

# The Trouble with Earnouts – A Blog Post by David Goldenberg

Earnouts can bridge valuation gaps—but often end in disappointment or disputes. Here's what founders and investors need to know.

Earnouts are a popular tool in M&A deals—especially when buyers and sellers don't quite agree on valuation. Rather than walk away, the parties split the difference: the seller gets some cash up front, with the rest tied to future performance.

It sounds like a win-win. But in the lower middle market (\$5M–\$100M deals), earnouts can often fail to deliver. Buyers change course. Sellers lose control. Financial metrics get murky. And instead of post-closing alignment, you get tension, frustration, or even litigation.

Here's how to think about earnouts—practically and defensively.

## 1. Most earnouts don't pay out in full

This isn't just anecdotal. In one study of private company exits, more than **60% of earnouts paid out less than half** of the potential total—and about a third paid nothing at all. That's not always because of bad faith. More often, the performance targets weren't met, or weren't measured the way sellers expected.

For sellers, this means **don't treat an earnout like guaranteed compensation**. It often makes sense to price the up-front deal as if that's all you'll get.

## 2. The real risk: loss of control

After closing, sellers usually have limited say in how the business is run. If the earnout is tied to revenue, what happens if the buyer changes the pricing model? Or shifts key accounts to another business line?

Even well-intentioned buyers may make decisions that unintentionally sabotage the earnout. That's why it's critical to define **governance rights, operating covenants, and reporting mechanisms** as part of the deal.

## 3. Choose your metric wisely

Common earnout metrics include revenue, EBITDA, gross margin, or customer retention. But each carries trade-offs:

- ➔ **Revenue-based earnouts** are easier to measure, but may ignore profitability.

- ➔ **EBITDA-based earnouts** align with value but invite disputes over accounting inputs.
- ➔ **Milestone-based earnouts** (e.g., launch a new product) can work—but require objective triggers.

As a rule of thumb: **simpler is better**, and metrics should be tied to factors the seller can still influence post-closing.

#### 4. Negotiate protections, not just dollars

Founders often focus on the headline number, but savvy counsel will help negotiate real protections:

- ➔ **Operating covenants:** Limit buyer discretion on things that impact the earnout.
- ➔ **Access rights:** Let sellers see the books or receive periodic reports.
- ➔ **Acceleration clauses:** Pay the earnout early if the business is resold.
- ➔ **Dispute resolution:** Avoid expensive litigation with clear forums and rules.

These can be the difference between a hopeful earnout and a bitter lesson.

#### Bottom line:

Earnouts can help get a deal done—but they're rarely free money. If you're a seller, structure the earnout to protect your upside and reduce dependence on the buyer's good faith. If you're a buyer, be transparent, document clearly, and don't overpromise. In M&A, misaligned incentives don't fix themselves.