

All Earnouts Are Not Created Equal

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Do earnouts really bridge the value gap, or just punt uncertainty to a later date?

Uncertainty has persisted in the business environment for more than six years now. COVID, supply chain disruptions, inflation, labor challenges, geopolitical conflicts, tariffs, the list keeps growing. Yet M&A activity persists, even if at a slower pace and over longer timelines than owners might prefer. Certain forces don't wait for markets to return to "normal": capital needs to be deployed, owners face retirement, family, and estate planning timelines, and some businesses encounter performance challenges for which the solution can't be indefinitely postponed. These pressures keep buyers and sellers at the table even when they disagree about where a business, or the broader market, is headed.

In the face of uncertainty, buyers and sellers increasingly lean on deal structure to bridge the gap between what each side believes about the future. That structure can take many forms, from seller financing to rollover equity, earnouts, holdbacks, and more. Nearly two decades ago we wrote about the emergence of earnouts as a tool for bridging the valuation gap in the aftermath of the Great Recession. The popularity of earnouts has waxed and waned since, but they remain one of the most frequently used tools in middle market M&A today. But does an earnout

actually solve the core problem it is attempting to address, or does it simply postpone the issue to a later, often more contentious, date?

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A Quick Refresher on Earnouts

Most operators and advisors are familiar with the concept of earnouts, at least at a high level. To offer a brief explanation, an earnout is a contingent piece of the purchase price. Instead of paying the full amount at closing, the buyer defers a portion of the price to be paid later if the business meets certain agreed-upon financial or operational targets, often revenue or EBITDA benchmarks measured over a one- to three-year period.



Earnouts exist for two main reasons. First, an earnout is a way to shift the risk between the parties, namely, to lower a buyer's risk and increase the risk that the seller ever receives the headline price they believe they are selling for. Second, earnouts can bridge a genuine gap in financing. A buyer may simply be unable to finance the full purchase price at closing, but can afford to pay the remainder out of the business's own future cash flows. In that sense, an earnout can be viewed as a financing mechanism, although with more risk to the seller than a seller note with mandatory payments.

The Problem with Earnouts: Misaligned Incentives

Earnouts are not categorically good or bad. There are legitimate risks in a transaction that can't be fully quantified in an all-cash offer. Management dependence on a departing seller, uncertain customer retention once the seller steps back, or recent performance softness the seller genuinely believes is temporary are examples of those risks. When used well, an earnout lets both sides get comfortable

with that uncertainty without walking away from the deal. Used poorly, it simply defers the disagreement about value to a date when the seller has far less leverage to do anything about it. That is why both parties need to understand precisely why the earnout exists and which risk it is meant to mitigate, and spend real time structuring it to avoid the pitfalls that repeat across nearly every disputed deal.

The core tension is caused by the nature of the transaction itself. The seller has effectively turned over the keys to the business, including day-to-day and major strategic decisions that drive performance, while remaining financially exposed to the outcomes of those decisions. A buyer's near-term priorities, such as integrating with another business, investing in new costs to drive growth, or shifting the organization's strategic plan do not line up well with the short-term earnout horizon.

Beyond that misalignment, earnouts tend to generate disagreement from a handful of structural issues:

1. Vague financial metric definitions, such as "EBITDA" or "Revenue" without specificity into how exactly those will be calculated;
2. A lack of protections against buyer actions that suppress performance, whether intentional or not;
3. Binary outcomes, in which achieving greater than 100% of an earnout metric results in full consideration for a seller, while falling just shy of the threshold earns the seller nothing;
4. Measurement periods that don't reflect the business's actual situation and don't align with the value disagreement that justified the earnout in the first place;

5. Limited reporting visibility and audit rights for the seller during and after the earnout period;

6. Poorly defined dispute resolution mechanisms that result in litigation;

7. Silence on what happens in a change of control during the earnout period, and whether the earnout is fully earned at that point, or extinguished, or something in between; and

8. Unclear payment and subordination mechanics that leave questions about where exactly the future funds will come from and where they will sit in the priority stack.

A Familiar Story

Consider a theoretical, but common, scenario. A founder sells a specialty manufacturing business for a price split between 80% cash at closing and a two-year earnout tied to maintaining a minimum EBITDA level for the remaining 20%. The buyer is a strategic acquirer with an experienced integration team, and both sides genuinely believe the earnout structure is fair.

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Within months of closing, the buyer begins folding the acquired company into its broader operations, consolidating back-office functions, shifting some sales coverage to its existing team, and opening a new facility to consolidate a portion of the

manufacturing operations. None of this is done with any intent to shortchange the earnout. It is simply how the buyer chooses to run the business. But it also makes the agreed-upon EBITDA number far harder to isolate, and by the end of the measurement period, the founder and the buyer disagree sharply on what the number actually is, how shared costs and facility start-up expenses should be allocated, and whether the integration itself should count against the seller.

What began as a straightforward calculation turns into a months-long negotiation. That outcome isn't the result of bad faith on either side. It is the predictable result of an earnout that wasn't built to survive contact with how the buyer actually intended to run the business.

Negotiating an Earnout That Protects You

As a seller, an earnout may be unavoidable if your preferred buyer is only able to meet your value expectations by adding this type of structure. Before accepting an earnout, it should be given the same rigor and attention in negotiations as the headline purchase price itself. As is largely implied by the pitfalls listed earlier, a seller should aim for:

- Precise, auditable metric definitions. Not just a label such as "EBITDA" but specific accounting procedures, exclusions, adjustments, and calculation methodology with an example calculation that supports the contract's language;
- Operational covenants that limit buyer actions that are most likely to suppress performance;
- Reporting rights during the earnout period, including access to the detail behind the number, not just the final figure;

- A defined dispute resolution process, such as review by an independent accountant or expedited arbitration, rather than open-ended litigation;
- Acceleration triggers in certain events like a change of control.

Wherever possible, push for milestones the seller can influence directly. Treat the earnout section of the purchase agreement with the same care given to the representations, warranties, and indemnification sections. In many deals, the earnout is likely to have a bigger real economic impact on what the seller ultimately collects than any of those more heavily negotiated sections. The specificity that might seem tedious to negotiate up front is exactly what may be needed to prevent a costly fight down the road.

Expect a Fight, and Be Prepared

No matter how strong the relationship is between buyer and seller at closing, and how aligned both sides feel on the earnout mechanism, sellers should prepare as though a fight is coming. That doesn't mean walking into the negotiation with knives out. It means approaching the



earnout provisions with healthy skepticism rather than assuming goodwill will carry the day once real money is on the line.

Working alongside legal counsel, an experienced transaction advisor can help a business owner structure earnout terms upfront that anticipate where these disputes typically arise, and can stay engaged through the earnout period itself to help protect the value the owner spent years building.

So, does an earnout genuinely bridge the value gap, or does it just punt uncertainty down the road? The honest answer is that it depends entirely on how carefully it's built. A well-structured earnout, with precise metrics, real protections, and a workable dispute process, can be a legitimate bridge between two reasonable views of a business's future. A loosely drafted one simply delays the argument about price to a moment when the seller has already conceded control of the ship.

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