

Acquire enough companies and you will eventually face the same negotiating moment: the seller believes the business will surge under new ownership, you believe your forecast already stretches reality, and neither side wants to blink on price. Earnouts exist to bridge that gap. They convert a portion of the purchase price into a future payment tied to performance, pulling price from opinion into outcomes. They can be brilliant, messy, or both, and the difference usually comes down to clarity, incentives, and discipline in execution.

I have seen earnouts save deals that were circling the drain, align founders and buyers through fragile transitions, and unlock value from unproven bets like new product launches or regulatory approvals. I have also seen them sour relationships when metrics were poorly defined or when integration changed the trajectory in ways no one anticipated. If you are Buying a Business or undertaking Business Acquisition Training for your team, understanding how earnouts really function in practice is essential.

What an earnout actually is, beyond the definition

At its core, an earnout is a contingent payment. The buyer pays a portion of the price at closing, then pays more if the business hits agreed targets after closing. The most common triggers are revenue, EBITDA, or gross margin targets. In tech and life sciences, I often see product milestones or regulatory approvals layered into the structure. The duration usually ranges from 12 to 36 months, although I have negotiated five-year earnouts for longer sales cycles.

Most earnouts are all-cash if achieved, but I have also seen payments in buyer equity or a mix that includes credits against indemnity claims. The flavor usually reflects the buyer’s balance sheet and the seller’s tax and liquidity preferences. What matters more than the payment medium is the specificity of the calculation, the control dynamics, and the path for resolving disputes without burning goodwill.

A simple example works best. Suppose a buyer agrees to pay 6 million at closing, plus up to 4 million tied to EBITDA over the next two years. If EBITDA equals or exceeds 2 million in year one, the seller receives 1.5 million; if it equals or exceeds 3 million in year two, the seller receives 2.5 million; otherwise, the payment scales down at preset tiers. Targets, tiers, and timeline are explicit, and both sides know the rules.

Where earnouts shine

Earnouts are most valuable in businesses with genuine uncertainty around forward performance. Think of a small software company about to commercialize a promising module, or a services firm with two outsized customers nearing renewal. The seller asks you to pay for potential. You need more evidence. The earnout pays for potential if it becomes performance.

They are also useful when a founder’s ongoing involvement is a material value driver but trust is new. The seller believes their relationships will keep the top line intact through the handoff. You are betting on those relationships too, but you are not ready to price them in fully at close. An earnout pays the founder for actually delivering continuity, not for promising it.

In roll-up strategies, earnouts can tune acquisition price to post-close integration success. For example, in a dental or veterinary consolidation, new patient growth and provider retention over the first 18 months often predict lifetime value under the platform. A lightweight earnout keyed to those metrics can stabilize valuations when trailing financials sit at cyclical peaks.

The flip side: when earnouts break trust

The chief risk with earnouts is misalignment. After closing, the buyer controls key decisions that affect whether targets are met. If the contract language leaves room for interpretation, disagreements start early. A simple operational change like shifting advertising spend, consolidating vendors, or moving accounting policies to the buyer’s standards can swing revenue recognition or margin. If the seller feels sandbagged, the relationship deteriorates.

Another common failure mode appears in downturns. The parties build targets on a base case that assumes normal market conditions. A slowdown hits, and the seller blames the buyer for not investing enough to offset it. The buyer claims prudence and capital allocation duties. The earnout dies on the vine, and both sides spend money on lawyers.

I once watched a marketing agency earnout implode because the buyer centralized lead generation faster than planned, then prioritized other portfolio companies in the same funnel. The sellers saw their pipeline drop, missed the earnout by a hair, and

sued. Everyone lost. Had the earnout defined lead allocation rules or carved out a stand-alone budget and channel strategy, the outcome could have been different.

Choosing the right metric is half the battle

The metric you choose should reflect value creation, be measurable with minimal manipulation, and tie to levers the seller can influence. Revenue is easy to track and hard to game, but it can encourage discounting and ignore profitability. EBITDA is closer to value, but creates opportunities to dispute allocations, shared services, and one-off items. Gross profit often hits the sweet spot in product-based businesses with relatively stable cost accounting. In subscription software, net revenue retention, new annual recurring revenue, or churn can all make sense, but each requires cleaner data hygiene and careful definitions.

Avoid composite metrics that blend several inputs unless you have the accounting sophistication to track them cleanly. Every extra metric multiplies the chances of ambiguity. If your integration plan involves major system migrations, ask yourself whether you can reliably measure the chosen metric across the cutover. If the answer is “probably,” it is the wrong metric.

Two practical rules from the trenches help:

- Pick the simplest defensible metric, then define it down to the footnotes. If using EBITDA, lock in accounting policies, treatment of stock comp, and allocation of corporate overhead, with specific dollar caps if needed.

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- Align the metric with who holds the levers. If the seller will run sales for 18 months, revenue or bookings can be fair. If you are absorbing the back office and setting pricing, be careful with margin-based hurdles that you control more than they do.

Anatomy of a well-drafted earnout

Good earnouts read like operating manuals. They specify the math, the data sources, the calendar, the authority structure, the dispute mechanism, and the guardrails on post-close changes. When I train junior associates in Business Acquisition Training programs, I tell them to imagine they will have to administer this contract with a skeptical auditor and an impatient CFO three years from now. If you cannot compute the payout in an afternoon with the documents alone, it is not ready.

Key ingredients that repeatedly prove their worth include a clear definitions schedule that fixes revenue recognition policies, bad debt reserves, returns, discounts, and timing. Overhead allocations should be either zero, formula-based with a fixed percentage, or capped so the buyer cannot inflate costs into the target company. The timeline should map to reporting rhythms: quarterly tracking, annual payout, 60 days to review, 30 days to dispute, and a named neutral accountant whose decision is final absent manifest error.

Control provisions need nuance. Sellers want the buyer to operate the business “consistent with past practice.” Buyers hate that phrase, because it handcuffs integration. The compromise is a set of carve-outs that protect the earnout’s integrity without freezing the company in amber. For example, the buyer can consolidate IT, accounting, and HR, but will maintain a minimum marketing spend, honor pre-close pricing corridors for top customers, and avoid moving the sales team to unrelated product lines without the seller’s consent, not to be unreasonably withheld.

You also want covenants around data access. Sellers need timely insight into performance. Buyers need to run the business without a second set of hands on the throttle. Monthly reporting access for the earnout metrics, read-only visibility into the CRM or ERP fields that drive those metrics, and a regular operating review cadence often strike the right balance.

The tax angle that often gets ignored

The tax treatment of earnouts can swing net proceeds by six figures or more in the lower middle market. Structure determines character. If the earnout is additional purchase price contingent on future events, it is typically treated as capital gain when paid. If it is tied to continued employment and subject to forfeiture on termination, the IRS may view it as compensation, taxed as ordinary income and subject to payroll taxes. Facts and contract language both matter.

I have worked with sellers who demanded to be “terminated” after 90 days to trigger severance that would not poison their earnout’s capital treatment. Others chose a clean separation from employment and a consulting agreement that carved the earnout out of the service relationship. The safe path is to involve tax counsel early, be explicit in the agreements about the earnout’s purchase-price nature, and avoid terms that look like a bonus plan disguised as contingent consideration.

On the buyer side, contingent consideration can affect purchase accounting. If you are on GAAP, fair value changes to the earnout liability may flow through P&L each period. That creates volatility and can confuse internal stakeholders who did not expect post-close adjustments to earnings from the deal economics. <https://imarketing.courses/product/jonathan-jay-the-complete-business-buying-course/> Finance teams appreciate heads-up modeling and a policy for updating assumptions.

Incentives and behavior, not just math

Numbers alone will not make an earnout work. You need honest alignment on what success looks like, and then you need to back that up with incentives and authority. If you expect the seller to drive growth, compensate them to do that and give them enough control to execute. If they are moving into a strategic advisory role, do not pretend they will drive the P&L. Link their earnout to milestones they can actually push across the line, such as key account renewals or partner launches.

Be wary of the sandbag effect. If the earnout pays heavily for hitting a cliff at year two and nothing beyond, managers may defer revenue to the earnout window or delay investments that pay off after the earnout expires. The antidote lies in graduated payout curves rather than cliffs, caps that do not feel confiscatory, and a broader incentive plan for the post-earnout period so managers do not pivot to zero-sum thinking.

One mid-market industrial buyer I advised solved this by layering a modest management incentive plan that extended two years past the earnout, keyed to the same metrics. Sellers-turned-executives knew that the behavior that helped during the earnout period would still pay later, so they did not hoard backlog or starve maintenance.

Real-world patterns by industry

In software, revenue-based earnouts are common, but I prefer ARR growth or net dollar retention if the systems can support tracking. Churn attribution must be [Buy a Business](#) handled carefully. If the buyer changes pricing or packaging, document how to adjust historical baselines.

In healthcare services, payor mix and provider retention drive outcomes. Earnouts that tie to provider headcount, new patient starts, or trailing twelve-month collections can be clean if billing systems are stable. Watch for lag effects that make a twelve-

month earnout too short to capture the revenue cycle's timing.

Consumer products often use gross margin dollars or channel-specific revenue to avoid channel stuffing risks. If the buyer introduces new distribution, the parties should clarify whether those sales count toward the earnout, particularly if the seller's historical brand work underpins the lift.

In regulated industries and certain hardware categories, milestone-based earnouts tied to approvals, certifications, or production ramp can be superior to financial metrics. They reduce accounting fights and pay only when objective markers arrive.

Integration strategy and the earnout's health

Integration decisions can nurture or kill an earnout. If your plan relies on consolidating salesforces or replatforming the tech stack early, budget time and risk against the earnout targets accordingly, or carve the affected lines out of the metric until the dust settles. Too many buyers rush to standardize systems, then discover that data integrity for the earnout metric was a casualty of the switchover.

Run a pre-close simulation of the first two reporting cycles with actual data. Pull the trial balance, model revenue recognition under the buyer's policy, and see how the metric would have tallied over the past year. This "day zero" audit is tedious and invaluable. It spots disagreements early, and it often trims several pages of future dispute letters.

Communication cadence matters too. I prefer a standing monthly review between the buyer's deal lead, the operating executive accountable for the earnout, and the seller's designee. They walk the metric, flag operational variances, and confirm that planned changes do not accidentally disqualify otherwise valid wins. It is more governance than ceremony. When surprises pop up, everyone has context and fewer conspiracy theories.

Caps, floors, and the shape of the payout

A fair earnout balances upside with predictability. Sellers like uncapped upside. Buyers prefer certainty and want to avoid paying for windfalls that stem from buyer-led investments. The middle ground is a cap that still feels generous relative to the base case, with a payout curve that is smooth rather than cliffy. If the model says the seller has a 60 percent chance to earn 60 to 80 percent of the contingent amount and a 10 percent chance to hit the top, the incentives feel real without turning into lottery tickets.

Conversely, minimum thresholds, or floors, can deter gamesmanship around lowball projections. A modest minimum payout if the business stays within a band of historical performance can smooth relations, especially when external shocks hit. I avoid guaranteed minimums unconnected to performance, because they dull the alignment you are trying to create, but I have used low-band floors to give sellers comfort that reasonable stewardship will not be punished.

Payment timing deserves more care than it usually gets. Quarterly payments improve cash flow and reinforce good behavior, but they increase administration. Annual payments reduce noise but risk large single-issue disputes. Some buyers split the difference with quarterly tracking and true-up at year end, which usually works well if definitions are tight.

Disputes: resolve them fast and keep moving

Despite best efforts, some earnouts end in disagreement. You can minimize damage by agreeing ahead of time to a dispute ladder: first, a finance-to-finance meeting to align on numbers, then executive-level discussion to settle business judgments, then an independent accountant to adjudicate the accounting issues within a short window. Keep lawyers in the loop but off the front line until it truly becomes legal.

Arbitration is better than litigation for these fights, but it is still slow and expensive. An accountant acting as expert, not arbitrator, with authority limited to calculations under defined policies, often resolves 80 percent of disputes far more quickly. Designate the firm in the agreement and spell out the scope of their review so you do not waste weeks negotiating process when tempers are high.

When to skip the earnout entirely

Not every valuation gap deserves an earnout. If the uncertainty is macroeconomic rather than business-specific, or if your integration will radically alter the cost structure in the first quarter, you may never be able to measure the earnout fairly. In those cases, a straight price reduction or a seller note with performance kickers tied to buyer-controlled milestones can be cleaner.

If the seller is exiting completely and will have no influence over post-close results, be cautious about dangling a material earnout. You risk paying for something no one can drive. A small token tied to passive milestones can be fine, but large contingent payments without corresponding control breed resentment.

Finally, if you cannot commit to consistent operating policies for the earnout period because of known strategy shifts, admit it early and negotiate a different solution. Pretending you can maintain “past practices” while planning to overhaul go-to-market is a recipe for conflict.

Practical checklist for buyers and sellers

Use this short list as a final scrub before you sign.

- Is the metric as simple as possible, defined with precision, and supported by systems that can track it day one?
- Does the party with the most influence over the outcome carry the incentive and the authority to act?
- Are accounting policies, overhead allocations, and permitted operational changes spelled out, with examples where needed?
- Have you mapped a dispute ladder with clear timelines and a named independent accountant?
- Do the tax and purchase accounting consequences match your intent, and are they reflected in the documentation?

A brief vignette: the good version

A European industrial buyer acquired a niche US controls integrator. The seller believed a new OEM relationship would triple revenue within two years. The buyer valued the relationship, but saw execution risk and a frothy cycle. They agreed to 12 million at closing, plus up to 6 million over three years, paid on gross profit dollars from the OEM channel only. They fixed pricing corridors, minimum marketing commitments, and carved out shared services allocations entirely for earnout purposes. Data came from the OEM’s purchase orders and the buyer’s ERP, reconciled monthly.



Year one, the OEM slipped a product launch by a quarter, but volumes surged thereafter. The seller missed the first-year tier, hit the second, and exceeded the third. The earnout paid 5.2 million total, just under the cap. No disputes, because the scope and data sources were crystal clear. The seller stayed on as a board advisor through year four. The buyer integrated operations gradually and avoided touching the sales channel until the earnout period ended. Both sides felt the price tracked reality.

A brief vignette: the bad version

A mid-market private equity fund bought a digital agency with a large Fortune 100 client. The earnout depended on EBITDA. The buyer centralized vendor contracts and introduced a shared creative pool with cross-charges. They also moved to accruals that accelerated recognition of annual bonuses as monthly expenses. The seller watched margins compress despite healthy revenue. Quarterly statements under the earnout showed misses by a few percentage points, primarily due to allocations the seller had never contemplated. The parties burned nine months in dispute, then settled at a steep discount to the headline earnout after legal fees that neither side budgeted. If they had used revenue from the key account as the metric, capped overhead allocations, or put EBITDA definitions in writing with explicit examples, the result could have been very different.

Final guidance for operators and deal teams

Treat an earnout like a product feature you plan to ship. Know the user story, prioritize simplicity, test for edge cases, and prepare to support it after go-live. If you are in the early stages of Buying a Business, add earnout design to your diligence checklist, not as a last-minute price plug but as a structured negotiation about risk, control, and timing.

When earnouts work, they do not feel clever. They feel boring and mechanical. The calculation is dull. The reporting is predictable. The parties talk more about customers and talent than about definitions of adjusted EBITDA. That is the point. The elegance lies in using a contingent tool to align interests while protecting both sides from surprises. Price what you can see, share the risk on what you cannot, and write it all down in a way your future self will thank you for.