Considering a Sale of Your Business? Be Familiar with the Concept of an Earnout

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If you are the owner of a radiology group, imaging center or other health industry service provider, you may wonder about the value of your business. If you are trying to sell your business, the answer you receive from a prospective buyer may not meet your expectations and may be downright disappointing. In such a situation, you and your potential buyer may be able to bridge a purchase price gap by using a mechanism called an “earnout”.

An earnout is an arrangement where the buyer of a business pays the seller additional consideration upon the business attaining certain predetermined goals following the closing of the acquisition. For example, if the seller believes its business is worth $20 million and the buyer believes it is worth $15 million, they could agree on an initial purchase price of $15 million to be paid at the closing, and an earnout would give the seller an opportunity to earn $5 million if the business meets the specified goals.

Typically, an earnout is proposed by the buyer, who wants to avoid overpaying for the business, to mitigate risk and if the buyer wants the seller to continue as an employee or consultant of the acquired business, to ensure that the seller has a stake in the future success of the business by keeping “skin in the game”. Before you agree to an earnout, consider the following issues:

1. Various performance metrics can be used when structuring an earnout. For example, the parties could base the earnout on certain financial metrics such as net revenue, net income or EBITDA. The earnout could also be based on the achievement of certain task-based milestones such as increasing the number of products sold or services provided. If the earnout is based on earnings, you should place restrictions on activities that could depress earnings (such as restricting the buyer from making large expenditures for long term research and development). You should also avoid an “all or nothing” approach and ensure that the earnout amount is paid based upon a sliding scale.
2. Your role, if any, in the management of the acquired business should be clearly defined. With an earnout, the management of the acquired business is going to determine whether the performance goals of the acquired business are met and whether you ultimately get paid. Therefore, the more that you can impact the future success of the acquired business, the more likely you will be able to minimize the risk that the acquired business will not achieve the specified earnout performance metrics.
3. The parties should address the “what if” factor and determine how the earnout will be impacted by the buyer (a) selling or merging the acquired business, (b) integrating the acquired business into the buyer’s other operations or (c) discontinuing the provision of certain services or product lines of the acquired business.

There are many other issues and points to consider in the process of arriving at a definitive agreement on an earnout, and a “one size fits all” approach is an invitation for litigation. The key to a successful negotiation is for both parties to consult with their legal, accounting and tax advisors as early as possible in order to ensure that an earnout is properly evaluated and negotiated. An earnout is not always the best solution; however, a carefully considered and diligently drafted earnout can create value for both the seller and the buyer, while mitigating each parties’ risks.

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