

Preparing a Business for Sale - Earn Outs - The Ultimate Challenge!

By Quentin Solt

As part of our series of 'Preparing a Business for Sale' articles, this month boutique corporate finance lawyer, Quentin Solt, looks at the challenges associated with earn-outs, in an interesting and thought provoking article that is designed to help buyers and sellers enter the earn-out arena with their "eyes wide open".

In difficult economic times buyers are wary of paying too much for businesses, whilst sellers are concerned that they are underselling their assets. The value of a business can be determined in many ways, but the bottom line is usually the bottom line - that is to say, the economic value of the asset being acquired. Where the parties cannot agree the value which should be paid for a business, it can make sense to agree that the "hope value" is determined by reference to what actually happens: if the business booms, the seller gets "top dollar", if the business does not meet expectations, the buyer will not have "bought a pup". The mechanism for determining the price (or a part of it) by reference to future performance is commonly characterised as an earn-out.

The earn-out principle is simple enough but, as with so many things, delve a little deeper and a host of practical and tax related issues lurk beneath the surface.

As with all aspects of the sale process, preparation is key and forewarned is forearmed, and here are some "starters for ten" to engage thought processes:

- ▶ **Whose business is it** - the seller has sold the business and the buyer has bought it, so following completion of the sale the business clearly belongs to the buyer. However, the seller has sold it on the basis that the amount to be paid will depend on future performance, so the seller has a vested interest in ensuring that the business continues to operate so as to maximise the potential earn-out payment. The buyer, who has bought the business, will want to retain its freedom to run the business as it sees fit. There is obvious potential for conflict here: the buyer wants to run the business as best suits it, whilst the seller wants to maximise the potential earn-out value - these two drivers could result in the ways in which the parties want the business to be operated during the earn-out period being quite different. This very basic dichotomy is at the heart of many of the difficulties of agreeing the detail of the earn-out terms.
- ▶ **Safety valves** - where an earn-out is contemplated negotiations should be started from that position with open dialogue as to the amount that the parties expect should be paid if the earn-out is achieved, and - particularly important - the bases on which that expectation is predicated. These bases will range from agreeing how the relevant business will be ring-fenced (so that the earn-out can be measured), to determining the funding to be provided

to the business and will also extend right down to how the earn-out business will be run on a day-to-day basis. The seller will want to ensure that the buyer will procure that the business continues to run in the ordinary course and is not required to take on unprofitable business, and that the buyer does not artificially manipulate or “distort” the amount payable to the seller, divert or delay value which might otherwise contribute to the earn-out payment, or impose management or interest charges which have not previously been agreed. All these bases will need to be reflected in the legal documentation, and the more clearly they can be articulated at an early stage the less opportunity there will be for subsequent misunderstanding or costly and time consuming negotiation. Commonly, the negotiated end-result is that the parties agree to adhere to procedures for running the business on the basis that if those procedures are not followed the earn-out price may be adjusted to reflect the amount that an independent expert determines should have been achieved had the procedures been followed.

- ▶ **Buttoning down sooner rather than later** - it is sensible to ensure that both parties are advised by appropriately experienced lawyers, accountants and financial advisers at this early stage, to avoid one party subsequently receiving advice that what the parties thought had been agreed is, on analysis, “inappropriate”. When negotiating, both parties would also be well advised to remember the truth of the axiomatic “too good to be true”: if the deal which is struck is too good to be true, rest assured that at some point that will become apparent.
- ▶ **Earn-out period** - as a junior solicitor a partner once advised me that an earn-out of three years or more was the best recipe he knew for subsequent disappointment and litigation. Since then, I have seen nothing to make me doubt that partner’s wisdom. The longer the earn-out period the more risk there is for interests to diverge and issues arise. Of course, too short an earn-out period is self-defeating. 36 months is the longest period that in my experience can stand the earn-out stress test. Even 18 or 24 month periods can be pretty testing. I commonly recommend that it serves all parties well to agree a regular -perhaps monthly - reporting schedule of the key metrics, so that expectations can be managed and “nasty surprises” avoided. Regular reporting allows issues to be spotted - and addressed - much sooner than the conventional “end of year” wrap-up. Depending on the metric by reference to which the earn-out is determined, it may also be possible to agree it on a monthly basis, too. In my experience, the mere fact of this open communication channel can help to dissipate latent tension developing in to full-blown disagreements.
- ▶ **What is the correct metric** -the calculation of the earn-out element should reflect the basis on which the business is valued. The difficulty is that as soon as you diverge from empiric top line numbers, the parties fall into the vagaries of accounting treatment. Commonly the valuation metric will be calculated by reference to a financial measure, such as profits or net assets. Significant consideration needs to be given as to how the relevant financial

measure should be determined - does the buyer agree to adopt the business' current accounting policies? What happens if GAAP changes? How should new investments and "extraordinary items" be treated? If there are synergistic benefits, economies of scale improved purchase/ debt terms arising from the association with the buyer, how should these be treated? There is a clear dichotomy between striving to achieve the twin goals of fairness and keeping things simple. Except in the case of the very simplest earn-out arrangements, attempting to negotiate these terms without expert accounting and tax advice would be foolhardy.

- ▶ **Tax** - it is vital that the parties take tax advice at an early stage. In my experience, it can be valuable to consider the overall tax implications of the proposed transaction - I have been involved in deals where by reviewing tax treatments at an early stage from both parties' point of view we have been able to assess that the overall tax cost would be reduced by adopting some alternative structure (for example, selling assets on which the buyer could claim tax deductions for amortisation costs or structuring some sort of roll-over relief), and that the entire agreement can be restructured to both parties' benefit. Individual sellers will want to ensure that if they are able to benefit from entrepreneurs' relief, the full benefit is captured. For the individual seller there are two major "watch-out" issues that commonly arise. The first is that if a maximum price is specified (which publicly quoted companies may inset on in order to avoid "class tests"), there is a risk that capital gains tax will be assessed (in the year in which the sale is completed) on the maximum amount of the consideration rather than on the amount actually paid in that year. HMRC manuals, legislation and practice are not quite in line here, so the better route is to ensure that the whole issue is circumnavigated (which it can be). The second common issue is that there is a risk that, if the seller is treated as continuing as an employee of the business, the earn-out consideration may be taxed as employment income (with the employer accordingly liable to account for tax and NICs under the PAYE system).
- ▶ **Out of the box thinking** - there are many ways to "skin the cat", and the parties should really focus on what it is that they are trying to achieve by introducing an earn-out. Could the objective be achieved in another way: for example, could the seller retain some shares with cross options to buy/sell them at some point in the future (be very aware of potential tax implications here) or could the value that the earn-out is designed to reward be identified in some other way? The seller may wish to consider taking security for the amount promised to be paid by way of earn-out, perhaps security could be taken over the very business or shares which are being sold. I have seen this work well in practice. Convention has much to recommend it, but it does not always instantly provide the best answer.

These are just some headline thoughts, the interaction of the earn-out provisions with the parties' commercial intentions needs to be considered as a whole, and the finally agreed earn-out provisions also need to be considered in the light of the entire transaction documentation. As mentioned above, the principle behind the earn-out seems simple, but delving a little deeper shows that the parties need to give serious consideration to the relative merits of the introduction of this level of complexity.

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