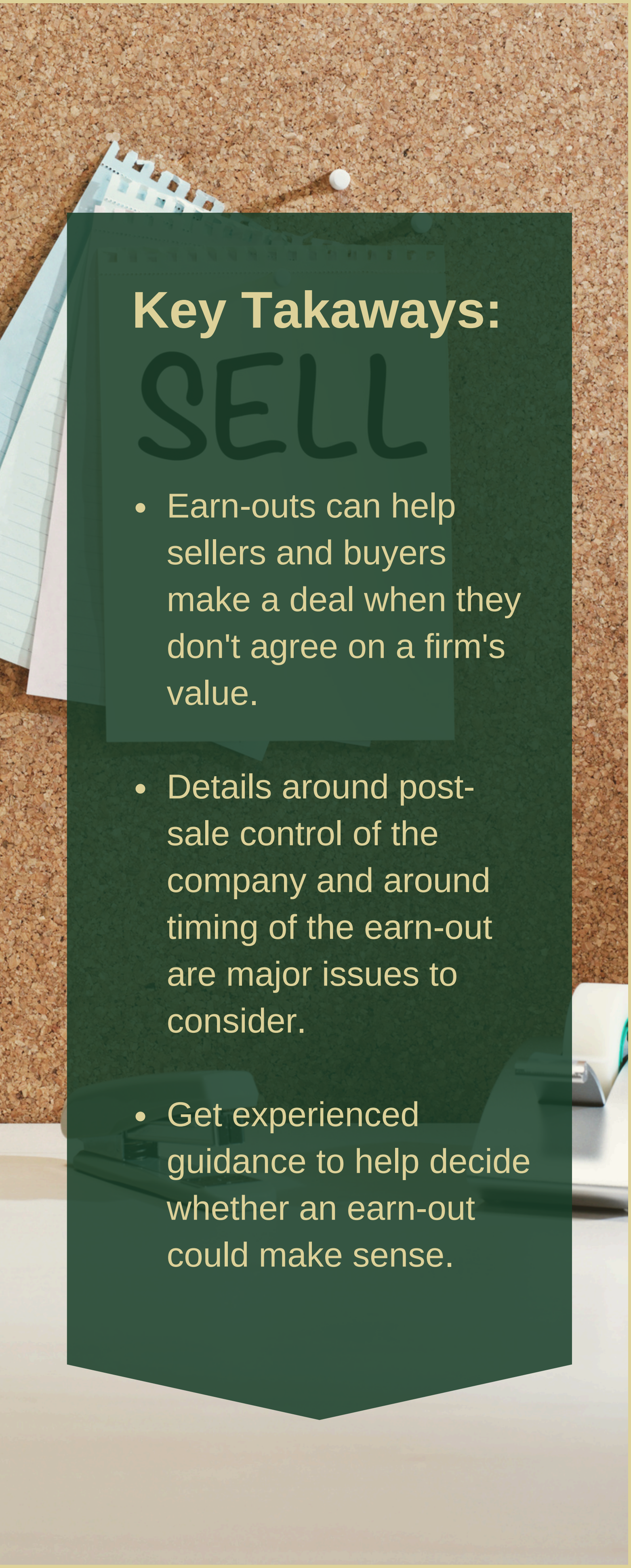


Key Takaways:

- Earn-outs can help sellers and buyers make a deal when they don't agree on a firm's value.
- Details around post-sale control of the company and around timing of the earn-out are major issues to consider.
- Get experienced guidance to help decide whether an earn-out could make sense.

Selling Your Company?

When selling your business, it might make sense to include an earn-out provision. But you've got to plan carefully and tread cautiously if you take this route.

With an earn-out, you essentially defer some of the purchase price and make receiving it dependent on the performance of the company for a period of time after you sell. If the business hits or beats certain performance targets, you get the rest of your money—and can potentially earn even more from the sale than the initial price, depending on the terms. Buyers might like to add an earn-out provision because it could protect them from overpaying for a business if it doesn't perform as well as predicted.

Earn-outs can be an effective way to reconcile the differences in a business's perceived value between buyers and sellers. With an earn-out in place, the buyer is essentially saying, "If the company's actual future income meets the seller's projections, then the seller should get the asking price." Meanwhile, the seller is essentially saying, "If my projections are on the money, I deserve an even greater amount for the company for taking on additional risk because of the earn-out."

Other reasons an earn-out might be considered include:

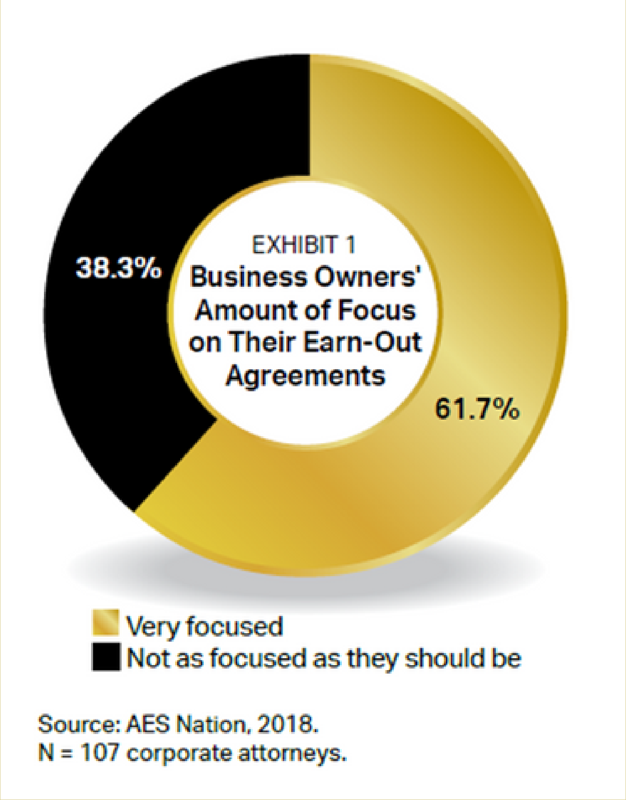
- The buyer wants the seller involved post-sale to ensure their success.
- There is a division or component of the business that the buyer is nervous about.
- The seller feels confident about the company's growth potential and wants to be compensated for it.
- The seller can't identify another buyer.

Conversely, there are significant risks that accompany the earn-out route. For example, earn-outs often aren't ideal if the seller is worried about the future prospects of the company (or the industry) or is worried about how the likely buyer will manage the firm post-sale. Also, if there's strong demand for the company from multiple potential buyers, an earn-out may be unnecessary. All that said, business sales and whether earn-outs make sense will depend heavily on each particular case.

The issues of control and timing

As important as an earn-out can be, we find that a significant percentage of business owners don't pay as much attention to their earn-out agreements as they should, according to attorneys who work with these clients (see Exhibit 1).*

One key issue to consider is how the variables are involved in measuring the earn-out. The key metrics to be evaluated will depend on the specific business but might include employee retention rate, customer retention rate or gross profit. That said, revenue and net profit usually top the list. So, for instance, a buyer might want to see next year's revenues of 90% or more of the current year's, along with an employee retention rate of 85% or higher. These deal terms are all negotiable, of course.



Another key aspect of an earn-out to focus on is control over decision-making. An earn-out provision will contractually obligate you to remain with the business after you sell, for a defined period of time. But for the earn-out to work well for you, you have to maintain a level of control over major business decisions that you feel are necessary and appropriate. If the buyer fully takes the reins from you and you give up all control, the business's income—and your earn-out, are at the mercy of their decisions. That could be an especially big risk if the buyer is a relatively inexperienced entrepreneur or is somewhat unfamiliar with the dynamics of the industry in which the company operates.

Note: Keep in mind that you may not be the only person the earn-out requires to stick with the company post-sale. Key employees (such as top salespeople or office managers) might also need to be part of the agreement, which means they'll need to agree to certain terms too.

Another major concern is the timing of the earn-out. The transition period of an earn-out tends to be relatively short. Ideally you want it to be no longer than the amount of time needed to maximize your earn-out payments. Typically, though, former business owners add in a bit of slack. For example, if you think you can achieve the earn-out-maximizing objectives in two years, you might negotiate to make the measurement period three years or less.

*Source: AES Nation, LLC. Survey conducted of 107 corporate attorneys in the first quarter of 2018. All respondents were members of the Association for Corporate Growth.

Timing is important because of the impact that decisions about the business can have in the near term. If, after the sale, the buyers decide to set up a research and development group or significantly increase marketing efforts, profits could be lower in the short term. That could translate into a lower earn-out, even though it might produce greater longer-term benefits

Legal protections

While you'll want to retain a considerable amount of managerial control over the business after you sell, you will probably no longer have any legal control. You will therefore need to put legal protections in place to ensure you can collect what you are owed. Such protections can take a number of forms, including:

- The ability to get early earn-out payments when certain benchmarks are reached
- Restricting actions (such as taking out loans) until after you have been paid
- Escrowing money to make certain the company can meet the earn-out payment obligations

Keep in mind that anything that increases costs has the potential to decrease the earn-out. So, for example, you do not want to be forced to hire new employees or expand the business.

Important: That doesn't mean you should seek to stop the company from growing, of course. The critical issue is who will pay for any expansion: you (through your earn-out) or the buyer? If the money for growth comes from the buyer, then expansion is something you may want to pursue. However, any business moves that are a financial drain on the company may very well lower your earn-out. If, for instance, loans are obtained to finance growth, the interest payments may end up working against your payout.

Also, all business dealings between the company and any affiliated companies of the buyer have to be arm's-length transactions. Otherwise, the company might end up selling or buying from the affiliates at prices that are not profitable. The pricing might even result in losses for the business.

Another consideration is maintaining the company's existing general and administrative costs (as well as its overhead costs) rather than using the cost structure that a buyer who owns other companies already has in place - which may be greater, potentially cutting into your payment.

Litigation concerns

Earn-outs can be quite complex. Litigation involving earn-outs is common in our experience—and such litigation can get expensive fast. What's more, buyers will often have deeper pockets than you have. They can use litigation to bludgeon you into submission so you settle for less.

Therefore, it's wise to consider adding a clause in any earn-out agreement that deals with the cost of litigation. Such a clause should require the buyer to pay the owner's legal fees if the owner is successful in litigation—and vice versa.

Addressing imputed interest

Sellers are often unaware that a portion of each earn-out payment is imputed interest, which is taxed at higher ordinary income rates instead of at the lower capital gains rate. There are a number of ways to avoid a higher-than-necessary tax bill, such as having the buyer pay the interest or by increasing the size of the earn-out payment to compensate.

What is important to recognize here is that it will cost you more to make earn-out payments than if you simply sold your company outright with no earn-out agreement at all. Therefore, you have to take steps to get the optimal value from the sale of your company, including addressing the tax differential between ordinary income and capital gains.

Getting help

The complexities around earn-outs are just some of the reasons we believe you should seek expert guidance when negotiating the sale of your business. Without a knowledgeable navigator, for example, you can end up becoming too optimistic about the likelihood that an earn-out will generate a massive payday for you. Putting too many of your eggs in an earn-out basket can be a mistake.

Armed with a team of people who can help, you can potentially put yourself in the best possible position to maximize the amount of wealth you have when you finally walk away from your business for the last time.

www.oswegowealth.com