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Earnout Burnout: Drafting Earnout Agreements to Minimize Disputes Following the Sale of Private Companies

By Anne Baroody on March 16, 2026

Private company buyers and sellers are more frequently using earnout provisions to help close the gap when they disagree over the price to be paid for the purchase/sale of the company. This creative solution can lead to conflicts, however, when the purchaser later contends that the earnout target was not met and, therefore, that no further amount is owed to the seller. In light of how commonplace litigation has become over the interpretation of earnout provisions in purchase agreements, this post offers practical guidance for buyers and sellers as they negotiate earnout terms that are designed to minimize post-sale disputes.

Earnout Provisions Can Help Achieve Purchase Transactions

Earnout provisions generally call for the buyer to pay most of the purchase price at closing, but also to agree to pay a *potential* additional amount on a contingent basis to the seller. The buyer is only required to pay this contingent amount to the seller if the business that is acquired achieves specific performance targets during a defined period after closing. For sellers, the earnout provides them with the opportunity to secure a much higher sale price following closing and usually after a transition period of one to two years. For buyers, earnouts lower the amount of cash they need to pay up front to the seller, and they also keep some risk in acquiring the new business on the seller, who may have to assist the business in performing well during the earnout period in order to secure the contingent payment.

Earnouts have become increasingly common, particularly in private non-life-science deals. According to the American Bar **Association's Private Target Mergers & Acquisitions Deal Points Study** in 2023, the use of earnouts hit a new high that year. Many earnouts last for 24 months, although shorter or longer periods are not uncommon. Due to the increase in the use of earnout provisions in 2023, we have seen a large number of earnout disputes surfacing in recent years. Specifically, buyers and sellers are having conflicts over how to value the performance of the business after closing and how to calculate the compensation due under the terms of the earnout.

In Delaware, Vice Chancellor J. Travis Laster of the Court of Chancery put it well: "an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome" (see *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132

(Del. Ch. 2009)). For both buyers and sellers who desire to avoid future conflicts and litigation between them, careful drafting of earnout provisions is essential.

Start with Selecting the Least Controversial Metrics

The starting point for avoiding conflicts over earnout provisions is to choose the right metrics to determine whether any earnout compensation will become due. The two most common metrics are revenue based and earnings based, though other approaches — such as product launch milestones — are also possible. Using revenue as the target rather than earnings is generally more straightforward and less susceptible to manipulation by the buyer. The revenues the company generated are typically a clearer, more reliable benchmark, because earnings are determined after deducting expenses, and deductions from earnings can be a ripe source of conflict.

For example, earnings-based metrics, such as EBITDA, offer more room for dispute because they require agreement on how various expenses, adjustments, and accounting treatments will be handled in calculating whether an earnout has become due. If the parties are nevertheless insistent on using earnings as the benchmark, they need to consider how the seller's business has measured earnings on a historical basis before the sale and how the acquiring company will calculate the earnings going forward. The parties should provide clear examples of how to calculate financial statements as exhibits to the purchase and sale agreement to ensure that they are on the same page regarding the manner in which the earnout calculation will be conducted.

Specific Guidance to Reduce the Risk of Post-Closing Conflicts

Based on our experience in handling earnout disputes, we prepared the following list of steps for company buyers and sellers to consider in negotiating an earnout provision that will help avoid or minimize future conflicts.

1. Clearly Define Accounting Practices

Whether negotiating a revenue-based earnout or an earnings-based earnout, the parties need to clearly define the accounting practices that will be used in valuing the business or any business-specific valuation issues. Vague language or assumptions

and inside baseball descriptions that assume “everyone will understand what we mean” provide a recipe for future conflict and litigation. A mathematical benchmark that is based on a pre-sale valuation of the company may seem clear at the closing of the transaction, but disputes can arise down the road if the parties have not clearly defined how the target should be measured, including the following issues that can provide fertile areas for dispute:

- **Revenue Recognition Timing.** The parties should specify when revenues will be recognized after closing — whether it will be done on a cash basis or an accrual basis. If management valued the business on a cash basis pre-sale, the use of accrual-basis accounting to measure earnout targets may be inappropriate and lead to disputes. The key is to make sure the parties accurately document their agreement so they are comparing apples to apples in calculating whether the earnout has been achieved.
- **Doubtful Accounts and Bad Debt.** How to handle doubtful accounts and bad debt is an area that is specific to each business. Depending on the industry or business, accounts may be paid on slower timetables, and when the time arrives to compute the earnout payment, buyers and sellers may disagree on the collectability of aged accounts. The parties’ agreement must clearly define the parameters for including or excluding accounts the buyer deems doubtful in determining whether the required performance levels have been met.
- **Handling Adjustments.** If the initial valuation was based on an adjusted EBITDA, the parties must set forth how these adjustments will be handled in calculating the earnout valuation. All accounting issues relating to the calculation of the earnout after the closing need to be addressed by the parties in their agreement to avoid later conflicts.
- **Expense Allocation.** What expenses will be permitted and how will they be allocated to the acquired company after closing? This is particularly important if the acquired company is the target of a strategic purchase and will be folded into a larger enterprise. Corporate overhead allocations and shared services charges can significantly impact earnings calculations.

2. Retain a CPA to Assist in Drafting

Despite the significant negotiation of earnout provisions, these disputes frequently involve conflicts over how to interpret the specific requirements of the provision. One way to limit these conflicts or to prevail when they do arise is to retain a CPA who is directly involved in the actual drafting of the earnout provision. A CPA can help identify business-specific accounting issues the deal lawyers may not anticipate, and they can ensure that the language used in the agreement closely aligns with accepted accounting principles.

3. Documentation

Another practical approach to help ensure the parties see eye to eye in calculating the performance of the business after closing is to attach financial or other revenue recognition statements to the purchase and sale agreement, which detail the model used to value the business and require that this same model be used by the parties when they calculate the earnout. Additionally, both parties should maintain documentation concerning the negotiation of the earnout provision and comments made related to the process. If a dispute arises, this contemporaneous documentation can be critical evidence of the parties' intent.

4. Ensure Access to Records

Sellers may have less access to books and records once the deal closes. Even a seller who stays on board to manage the business after closing may have less access to financial records by the time the earnout is calculated months or years later. This lack of access can put sellers at a serious disadvantage. To address this concern, parties should consider including contract terms that facilitate the exchange of information necessary for sellers and buyers to align on the earnout valuation. These provisions should specify what records the buyer must maintain, how frequently the seller can request access to the records, and in what specific format the information will be maintained and provided.

5. Appoint a Referee

To avoid litigation, the parties can stipulate that all accounting disputes relating to the calculation of the earnout will be decided by a CPA firm the parties designate to serve as the neutral referee. For this provision to work well, the parties need to list the CPA firm (or firms) to be used in their agreement and also specify how the referee will resolve these disputes by detailing (i) the information to be provided to the referee, (ii) the process the referee is to follow to resolve the disputes, (iii) the timetable for the referee to decide the matter, and (iv) by mandating that the referee has sole authority to resolve disputes relating to the earnout.

6. Arbitration If Required

Despite the appointment of a referee, the parties may engage in conflicts over the actions or rulings of the referee, and in that event, these disputes should be resolved exclusively by the filing of a fast-track arbitration that will take place in a matter of 60-90 days. This requirement of mandatory arbitration is the last fallback in the dispute resolution process to ensure that all conflicts between the parties relating to the earnout will never become bogged down in litigation.

Conclusion

The goal shared by company buyers and sellers of structuring a win-win deal is what leads them to adopt an earnout provision because the contingent purchase price works for both sides. But for a contingent provision to successfully stand the test of time, it cannot result in the parties becoming locked in combat. A well-drafted earnout provision enables the parties to head off potential disputes at the drafting stage before they ever become embroiled in litigation.

Crafting an earnout provision that will avoid future conflicts is possible when the parties are assisted by CPAs during the drafting stage, when they draft contract terms based on the actual performance of the company being acquired, when they attach financial statements that govern the calculation of the earnout, and when they provide for access to all documents necessary to conduct the calculation of the earnout. Finally, if conflicts do arise, the earnout provision needs to provide for the

appointment of a referee to resolve these disputes, and ultimately, for an arbitration to take place that will result in a final, non-appealable award if the parties stymie the referee's efforts.

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