

Hogan  
Lovells

Arnold & Porter

# Introduction to Earnouts

Mark Kurtenbach, Carlyn Williams and  
Sydnie Pennington

November 13, 2024



# Introductions



**Mark Kurtenbach**

Partner, Denver

+1 303 454 2460

[mark.kurtenbach@hoganlovells.com](mailto:mark.kurtenbach@hoganlovells.com)



**Carlyn Williams**

Partner, Arnold & Porter

+1 303 863 2364

[carlyn.williams@arnoldporter.com](mailto:carlyn.williams@arnoldporter.com)



**Sydnie Pennington**

Associate, Denver

+1 303 899 7300

[sydnie.pennington@hoganlovells.com](mailto:sydnie.pennington@hoganlovells.com)

# Background on Earnouts

- Addresses Valuation Gaps in Private Company M&A
  - Buyer mitigates valuation risk: contingent payment based on the actual future performance rather than projections
  - Seller gains potential upside: greater overall payment if milestones met
- Purchase and Sale Agreement Location
- Earnout Triggers
  - EBITDA / Gross Margin / Operating Income
  - Revenues (net)
  - Milestone, Regulatory Approval, Other

# Background on Earnouts

- Length of Earnout Period
- Type of Earnout Consideration
- Presence in Deals (contrast to life sciences deals)
  - 21% - 2022
  - 33% - 2023
- Dispute Risk + Rising Litigation
  - **Buyer:** unilateral discretion to manage business; minimize earnout payments
  - **Seller:** efforts to achieve + input on business; maximize earnout payments

# Valuation basics

## ■ Enterprise Value Basics

- EBITDA multiples
- Revenues multiples

## ■ Equity Value Bridge

- Enterprise Value
- (+) Cash
- (-) Debt
- (+/-) NWC excess/(deficiency)

# Earnout scorecard

Topic	Description	Buyer Position	Seller Position
<b>Earnout Trigger</b>	Revenue ( <i>Seller</i> )	Net of discounts, rebates, returns, bad debts, etc.	<b>Gross Revenues</b>
	Profitability ( <i>Buyer</i> )	<b>EBITDA</b>	Gross Margin
<b>Accounting Standard</b>	Past practices, methodology, etc.	Only if GAAP compliant	<b>Yes</b>
	GAAP	In effect at time	Frozen at closing

# Earnout scorecard

Topic	Description	Buyer Position	Seller Position
<b>Business Eligible for Earnout</b>	Growth of business	Organic - no M&A (consider even limiting to existing customers/technology)	All organic and inorganic growth included
	Buyer costs / allocations	Included	Excluded (consider up front fixed allocations)
	Seller continued employment	Yes	<b>No</b>
<b>Calculation Structure</b>	Calculation structure	All or nothing	Graduated payments over minimum thresholds
	Overall payment cap	<b>Yes</b>	No
	Measurement periods	Single period or clawback	Separated periods with no offset or clawback
	Timing for calculation	After completion of financial statement audit	ASAP
	Interim reporting	Yes w/ preclusive impact	Informational only

# Earnout scorecard

Topic	Description	Buyer Position	Seller Position
<b>Payment Certainty Topics</b>	Parent guaranty, LOC, etc.	No	Yes
	Impact of Buyer debt obligations	Lender may require payment subordination	Payment allowed absent event of default
	Acceleration of Payment (full/partial)	No (consider early buyout options)	Change of control Sale of acquired business Termination of principal(s)
	Stated interest (once due)	No	Yes + costs of collection
	Offset Right	Yes (indemnification or any other seller obligation)	No



# Earnout scorecard

Topic	Description	Buyer Position	Seller Position
<b>Operation of Business Following Closing</b>	Fiduciary duty imposed on Buyer	No	Yes
	Discretion to Operate	<b>Sole and absolute discretion</b> (consider non-circumvention)	<ul style="list-style-type: none"> <li>• Best Efforts or CRE</li> <li>• Overall goal to maximize earnout</li> <li>• Consistent with past practice</li> <li>• Minimum operating standards               <ul style="list-style-type: none"> <li>• Budget compliance</li> <li>• Pricing/margin protections</li> <li>• Retention of key employees</li> </ul> </li> <li>• No deferring of revenue/earnings               <ul style="list-style-type: none"> <li>• No acceleration of expenses                   <ul style="list-style-type: none"> <li>• No dispositions</li> </ul> </li> </ul> </li> <li>• Affiliate transaction protections               <ul style="list-style-type: none"> <li>• Separate books and records</li> </ul> </li> <li>• No NWC or accounting changes               <ul style="list-style-type: none"> <li>• Information access rights</li> </ul> </li> <li>• Stand-alone unit from buyer</li> </ul>

# Drafting Earnouts

- Formulas / Grids
- Example calculations
- General ledger accounts
- Definitions
  - Accounting Principles
  - GAAP
- Mechanics
  - Reporting Period
  - All or Nothing vs. Graduated
  - Audit and Inspection Rights
  - Dispute Resolution

# Q&A

