BMA ADVOGADOS

Earn-Out Clauses: Bridging Valuation Gaps Without Derailing the Deal

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Price is a central element of any contract and, in M&A transactions, is often one of the most heavily negotiated terms between buyer and seller. Determining the purchase price involves not only an analysis of historical financial performance, but also the parties' differing views, particularly as to the asset's future potential. Buyers and sellers typically rely on different assumptions in arriving at a valuation, and these divergences can make it difficult to agree on price – at times putting the deal itself at risk.

This is where the earn-out comes into play. An earn-out is a contractual mechanism under which a portion of the purchase price is deferred and made contingent on the target achieving specified financial or operational milestones post-closing. In practice, it allows the parties to share the risk associated with the business's future performance, serving as a bridge between differing valuation expectations.

Despite their advantages – including facilitating transactions, aligning pricing expectations, and even serving as a form of financing – earn-out provisions require careful structuring and drafting. Experience shows that earn-outs are a frequent source of post-closing disputes, particularly where the agreement lacks clarity around the calculation methodology and the management of the company's affairs during the earn-out period.

To mitigate the risk of disputes, earn-out provisions should be drafted with precision and clarity, addressing, among other things, the payment formula, performance targets, the applicable timeframe, relevant accounting standards, and any limits on management powers.

In fact, one of the main sources of conflict is the management of the company during the earn-out period: who will be responsible for managing the company, and what limits will apply to their decision-making? It is critical to address this issue at the negotiation stage, as the parties may have diverging incentives. While the seller may prioritize short-term performance to maximize the earn-out payment, the buyer may favor longer-term strategies that could temporarily depress results. This dynamic will depend on the structure of the transaction and the size of the stake acquired. In a full acquisition, the buyer will typically assume control of the business. In partial acquisitions, however, the seller often remains involved in management, making it essential to clearly define the scope and limits of the seller's role.

Where the earn-out payments are linked to financial metrics, it is critical to define the applicable accounting rules and underlying financial concepts. Seemingly straightforward issues – such as whether certain revenues, expenses, provisions, or extraordinary items are included or excluded – can materially impact the calculation of the earn-out payment and may give rise to disputes. In addition, the agreement should specify whether the calculation is based on the company's overall performance or the performance of a particular asset or business unit.

The agreement should also clearly establish the limits on the actions that management may take during the earn-out period. In the absence of such provisions, decisions will be governed by management's fiduciary duties and the best interests of the company, making it difficult to attribute liability if the projected targets are not met. In other words, failure to meet the targets, in itself, is not sufficient to establish liability.

Another important issue arises where payment of the earn-out is conditional on the seller remaining involved in the management of the company post-closing. While this structure can promote continuity and facilitate post-closing integration of the business, it may also result in disputes as to the legal nature of the amounts paid to the seller, particularly whether they constitute compensation for services, rather than part of the purchase price.

Negotiating an earn-out clause calls for more than commercial alignment between the parties: it requires careful legal analysis to define the applicable criteria, governance arrangements, and the risks involved. Properly designed, an earn-out should be seen not as a way of deferring disputes, but as a tool for avoiding them – and for enabling the successful completion of the transaction.

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