Corporate earnout: when selling your company, an earnout agreement can seem like an attractive option—but things could get ugly if you're not careful

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IT'S TIME TO sell your business. You've found a buyer, and you're negotiating the terms of the sale. But there's a problem. While you predict triple-digit growth over the next three years, the buyer doubts your projections and refuses to pay more than a percentage of your asking price. The company's valuation is up in the air.

Enter the "earnout" agreement, a contract where the seller gets paid a percentage of the asking price and agrees to meet specific financial goals over a period of time to earn more money. For example, the buyer might agree to pay 90 percent of the company's purchase price upfront, with another payout contingent on fulfilling a three-year plan. An earnout agreement allows the seller and the buyer to compromise on what they feel the company is worth. Earnouts are also used when the buyer needs the seller to stick around to maximize company performance after the acquisition.

Earnouts are an attractive option in the post-dotcom era, where the focus has shifted from promising projections to post-acquisition performance. "Buyers aren't paying for potential anymore, not upfront. But they will pay for potential realized post-acquisition," says Dave Kauppi, president of Mid Market Capital, a Hinsdale, Illinois, business brokerage that works on mergers and acquisition deals.

Earning Your Keep

Earnout agreements can last up to five years and are calculated at anywhere between 10 percent and 30 percent of the purchase price, with payment made in cash or stock. Earnout goals can be based on a variety of targets, including net income, gross revenue, new clients generated, cash flow and earnings.

You'll have a nice payday if everything goes well, but understand what you're getting into. An earnout arrangement obligates you to keep working for the company after you've ceded most, or all, control to the buyer. "While the seller may have an equity interest, he's not going to make ultimate, big-picture policy decisions," says Mark J. Mihanovic, who's worked on both sides of earnout deals as a mergers and acquisitions partner with the McDermott Will & Emery law firm in Palo Alto, California. There's a risk the buyer could make poor business decisions that run the company into the ground, damaging the earnout. Noncompete clauses in these contracts, meanwhile, might keep you from pursuing similar business ideas. At the very least, chasing an earnout might take up all your time.

Your mojo to hit a series of long-term goals can fade, too, especially if you've made a lot of money from the initial sale. "The same incentive to make [the company] successful is usually not there. It's [a] natural human reaction," says Bruce Crair, a serial entrepreneur in San Marina, California, who sold business-networking company ZeroDegrees to Barry Diller's InteractiveCorp last year. Crair, 49, is bound by nondisclosure agreements regarding earnout deals he's signed, but he has firsthand advice about surviving the arrangement. Get as much money upfront on the sale as possible, and get used to the idea of being the buyer's employee. Also understand that an earnout isn't a sure thing. "Sign the agreement with the attitude that the only money [you're] going to get is what [you] get upfront," Crair says. "Everything else is gravy."

Keeping earnout agreements simple and measurable is important, says Robert F. Bruner, a professor of business administration at the University of Virginia in Charlottesville and author of Deals From Hell: M&A Lessons That Rise Above the Ashes. "Structuring an earnout is a real art form," he says. "You need to be very careful about the benchmarks against which the performance of the business unit will be evaluated."

Mihanovic encourages sellers to tie earnout contracts to unit sales or revenue instead of earnings--using earnings allows buyers to factor in high overhead expenses. Crair also stresses the importance of avoiding administrative chargebacks whenever possible. "Often, the parent company will charge the subsidiary companies a percentage of the parent company's costs on a pro rata basis," he says. "You need to make sure your earnouts are totally separate from that because the chargebacks aren't under your control." Finding a good lawyer who understands the fine print is essential.

Keep in mind that you're taking a gamble, and gamblers often lose. Crair notes that of the dozen or so earnout agreements he's observed, only one entrepreneur lasted more than a year. But sometimes gamblers win big. "You can allow [the buyer] to buy you out of the earnout three years into it if you're blowing away the numbers," Kauppi says. Now those are nice terms if you can get them.

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