "You don't call the shots anymore." Beyond the psychological fallout, entrepreneurs are often powerless to act if the CEO's decisions hamper the company's ability to meet targets set by the earnout agreement.

Still, there is hope. "There are ways to mitigate your lack of control," says David Minor, William Dickey Entrepreneur in Residence at Texas Christian University in Fort Worth. The key to a successful earnout lies in negotiating smart, achievable targets, making sure they're spelled out clearly in your contract, and keeping some power over decisions that directly affect them. You'll also want to nail down your own position in the new company -- and your eventual exit from it.

PROTECT YOURSELF

Before you agree to anything, get a lawyer who specializes in mergers and acquisitions. Besides helping to negotiate the deal, a lawyer can keep emotions from boiling over when things get dicey. "If you feel uncomfortable taking a hard line with a buyer, who may also be your future employer, your attorney can be the bad guy," says Mark Mihanovic, a partner with Los Angeles law firm McDermott Will & Emery. "You can stand back and be above the fray."

The next step is obvious: Get the largest up-front payment you can, even if the earnout is substantial. When Christi Black and her partner, Robert Deen, sold their eponymous Sacramento public-relations firm in 2001, they negotiated an immediate payment of \$2 million. Even

though the lion's share of Black & Deen's value was contained in the four-year earnout, the duo reasoned that \$2 million gave them the cushion they needed. Says Deen: "Even if we tanked, there was some protection."

Then, you've got to negotiate the targets for the earnout -- usually revenue or profit goals -- and make sure you've got a reasonable chance of achieving them. But what was reasonable under your leadership may not be under the new owners. So it's essential to protect yourself in case they decide to operate differently, as happened to Feldman and his partners. "If the buyer makes significant changes to processes and operations, make sure it doesn't affect your compensation at the end of the earnout," says Minor.

That means that if your earnout is based on profit numbers, you need to make sure the buyer can't use excessive spending to depress earnings. Your agreement should include budgets for capital expenditures, research and development, advertising, and maintenance. Or you can stipulate that the income calculation won't include overhead costs. That way the purchase of a new computer system, for instance, won't hurt your chances of making your earnout.

Black and Deen faced a similar issue when it was time to merge their benefits package with that of the new company. Black & Deen offered superior health insurance, but the new owners had a better -- read more expensive -- retirement plan. The duo had to strike a delicate balance between maintaining good benefits and high employee morale while keeping their earnout within reach. Adopting the more expensive retirement plan while the 50 employees were still covered by Black & Deen's more generous health insurance could have endangered Black and Deen's ability to make their earnout. Because their firm had a young workforce, Black and Deen opted to delay the phase-in of the retirement plan.

Such trade-offs are one reason many experts recommend using revenue targets instead. "It's harder for buyers to do things that will depress sales than to depress income," says Mihanovic. But you'll still have some messy issues to resolve. Is a one-year service contract, billed monthly, counted as 12 months of revenue when the contract is signed, or is revenue booked only as the payments come in? You'll need some control over marketing, personnel, and other decisions that can affect sales. If hitting your sales target depends on stepped-up spending in research and development, you need to be able to veto decisions about R&D costs.

The main downside of revenue-based formulas is that they leave you vulnerable to preemptive strikes by the purchaser. An acquirer with a competitive product may want to take yours off the market. "A buyer may also bundle your product with its own, so you wind up with little incremental revenue," says David Jaffe, a partner with Schnader Harrison Segal & Lewis in Pittsburgh. A "best-efforts" clause -- one that requires the buyer to assert that it's not trying to mothball your product -- can help protect you, says Jaffe.

For many entrepreneurs, the best option may be to base the payments on something other than the company's financial health. "Milestone payments are preferable because they're more objective," says Brooks Dexter, senior managing director at USBX Advisory Services in Santa Monica, Calif. They can include booking a specific number of new customers by a certain date or retaining a percentage of existing clients. Again, make sure you have the resources needed to deliver. If your earnout is dependent on signing up new customers, the last thing you need is for the new CEO to cut your marketing budget.

No matter which type of target you use, fight for sliding-scale rather than all-or-nothing payments. That ensures that "if you're within 80% of the threshold, you'll get 80% of the payout," says Dexter. Ask also that disagreements over how costs are determined be submitted to binding arbitration.

A GRACEFUL EXIT

Then there's the unenviable task of trying to guess the future. What if the acquiring company gets sold? Or goes public? What if your division gets transferred overseas? When Arensmeyer sold his company, he insisted on a clause that guaranteed him a stake in the proceeds if the combined company was sold during his three-year earnout period -- a prospect that seemed very unlikely at the time. Two years later, a major public company bought the business. Arensmeyer says that provision resulted in a doubling of his earnout.

The last task is getting your own employment contract. Without one, "They can pull the rug out from underneath you," says Phil Thompson, a partner with Thompson Associates, a law firm in Richmond Hill in Ontario, Canada. That might mean the purchaser gives your job to someone else or demotes you after the sale closes. If you're lucky, you'll get the right to quit before your earnout ends without forgoing the entire payout.

Deen didn't have an exit clause, but two-and-a-half years after Black & Deen was sold, and with a year yet to go, he was ready to walk. The reason he had wanted to sell in the first place was so he could do something new. He wanted to travel and throw himself into hunting and fishing. Deen, who had tried to have a good relationship with the new owners, broached the idea of leaving early. Much to Deen's surprise, the owners agreed to let him go, and he left without losing a cent. Deen was lucky, but earnouts are too important to leave to chance. Far wiser to fix your good fortune with a smart agreement.

By Anne Field

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