Wenger & Vieli Ltd.

# Earn-out in an exit – Can an earn-out solution save the deal?

In case of an exit, the negotiations between the sellers and the buyer on the purchase price of the target are naturally driven by different perspectives of the parties with regard to revenues that the target can generate in the future. With an earn-out, risks and benefits of the future development of the target are borne by the selling shareholder(s) and the buyer and thus the parties may be able to agree on a purchase price which is satisfactory to both sides. In this sense, at least in theory, earn-out solutions can help to find compromises and hence build a bridge between the purchase price expectations of both the sellers and the buyer.

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## Basic mechanism of an earn-out

An earn-out is a variable part of the purchase price that the parties usually agree on in addition to the fixed purchase price. The amount of the variable component is linked to the achievement of certain milestones in the future, agreed between the parties. Depending on the achievement of the milestone(s), the earn-out payment will be higher or lower.

An earn-out makes particularly sense if some of the sellers continue to work for the target for a certain period of time after the exit. Usually an earn-out is linked to financial parameters, such as the achievement of certain sales, profit or cash flow figures, or the generation of a certain EBIT/EBITDA. However, it is also possible to choose other milestones such as the maintaining of a certain customer base or the acquisition of a certain number of new customers. Furthermore, also the continuance of the sellers in the target for a certain period can serve as such a milestone.

## Advantages of earn-out solutions

An earn-out mechanism allows a buyer to ensure that it does not overpay for the target. The sellers on the other hand has the opportunity to profit from a positive development of the target even after the exit in order to achieve what it considers to be the appropriate purchase price. Further, a seller who is willing to agree to an earn-out also signals to the buyer its confidence in the positive development of the target and the accuracy of the business plan. In addition, the buyer does not have to pay the full purchase price immediately. The earn-out payments can potentially be made from future profits generated by the target. The buyer only has to pay if the target actually achieves the milestones and thus eliminates part of its valuation risk. If the agreed milestones are not achieved, the expectations of the parties have not been fulfilled and, consequently, the seller does not receive any or only a reduced subsequent payment of the purchase price.

## Drafting of the earn-out mechanisms and protection of the seller

Although the advantages of the earn-out principle seem persuasive, the contractual structuring is crucial and challenging as it is almost impossible to regulate all potential future developments in every detail. Experience has shown that earn-outs can often lead to disagreements and disputes between the parties.

If the earn-out is linked to financial parameters, the definition of the relevant revenue is key and should be stipulated in a way which reduces potential manipulation from the outset. In principle, the buyer would be free to restructure the target's business or to transfer assets, sales or profits to another (group) company. Therefore, the seller has to protect itself against any measures taken by the buyer that could adversely affect the earn-out and thus the amount of the purchase price to be paid. At least from the seller's view, it is recommendable to use the EBITDA as calculation basis which may not easily be manipulated by buyer's investment and/or depreciation strategy.

Inspection and audit rights regarding the annual financial statements and other underlying documents regarding the calculation of the earn-out are indispensable for the seller, however not sufficient. Moreover, the earn-out mechanism should correct non-periodical, non-operational and extraordinary elements after the completion of the exit. In order to avoid any further misunderstanding, the parties preferably also include a calculation example in the purchase agreement reflecting the items of the income statement relevant for the agreed earn-out calculation. Finally, it is essential that the parties define the applicable accounting policies.

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### Tax risks of earn-out solutions

It is important that the seller has a potential earn-out mechanism reviewed for tax purposes: The gain on the sale of shares which are held as private assets is in principle tax-free. Where an earn-out clause is included in the purchase agreement, such mechanism is generally scrutinized carefully by the tax authorities, provided that it is linked to the seller's employment activity. In such a constellation the tax authorities may regard the earn-out payment as remuneration for performed work, which is classified as employment income (subject to tax and social security) and not as a (tax-free) capital gain.

### Conclusion

Earn-out solutions are suitable for start-ups as they can be attractive for both the selling shareholder and the buyer. However, the diverging interests of the parties require careful negotiations and detailed regulations in the purchase agreement. This also includes the procedure for determining the earn-out and dispute resolution proceedings if it is not possible to reach an agreement. In any event, earn-out structures have to be tailored to the individual case. Care should also be taken with regard to the milestones, since certain milestones might lead to a reclassification of the tax free capital gain. As earn-out solutions are prone to discussions if not to say litigation, we propose to find other suitable solutions, without an earn-out structure.

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## Facts and Figures

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| Organization | Wenger & Vieli Ltd. |
| Foundation | 1971 |
| Mission Statement | Having a strong focus on start-ups and venture capital, Wenger & Vieli strives to contribute to your venture's success by sharing our profound experience and expertise with you. |
| Employees | Approx. 100 lawyers, tax experts, consultants, paralegals, accountants and assistants |
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