Earn-Outs in M&A: Bridging the Valuation Gap Without Creating a Future Fight

An earn-out is a deal mechanism used when a buyer and seller cannot fully agree on what a business is worth today. Instead of forcing the entire purchase price to be paid at closing, the parties agree that part of the price will be paid later if the acquired business hits specific post-closing targets. In simple terms, the seller says, "This business is worth more because of where it is headed," and the buyer responds, "Prove it, and I'll pay more if the business actually performs."

Earn-outs are common in private M&A deals where future performance is uncertain. They are especially useful when a company has limited operating history, promising new technology, a new product, a temporary dip in earnings, or operates in a volatile market. Rather than arguing endlessly about projections, the parties can tie part of the purchase price to future revenue, EBITDA, net income, customer growth, regulatory approval, litigation outcomes, or other measurable events.

For sellers, an earn-out can preserve upside. If the buyer is discounting the purchase price because it is skeptical of future growth, an earn-out gives the seller a path to receive more if that growth actually happens. It can also allow a distressed seller to close now while keeping a chance at additional value later. For buyers, earn-outs reduce the risk of overpaying. They allow the buyer to pay based on actual post-closing performance rather than optimistic forecasts. They also defer part of the purchase price, which can reduce the amount of cash or financing needed at closing.

But earn-outs are not free money, and they are not simple. They frequently create post-closing disputes because the buyer now owns the business, but the seller still cares deeply about how that business performs. T*he seller wants the buyer to operate the company in a way that maximizes the earn-out. The buyer wants freedom to run and integrate the company as it sees fit. Those incentives can collide quickly.*

The most important drafting issue is the target itself. Financial targets like revenue, net income, EBITDA, earnings per share, or net equity are common, but each has tradeoffs. Sellers often prefer revenue because it is easier to measure and harder for the buyer to manipulate through expenses. Buyers often prefer net income or EBITDA because they care about profitability, not just sales volume. EBITDA is a common compromise, but only if it is defined carefully. Saying "EBITDA" is not enough; the agreement should explain which accounting principles apply, whether GAAP is used, whether it is applied consistently with past practices, and how unusual items, transaction expenses, shared overhead, acquisitions, integrations, and intercompany charges are treated.

Not every earn-out needs to be financial. In some deals, non-financial milestones work better. A biotech company might use regulatory approval. A software company might use a product launch or customer threshold. A business with an important lawsuit might use a favorable litigation result. Milestone payments can be easier to administer because the event either happens or it does not, and in many cases the event is outside either party's direct control.

The earn-out period also matters. Many earn-outs run one to three years. Shorter periods give sellers a quicker answer and reduce their exposure to buyer credit risk, while buyers like shorter periods because they reduce the time during which the buyer's operation of the business may be restricted. Longer periods may make sense if the seller remains involved or the business needs more time to prove itself. The payout can be a flat amount, a formula, a percentage of performance, a multiple above a target, or some other agreed calculation. The agreement should also address whether missed targets can be made up later, whether overperformance in one period affects later periods, and whether payments are capped.

Because the buyer controls the business after closing, sellers often ask for operating covenants. These may require the buyer to operate the business consistent with past practice, maintain separate books, provide access to records, maintain working capital, use commercially reasonable efforts to achieve the earn-out, avoid selling the business, or refrain from firing key employees. Buyers usually resist these restrictions because they purchased the business and want control. A common compromise is a fair-dealing covenant: the buyer is not required to maximize the earn-out, but it cannot act in bad faith to avoid paying it.

Dispute procedures are essential. The agreement should say who prepares the earn-out calculation, when it is delivered, how long the seller has to object, what supporting information the seller can review, and how disputes are resolved. Many agreements send accounting disputes to an independent accountant, with rules for timing, scope of review, and fee allocation. Without a clear process, the earn-out can become a second negotiation or a lawsuit.

Sellers should also think about payment security. If the buyer may not be able to pay later, the seller may ask for an escrow, parent guaranty, security interest, or restrictions on buyer debt that could block payment. If the buyer is paying the earn-out in equity instead of cash, the parties must address valuation, dilution, securities-law restrictions, transfer rights, and whether the seller receives any stockholder-type rights.

Tax and accounting can materially change the economics. If an earn-out is treated as deferred purchase price, sellers may receive capital-gain treatment; if it is tied too closely to continued employment, it may be treated as compensation taxed at ordinary income rates and subject to employment taxes. Deferred payments may also include actual or imputed interest. Installment-sale rules can defer tax, but special basis recovery rules can create unexpected acceleration of gain. Buyers must also consider accounting rules requiring potential earn-out payments to be recorded at fair value and remeasured over time, which can create earnings volatility.

Earn-outs can bridge a valuation gap and get a deal done, but they are also fertile ground for disputes. The more specific the parties are about targets, accounting rules, operating covenants, dispute procedures, security, tax treatment, and payment mechanics, the more likely the earn-out will function as intended rather than becoming the next fight after closing.

For help with your merger or acquisition, call or email:

Geoff Long 713.800.3616
Geoff.Long@dtlawyers.com

Robert Cherry 713.275.1370
Robert.Cherry@dtlawyers.com