DEFERRED CONSIDERATION/ EARN-OUTS

On the sale of a business, many companies achieve a high goodwill value to reflect their historic profits. Buyers often try to mitigate their risk by differing some of the consideration. What is the reality for the Seller?

In an ideal world most sellers would like the total sale price to be paid in cash on completion. This can be an unreal expectation, as most transactions are likely to involve a payment linked to the company's future performance. This performance-related payment is not conditional upon the owners staying. It can be paid to the vendors even though they are no longer involved in the business. However is most cases 100% of the equity is sold at the outset, with a purchase consideration reflecting the current net asset value and future profits.

Why do purchasers like performance-related payments? The simple answer is comfort, confidence and funding. A purchaser may believe that he current owners are pivotal to future success and consequently wish to insure their commitment and against them leaving, by deferring payment over time. Alternatively, future profits maybe vulnerable if, for example, a major client is lost as a result of the sale. A purchaser would consequently look to defer payment until it is confident with a new client/ customer relationship.

Lastly, a purchaser may not have enough funding for the purchase on completion and would look to pay over a period of time.

How can a vendor guarantee these future payments? The usual way of securing deferred payments is an escrow account. This is a third party held bank account (usually a solicitor) which holds the funds that relate to the deferred consideration. When the targets are met, the funds are released. However, many purchasers do not have the ready surplus funds to place in an escrow account so other insurances have to be sought. Guarantees are an excellent second best from either the buyer's bank or from the buyers themselves. Other ways of securing payment are to retain title over some of the shares or to take a first/second charge over the acquiring company's assets. This however is likely to constitute "financial assistance" and a complex legal procedure known as a "whitewash" will need to be carried out.

Many sellers are uncomfortable about performance-related payments especially if they are not there to monitor or influence future business activities. A purchaser may make a mess of the business, but it is rarely deliberate, as most purchasers want to grow the business and not run it into the ground. By accepting a performance-related payment the vendor is saying, "I believe in my business and I believe in the purchaser's ability to continue my business and expand on what I have begun". Sellers should therefore seek the best buyer, make sure they have as much protection as possible and whilst it is a fact of life that they may need to accept a deferred payment, they should try and get as much as possible on completion.