

PURCHASE OF BUSINESS – EARN-OUT FORMULA

(Notes)

When transferring the ownership of a business through a sale of share, the valuation of the shares is frequently a significant source of conflict which sometimes imperils the execution of the sale.

This issue is mostly caused by the fact that, on one hand, the vendor refuses to discount the profit potential of the business he's selling, while on the other hand the purchaser does not want to acknowledge a speculative value for the same business, at least until he's certain that the business will effectively be able to generate the expected return on his investment.

To avoid stalling the transaction, the parties sometime agree on a two steps formula to calculate the sale price of the shares. The first step is usually the base price agreed upon for the business. It is, in a way, the floor price for the business.

The second step is essentially a performance bonus calculated according to the actual financial performance of the business. This bonus may subject to an upper limit, but that is not always the case. This portion of the sale price known as "earn-out" is conditional to attaining specific results, otherwise it shall not be due.

Even though it is an attractive scenario in theory, this type of mechanism is not always an appropriate addition to a sale of business agreement. In addition, even if it is an appropriate addition, such a mechanism requires a specific framework to create the desired result with as little trouble as possible.

First, the ideal situation to use this mechanism is when the vendor retains, despite the sale of the controlling interest, the operational control of the business for the entire duration of the reference period agreed upon by the parties for the calculation of the "earn-out" portion of the sale price. On the other hand, this mechanism must not be used if the vendor does not retain the operational control of the business, as without such control, the vendor depends solely on the performance of an unknown manager to obtain his due.

The choice reference amount for the calculation of the earn-out amount is known by the acronym "EBITDA" (Earnings Before Interests, Taxes, Depreciation and Amortization.) For example, in the calculation of the reference amount in a given transaction, the base price would be set at three times the mean EBITDA of the last three years and the earn-out amount would be calculated according to any surplus EBITDA during the reference period (for instance, three years from the sale). Of course, this illustration may vary in numerous ways.

In addition, if the parties elect to use this mechanism, it is important to create provisions protecting the integrity of the mechanism for the entire reference period. Such provisions concern the following matter: