SELLING YOUR BUSINESS: STRUCTURING EARNOUTS AND DEFERRED PAYMENT PLANS

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The Devil Is In The Details

The great thing about selling your business with an earnout component or seller-provided financing is that these factors help you maximize your price, but they can be tricky to work with. What seems pretty simple early can get a lot more traumatic once the lawyers and accountants start to get the details down on paper.

This is a complex topic since no two deals are exactly the same. In this article I will outline some of the things you need to think about when putting an earnout deal together, but there is no substitute for getting some solid professional advice as early as possible.

A Note On The Special Case Buyer

Please note that this article assumes you are selling to an arm's length third party buyer. There are other articles on our website www.thompsonlaw.ca dealing with structuring transactions when you are selling to family members, existing partners, or existing employees or managers. If you are thinking about selling to a buyer from one of those categories, be sure to research materials devoted to that specialty buyer.

Make A Commercially Sensible Deal

After making sure you have the right people to buy your business, your next priority is to make a commercially sensible deal for both parties, which should include three main elements:

- *Make sure you agree on a fair price for your business*. You must resist any temptation either to sell yourself short or to put an excessive burden on your buyers. If the price is too low, you won't have been fair to yourself and may not secure what you need to meet your financial needs or goals. If the price is too high, you risk demoralizing your buyers after the deal is closed, resulting in a very unhappy buyer who will still owe you a lot of money, or even destroy the deal altogether. Buyers who come to realize that they have taken on a burden that is unfair or unrealistic have been known to walk away. Get good professional advisors involved and make a realistic assessment of what you have to sell.
- *Make sure the deal is financeable on reasonable terms*. Even after you get a deal on price, you need to make sure that is financeable on terms that are reasonable to both parties. This means not only third party financing, but that the business can carry the cash flow burden of the buyout. Accounting assistance is important, because pro forma income statements, balance sheets and cash flows are critical tools needed to test the financeability of your deal. You don't want to take too long to get paid, and your buyers don't want to be paying you off for years and years. You don't want to burden the business so much that it lacks the capacity

to meet new challenges or exploit new opportunities. On the other hand, you don't want to leave financing opportunities on the table. It is not an easy balancing act. However the right parties with the right attitude, working with good professional advisors, can make it work.

- *Make sure the deal is good for the business and all its stakeholders*. Ultimately, these deals are about the business. You can put a deal in place that you can look back on with pride as you see your business continue to thrive and prosper. Or you can put a deal in place that ultimately sets the business on a slow drift toward the rocks. Sometimes it is not clear which is which until well after the deal closes.

Issues To Address

There are lots of important details to sort out when structuring a deal to buy or sell a business.

There are even more complications than usual when structuring a deal with an earnout component or deferred purchase price component or both.

Some buyers are only looking for a chance to try something out with the freedom to change their mind after the deal is closed. This can make things very difficult for an owner manager who wants a solid deal to sell their business so they can get on with their lives.

On the other hand, some owner managers have difficulty letting go, and structure a deal that takes too long for the buyer to step into the dominant position in the company.

Here are some hurdles that earnout and deferred purchase price deals must clear if they are going to work:

- *The buyer should put as much money into the deal as possible*. The seller should avoid providing 100% of the financing, even for someone they like. Deals tend to work better if the buyer puts up as much real money as possible. It may not be much compared to the overall purchase price, but it should seem like a lot to them. It's evidence of their commitment. It puts them at risk. It gives them a sense of ownership. It might come from a mortgage on their house, it might be borrowed from a relative, or simply or it might be a significant reduction in pay. Whatever it is, it's best to have something tangible on the table.
- *The parties must balance how the buyer can lever the assets of the purchased business to finance the purchase price*. If the buyer can finance 100% of the purchase price using his or her own money and company assets, then the seller doesn't need to worry. However, if the deal needs money from the buyer, plus money raised against the assets of the company, plus a deferred purchase price component provided by security to the seller, then the seller has to be careful. If the proposed security for the deferred purchase price component includes the assets of the business, then the extent of financing raised by the buyer ranking ahead of the seller can be a big issue. If the assets of the business are over-levered, the business will be more vulnerable to a downturn and fortunes and the buyer is more likely to default on the deferred payments to the seller. In addition, the seller will end up having to assume a lot of debt if taking the business back to realize on the seller's security is a likely outcome of default. The definitive agreements should contain formulas and other mechanisms to protect the seller from a buyer who over-levers the business, while leaving the buyer enough room to properly fund operations, expansion and the payments to be made to the seller.
- *The parties should consider and negotiate an interest rate component*. The buyer should be motivated to payout the seller as soon as possible. One way to do that is to add an interest

component on any deferred purchase payments at a rate at the high end of the range of capital, term or operating loans that the buyer could. This encourages the buyer to finance elsewhere as much as possible, and reflects the high risk of the capital provided by the seller. However, the interest rate must not be crippling, punitive or demoralizing. It must be fair, without potentially wrecking the deal. If the buyer becomes capable of replacing all or some of the seller's more expensive money with less expensive money, he or she should be able to do so without penalty, provided that the overall security position of the seller is not significantly impaired by the new financing.

- *You need to secure the unpaid part of the purchase price*. Since the seller is giving up a significant amount of control, it is likely that the buyer will have much more impact on the likelihood of a successful earnout than the seller. Additionally, one common reason for selling in the first place is to reduce the risk of negative developments in the business. This risk is only eliminated to the extent that the purchase price is actually paid. This is why there is usually a significant security component in an earnout detail. Sometimes it involves assets other than the business or parties other than the buyer or both. Occasionally real estate or other significant assets or guarantees are pledged to support the earnout or deferred part of the purchase price. However, the security for an earnout or vendor take back financing usually includes a pledge of the purchased shares or all shares of the business (if a share deal), plus security over all the assets of the purchased business ranking behind normal trade debt and bank and other third party financing. The detailed agreements must include parameters on any financing ranking in priority, reporting and accountability mechanics so the seller can keep tabs on things, notices of default from the seller and options to cure from the buyer, acceleration clauses, and ultimately rights to enforce the security by taking over, taking back or selling some or all of the secured assets with or without forfeiture of all or some of the purchase price paid to date. All in all, this is a pretty complex part of any deal, and good professional advisors and lots of patience will be required to get through this thorny issue.

- *The parties need to consider the use of holdbacks.* In some deals the buyer has the money to pay the entire purchase price up front, but is looking to tie some of the purchase price to post-closing performance by the company, the seller, a major customer or a supplier. In those cases it is not unusual for the buyer to prepay the potential purchase price to one of the lawyers in trust, to be released when the post-closing performance has been achieved or if it has not been achieved within an agreed time-frame. The terms of the holdback need to be carefully spelled out to avoid disputes.

- *Setoff rights need to be considered.* Along the same lines, setoff rights need to be considered. "Setoff" is the idea that if I owe you $100, and you owe me $20, I can setoff what you owe me against what I owe you, pay you $80, and release you from your $20 obligation. Setoff rights are not automatic in purchase and sale transactions. In earnout and deferred payment transactions, the parties need to consider who can setoff what, when they can do it, what kind of notice must be given, what kind of chance the other party should have to fix the problem, and how disputes will be handled. You also need to consider what happens if a third party causes the setoff. For example, if a buyer has the right to setoff a future payment because one of the company customer's did not pay a receivable owing as of closing, there is no reason why that bad debt can not be assigned to the seller so they can try to collect it. The seller should be given the chance to collect this money if they want to. This kind of thinking can also apply to inventory that has not turned over and other financial contingencies that cost the seller purchase price.

_ *The buyer should make serious commitments on matters other than price and payments*. The buyer needs to focus on paying the purchase price before running too far ahead with his or her own plans for the company. Additionally, if the deal is too easy to escape, the buyer may not push hard if something unexpected or difficult arises. No one wants to unwind a deal a good one. Typical commitments include:

- Security for the unpaid purchase price.
- Reporting and accountability to the seller.
- Limits on other third party financing without seller approval.
- Limits on capital expenditures without seller approval.
- Limits hiring and operational expansion without seller approval.
- Limits on profit taking, and redirecting of profits to the seller in payment of the deferred purchase price component, before the buyer gets to take any profits out of the company.
- Salary and compensation caps on the buyer.
- Non-competition and non-solicitation obligations imposed on the buyer that keep the buyer tied to this business and penalize a buyer for leaving before paying off the purchase price.
- Consent to the seller taking back or selling all or part of the business if a serious default is made which is not rectified.

As a seller, you are looking for real commitment. You want to see appreciation. You want to see risk. You want to see the buyer's belief in himself or herself, in the business and in the deal.

_ *The seller needs to be willing to let go on a reasonable timetable*. There is a temptation for the seller to hang on to control until the last dollar is paid. This does not work well in some deals, especially if the payout is over a period of years. There needs to be some defined tipping point. Depending on the deal, it may happen at closing. However, even if it does not go that way, the buyer should have a significantly elevated position of authority right away – a seat on the board, a position as an officer of the company, and leadership of key commitments. Based on the chosen points of reference – passage of time, payment of a certain percentage of the price, the business achieving certain milestones – the buyer should assume an equal position of responsibility and authority. Finally, based on the next level of reference, the buyer should end up with the primary and majority position in the company. The timetable should be explicit, acceptable to everyone, and should motivate the buyer and the seller to work together to meet their goals quickly.

_ *There need to be milestones, and consequences for missing them*. This can be a tricky issue, especially if the buyer is not in control of the business from the outset. But they are nevertheless necessary. The milestones may include failure to make certain payments, or to get the business to certain milestones. The consequences can include interest rate adjustments, reductions in personal compensation, purchase price adjustments, termination without a severance package, or an unwinding of all or part of the deal. No two deals are identical, but creative and experienced professional advisors can help you and your manager buyer work out a system that is fair and commercially sensible.

- *You need to spell out how profits will be used*. Businesses need profits for many reasons – to pay down debt, to fund capital expenditures, to fund research and development, to fund new opportunities, to provide bonuses, raises or improved benefits to employees, and to provide return on investment to its owners. A management-led buyout has all of these needs, plus the profits are necessary to pay off the purchase price. You need to work out who will make the decisions on how to use the profits, especially if there is surplus money available. It is not unusual in management-led buyouts for the buyers to agree that all profits of the company which they payout out to themselves for bonuses and dividends must be applied to the purchase price after payment of any relevant tax burdens. This allows them to leave profits in the business if they want to, which improves the security for the seller, but makes paying for the business the first priority for any profits they want to take out for themselves. This prevents the buyers from improving their personal financial situation – other than by improving the value of their shares in the business – until they take care of their financial commitments to the seller.

- *You need to deal with ongoing financial needs of the business*. If the payout takes place over time and the seller has taken back security on the company to support the payment of the purchase price, you still need to allow the primary needs of the business to be financed so the business will continue to grow. It is not unusual for the seller to be obligated to postpone his or her security in the company assets to new and ongoing bank financing, as long as that money is being used in operations and not to distribute profits to the buyers. The deal needs to consider who makes such decisions, how they get made, and what limits are imposed on the parties. The seller won't want to postpone to financing that he or she thinks is too expensive, is unreasonable, or will not be used wisely.

- *You need to deal with other operational decisions*. Until he or she is paid out in full, the seller is going to be seriously interested in the operational decisions made by the company. They are going to want payment of their purchase price to be a priority, and won't want jeopardize that requirement. It is not unusual to place operational limits on the business, including capital expenditures, expansions, geographic locations, and similar matters. This needs to be acceptable to the buyer and the seller, and to tie in to the level of control the seller is going to have as the deal goes forward, including any milestones that determine when that control is lessened or eliminated over time.

- *You need to deal with the offer that cannot be refused*. Either the buyer or the seller may receive a post-closing offer to buy the business from a third party that they simply "can't refuse". Your deal needs to address how to deal with them. It is not unusual for the seller to continue to have the right, until certain milestones are reached, to accept such offers subject to a right of first refusal in favour of the existing buyer. It also not unusual to authorize the buyer to accept such offers, as long as they are sufficient to pay off the purchase price in full. Sometimes they also contain price adjustment clauses, so that if the third party buyer is paying more than an initial threshold, then the manager-buyer does not get to keep all of the windfall but has to share it with the owner-manager-seller if the buyer accepts the third party offer, and the seller-owner-manager has to share it with his or her manager-buyer if it is the seller-owner-manager who triggers acceptance of the third party offer.

Planning For Problems After Closing

Your deal also needs to address certain "unthinkables":

_ *Your death*. Depending on how your deal is structured, your death might have a big impact on the deal. It can certainly affect things if you were planning to stay involved to steward the business or mentor your buyer. It could also affect things if you were relying upon taking the business back if things didn't work out. Your death could trigger an acceleration of the purchase price including an option for your estate to sell the business to a third party if the buyer could not meet the terms of the acceleration. They may also be a role for insurance in this situation

_ *The death of your buyer*. Your whole succession plan could go out the window if your manager-buyer dies. The deal may have to be unwound in some way that is fair to everyone. Again, there may be issues of acceleration, or a role for insurance.

_ *Disability – yours or your buyer's*. Similar issues arise if the buyer or seller becomes disabled in some way. If the buyer or seller are active in the business when the disability occurs it could be devastating to the deal. Unwinding the deal or selling to third parties are always options, but insurance is not as useful in managing this risk.

_ *Default must be anticipated*. Things could go wrong and your buyer could end up defaulting in some way. While the issues are not greatly different from a third party sale if this occurs, it could be significant that your defaulting buyer was and probably continues to be a key employee. Not only do you lose your succession plan and your buyer, you might lose a key employee. This is where security documents become very important, including notice provisions and any rights to take the business back or sell it to someone else. This is also where security outside the company can become important, since in many cases the business is in pretty sad shape by the time the buyer defaults.

_ *Someone changing their mind*. Sometimes people regret these deals after they have closed. Buyer's remorse as well as seller's remorse must be considered. Some buyers want to test drive before they buy. Some deals are structured to give the parties an opportunity to do so, either with options to buy, or with optional staged buy-ins. Or sometimes the seller has the option of selling a part of the business (e.g. 50%), and then deciding not to proceed with the rest. While these situations are rare, they need to be considered.

Insolvency - Yours, Theirs Or The Company's

Another "unthinkable" subject is insolvency. Privately owned businesses are inherently high-risk investments. They lack the management and financial depth of larger enterprises, making them tricky to manage. Most of us would rather ride out a storm in a large cruise ship than a canoe, even if the canoe is more maneuverable in some conditions. That risk will not disappear while you are waiting for your buyer to finish paying you. They might even go up. Therefore, the risk of insolvency can also be a thorny issue in a management-led buyout:

_ *Your insolvency*. Your insolvency after closing probably does not make much difference. Your creditors will simply step into your shoes. The buyer might insist that certain rights be personal to you, such as the right to take over management of the company. Certain rights and remedies might unwind if you are not around to personally execute on them. But overall, the insolvency of the seller is not usually a significant issue in a management buyout.

- *Your buyer's insolvency*. Your buyer's insolvency after closing is a major event. It opens the door for the creditors of the buyer to take over the deal. Most outgoing owner managers find this unacceptable. Most management-led buyouts of owner-managed business provide serious remedies in favour of the seller if the buyer goes bankrupt or into insolvency. The buyer should not care how draconian those rights are, since the point of the deal was not to enrich the buyer's creditors.
- *The insolvency of the business*. The insolvency of the business after closing can be catastrophic. You can not only lose the performance part of your purchase price, but also the ability to get the purchase price at all. On top of that, you won't be thrilled at the opportunity to take back an insolvent company. Your deal must be structured to allow for problems to be intercepted before they occur.

Typical risk management techniques for these problems include:

- Your ongoing involvement.
- Distribution of financial reports.
- Access to information.
- Ongoing board representation.
- Limitations on decision-making (expansion, hirings, capital expenditures, borrowing).
- Maintenance of basic financial covenants (tangible net worth, liquidity, profit distribution).

Your deal must also allow you to take the reins if things take a turn for the worse. There are many ways of doing this, including:

- Retaking board majority.
- Suspension of buyout.
- Rights to unwind all or part of the deal.
- Taking over management control.
- Enforcing security rights.
- Receivership.
- Taking the business back.
- Selling the business to someone else.
- Realizing on outside security.

The important thing is to do what you can to increase the chances of getting purchase price you contracted for in a situation where you may no longer be in control of the business. The risk needs to be identified, quantified and managed.

Concluding Thoughts

There is no question that earnouts and deferred purchase price deals can be a practical or even necessary part of an owner-manager's deal to exit their business. When they work, they work very well.

However, a poorly structured earnout or deferred purchase price deal can be a disaster for the seller-owner manager, for the buyer, and for the company.

Not only can you lose your succession plan, you can end up with a struggling company without some the key people you would normally count on to help you through tough times.

The keys to buyouts with these components include excellent professional advisors and lots of patience when putting the deal together.

However, just like any other successful deal, what you need most of all is the right people with the right attitude, open communication, and mutually committed to a satisfying and fair win-win transaction.