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Seller Carries, Earnouts, Earndowns, & Equity Rollovers

Sometimes negotiations stall and deals need a bit of creativity to close. This most often happens when the parties can't agree on the price of the business. Below you'll find several tools that can be used to bring the parties back together and get the deal done.

Seller Carry

A "seller carry" is simply a promissory note executed on behalf of the seller by the buyer promising to pay a portion of the purchase price of the business over time.

The seller carry serves several purposes. First, the carry helps bridge the gap between traditional bank debt, equity, and the purchase price of the business. Banks have limits on the amount of financing they will provide and seller carries are usually required to get a deal done.

Secondly, and equally as important, the seller carry demonstrates to the buyer and the other debt and equity sources that the seller shows confidence in the business and in the deal by keeping "skin in the game". The seller is incentivized to make sure the business will prosper after the sale by making a fair deal and further supporting the buyer in a training and consulting capacity post-sale.

The seller carry typically ranges from 10% to 25% of the purchase price, has a 4 to 6 year term at market interest rates, and has a deferred payment start for up to one year so as to insure the business maintains sufficient cash flow in the critical period following the sale transaction. Seller carries are always subordinated to the senior loan(s) and are secured by the assets of the business only with no personal guarantee from the buyer.

Larger seller carries can often help bridge small to medium price gaps.

If the deal is being financed via an SBA loan, the seller carry will tend to be smaller but the SBA usually requires the seller note (or a portion of it) to be on "standby" which means that the seller will receive either no payments or interest-only payments until the SBA loan is paid down or paid off.

Earnout

In all but the most exceptional circumstances, buyers determine the price they will pay for a business based on proven past earnings and to some extent future booked work, which can include long term contracts to provide goods or services.

Sometimes a seller believes that their business has exceptional potential, due to some key intellectual property, or the like, and wants to be paid based on the future earnings potential of their business as well as its past history.

This often leads to an impasse in negotiations as the buyer and seller arrive at very different valuations for the business. One way to bridge the price gap is via an "earnout" whereby the seller will receive additional post-sale payments if certain targets are met. In other words, an earnout lets the seller participate in future earnings of the business, and ultimately receive more for their business, if their vision comes to pass as predicted.

Earnouts are completely negotiable and can be based on almost anything measurable including gross revenue, operating margin, market share, patents secured, etc., but the metric most commonly used is some percent of

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earnings above a certain target for one or more years based on estimates that match the seller's representations and projections.

Payout targets are evaluated at specified times, quarterly, annually, etc., and then the earnout calculation is performed and the payout made to the seller.

The earnout period is limited to a certain time period and earnouts often come with earnings caps, which limit the amount of the payout to the seller to some extent. Additionally, earnouts are usually limited to only the portion of the business purchased excluding non-organic expansions like acquiring other businesses, opening other locations, expanding to other geographic areas, etc.

During the earnout period, the buyer will have absolute control and decision making according to reasonable effort and best practices. Limitations on the buyer may exist but if so, they will be carefully specified up front.

Finally, since litigation is somewhat more likely in this type of arrangement, defined mediation and arbitration agreements should be put in place at the time the deal is made to avoid lengthy and expensive court battles.

Earndown

When financing is secured via the SBA the seller is not allowed to receive more than the price of the business at the time of sale. This means that *earnouts*, per se, are not allowed.

A possible work-around is colloquially known as an "earndown" which is a cousin of the earnout discussed above.

In an *earndown*, the buyer pays the highest fair value for the business while the seller takes a larger part of the purchase price in the form of a seller carry. Performance targets are set as in an earnout, but in this case, if the targets are **not** met, specified portions of the seller note are **forgiven**.

The upside to the seller is not as great as in an earnout. Still, this arrangement allows the buyer and their subsequent financial backers to feel comfortable paying the highest fair price possible for the business, while still retaining some protection if the seller's predictions with regard to the company's potential fail to materialize.

Equity Rollover

One final tool that can be used to provide the seller with some upside based on the performance of the company post-sale is the equity rollover. This simply means that the seller retains some equity in the business post-sale, almost always through a non-voting form of ownership (eg. preferred stock, non-voting "Class B" common stock, etc.).

It should be noted that as with earnouts, the SBA does not allow equity rollovers in most cases.

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