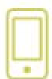
Roxburgh Milkins

Guide to Earn Outs and Deferred Consideration



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Introduction

It has been well documented that the credit crunch and subsequent recession led to a significant tightening of the availability of bank funding for transactions and a mismatch between the price expectations of buyers and sellers. This has resulted in an increase in the use of "alternative" funding structures for transactions such as structures involving deferred consideration and earn outs. The tougher economic climate and availability of cash has also led to more disputes, particularly over the calculation of earn outs when performance targets have not been achieved. In this guide we look at what deferred consideration and earn out deals are, when they are used and some of the points which buyers and sellers will need to consider.

What are they?

- A deferred consideration structure is any structure where the seller agrees to defer part of the purchase price in a transaction and is in effect lending that part of the purchase price to the buyer.
- An earn out is a mechanism by which all or, more commonly, some of the purchase price is calculated by reference to the future performance of the target company or business. This would normally be linked to the profits or sales of the target, but such a mechanism can involve any financial measure which is relevant to the target.

When are they used?

- **Deferred consideration** is normally used when the purchase price is fixed, but the buyer does not have the funding available from its own resources or from third parties (banks, venture capitalists etc) to pay all the purchase price on completion of the transaction. For an example see Box A.

Box A
The owner manager of A Ltd wishes to retire and sell the company to the next tier of management for an agreed price of £5m. The management team have raised £4m from a combination of their resources and a loan of £3.5m from XYZ Bank Plc, but are unable to raise the full £5m. The owner manager then has the choice of not doing the deal at all and continuing to run the business, reducing the purchase price or agreeing that he will defer part of the purchase price for a period which will enable the target to generate sufficient cash to pay the deferred consideration at the end of that period.

- **An earn out** is used when there is uncertainty about the future performance of the target business or where the target may have developed a product, revenue stream or significant contract the benefit of which is not reflected in the historic results and which the seller has not had the opportunity to develop to its full potential prior to sale. Buyers also like to use earn outs to incentivise and retain sellers in the crucial post completion period. For an example see Box B.

Box B
B Ltd has a number of products and has just signed a deal to distribute this product in the US. The seller is expecting the new distribution contract to double sales over the next 3 years, but the sales potential is unproven. The buyer is willing to offer £5m for the business, but the seller does not believe that this offer reflects the potential of the new distribution contract and is seeking a price of £7.5m. The buyer offers to pay £5m on completion and up to a further £2.5m depending upon the increase in the level of sales over the next three years and provided that the seller remains employed in the business during that three year period.

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What do I need to think about when using deferred consideration or an earn out – the legal bit

- **Timing and Conditions** - What are the timings of deferred consideration payments? Are there any conditions attached to payment? If so, these need to be sufficiently clear to enable achievement to be independently and objectively judged. If the buyer is entitled to set off any claims under the acquisition agreement against the deferred consideration or earn out then the procedure for this should be included in the agreement.
- **Interest** - Will the seller be paid any interest on the deferred consideration? If so, at what rate and when?
- **Mechanics of calculation** - Sellers and buyers will need to take care to ensure that the mechanics used to calculate the earn out accurately reflect their agreement. This will need to cover what is to be included and excluded from the relevant calculation, the relevant accounting principles to be applied to the calculation and the procedures and timing for production of the earn out accounts, agreement or determination of the accounts and payment.
- **Earn out protections** – A seller will normally want to include various protections during the earn out period so that he has the best chance of maximising the earn out. For example, the seller will want the buyer to undertake to carry on the business in the ordinary course, not divert business from the target, not put unreasonable management charges or intra group charges through the target etc. The buyer will not want to limit its freedom to run the target business after completion too much, so this is an area that is likely to involve some negotiation.
- **Continued Involvement of Sellers** - Will the payment of the earn out be dependent upon the seller remaining involved as an employee or consultant throughout the earn out period. If so, the seller will want protection against being forced to leave through no fault of his own. Usually, a seller will not lose a right to an earn out if he leaves as a result of death, critical illness or he is sacked without cause.
- **Security** - Is there any security available to secure the payment of the deferred consideration and/or the earn out to the seller? This may be in the form of a charge over the assets of the buyer and/or target, a bank guarantee or cash paid and held in an escrow account. Without security the seller will just be an unsecured creditor who needs to enforce a contractual claim through the courts and who will rank behind secured creditors in the event that the buyer is unable to pay.
- **Subordination** - Will the bank providing funding for the transaction require the seller's deferred consideration and/or security to be subordinated to the bank. In the example in Box A the bank will normally expect the seller to agree that it ranks behind the bank and that payments of interest and/or the deferred consideration will only be paid if the buyer is meeting its financial covenants under its lending arrangements with the bank.
- **Taxation** – the taxation of proceeds of sale received as deferred consideration or earn out is beyond the scope of this blog, but sellers should take advice at an early stage from their tax advisers on the tax treatment of any deal structure involving deferred consideration or an earn out

The Final Word

Earn outs and deferred consideration structures need to be treated with care because they can be a recipe for significant disagreement after completion. However, used properly they can be very successful for buyers and sellers, enabling deals to be done that might otherwise fail, allowing buyers to calculate the price paid for a business based upon its actual performance after completion and giving sellers the opportunity to maximise the price achievable on a sale.

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