

DOCUMENT #20

The Blueprint System™ - Deal Structure Series

Earnout Structures That Work

Bridge the valuation gap and protect your downside

What Earnouts Really Do

- **For Buyers:** Pay for performance, not promises
- **For Sellers:** Get paid for future growth
- **Reality:** 50% lead to disputes without proper structure

The 5 Types of Earnouts

Type	Based On	Best For	Risk Level
Revenue-Based	Top line sales	Growth businesses	Medium
EBITDA-Based	Profitability	Mature businesses	High
Gross Profit	GP margins	Seller staying on	Low
Milestone	Specific events	Project businesses	Low
Customer Retention	Keep accounts	Service businesses	Medium

Structure #1: The Tiered Revenue Earnout

Example Structure

Base Purchase Price: \$1,000,000

Earnout Period: 3 years

Year 1 Revenue: – Under \$2M: No earnout – \$2M – \$2.5M: \$100,000 – \$2.5M – \$3M: \$200,000 – Over \$3M: \$300,000 Year 2 Revenue: – Under \$2.5M: No earnout – \$2.5M – \$3M: \$150,000 – Over \$3M: \$250,000 Year 3 Revenue: – Under \$3M: No earnout – Over \$3M: \$200,000 Maximum Earnout: \$750,000

Why This Works

- Clear targets everyone understands
- Rewards growth, not maintenance
- Annual payments reduce dispute risk
- Seller motivated to help transition

Structure #2: The EBITDA Percentage Play

The Formula

Earnout = $30\% \times (\text{Average EBITDA} - \text{Baseline EBITDA}) \times 3$ Where: –
Baseline EBITDA = Last 12 months pre-sale – Average EBITDA = 3-year

average post-sale – Minimum increase: \$100k to trigger Example: –
 Baseline: \$500k – 3-year avg: \$750k – Earnout: $30\% \times (\$750k - \$500k)$
 $\times 3 = \$225k$

⚠ EBITDA Earnout Pitfalls

- Buyer can manipulate expenses
- Allocation disputes common
- Requires detailed definitions
- Seller loses control of costs

Structure #3: Customer Retention Model

Perfect for Service Businesses

Structure:

- Identify top 20 customers (80% of revenue)
- \$10,000 earnout per customer retained at year 1
- \$5,000 additional per customer at year 2
- Maximum earnout: \$300,000

Customer List: 1. ABC Corp – \$200k/year → Worth \$15k earnout 2. XYZ Inc – \$150k/year → Worth \$15k earnout [... continue for all 20] Year 1: 18 retained = \$180,000 Year 2: 16 retained = \$80,000 Total Earnout: \$260,000

Structure #4: Milestone-Based Earnouts

Milestone	Payment	Due Date	Verification
FDA approval obtained	\$500,000	Within 24 months	Copy of approval
Patent issued	\$200,000	Within 18 months	USPTO filing
Key contract renewed	\$150,000	Within 12 months	Signed contract
New location profitable	\$250,000	Within 36 months	P&L statement

Critical Earnout Definitions

Define EVERYTHING in Writing

Revenue means:

- ☐ Gross or net?
- ☐ Include or exclude returns?
- ☐ Cash or accrual basis?
- ☐ Include new product lines?
- ☐ Geographic limitations?

EBITDA adjustments:

- ☐ Owner salary normalization
- ☐ Related party transactions
- ☐ One-time expenses
- ☐ Allocation of overhead
- ☐ Capital expenditure policy

Acceleration & Protection Clauses

Seller Protections (Demand These)

1. Acceleration Triggers:

- Sale of business = immediate full payout
- Material breach by buyer = acceleration
- Bankruptcy = immediate payment

2. Operational Covenants:

- Maintain similar business operations
- No material changes without consent
- Minimum marketing spend
- Can't fire key employees

3. Information Rights:

- Monthly financial statements
- Right to audit annually
- Access to books and records

Buyer Protection Strategies

Protect Against Manipulation

1. Offset Rights:

Earnout Payment Due: \$200,000 – Indemnity Claims: (\$50,000) – Working Capital Adjustment: (\$20,000) = Net Payment: \$130,000

2. Conduct Restrictions:

- Non-compete during earnout period
- Non-solicitation of customers/employees
- Cooperation requirements
- Confidentiality obligations

3. Escrow Arrangements:

- 10-20% of earnout in escrow
- Released after audit confirmation
- Protects against clawbacks

Tax Optimization Strategies

Structure	Seller Tax	Buyer Benefit	Best Use
Purchase Price	Capital gains	Amortizable	Default choice
Employment Comp	Ordinary income	Deductible	Seller staying on
Consulting Fees	Ordinary income	Deductible	Transition period
License/Royalty	Ordinary income	Deductible	IP-heavy deals

Real-World Earnout Examples

Example 1: HVAC Company

- Base price: \$2M
- Earnout: 20% of revenue over \$4M baseline

- 3-year period, annual payments
- Result: Seller earned additional \$400k
- Key: Clear revenue definition, seller stayed 1 year

Example 2: Marketing Agency

- Base price: \$500k
- Earnout: \$50k per major client retained
- 10 clients identified
- Result: 8 retained, earned \$400k
- Key: Specific client list, objective measurement

Negotiating Earnouts

Seller's Negotiation Points

1. **Start high:** Ask for 40-50% in earnout, settle at 20-30%
2. **Shorter period:** 2 years better than 5
3. **Multiple metrics:** Don't rely on one number
4. **Guaranteed minimum:** At least some payment likely
5. **Audit rights:** Trust but verify

Buyer's Counter-Points

1. **Longer period:** Spreads risk, proves sustainability
2. **Higher thresholds:** Pay only for real growth
3. **Single metric:** Simpler to track and dispute
4. **All-or-nothing:** Hit target or no payment

5. **Integration flexibility:** Right to run business

Earnout Dispute Resolution

Pre-Agreed Resolution Process

Step 1: Good Faith Discussion (30 days)

Step 2: Mediation (30 days)

Step 3: Expert Determination (Binding)

Expert determination clause:

"Big 4 accounting firm partner with 10+ years experience in [industry] shall serve as expert. Decision is binding. Costs split 50/50 unless one party position is >20% off determination, then that party pays all costs."

Alternative to Traditional Earnouts

The "Reverse Earnout" or Clawback

Pay full price upfront, but seller must repay if targets missed:

Purchase Price: \$2,000,000 (paid at closing) If Year 1 Revenue < \$3M:
Repay \$200,000 If Year 2 Revenue < \$3.5M: Repay \$150,000 If Key
Customer Lost: Repay \$100,000 Security: \$450,000 escrow or personal
guarantee

Benefits: Seller gets money now, buyer gets protection

The Perfect Earnout Checklist

Before Signing Any Earnout

- ☐ Metrics clearly defined with examples
- ☐ Calculation methodology detailed
- ☐ Payment dates specified
- ☐ Acceleration triggers included
- ☐ Information/audit rights clear
- ☐ Dispute resolution process agreed
- ☐ Tax treatment confirmed
- ☐ Operating covenants reasonable
- ☐ Offset rights limited
- ☐ Legal review complete

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