Avoid a long-term earnout in agency sale

Q: I am seriously thinking of selling my travel agency to a much larger one. I think that the best deal for me would be a long-term one, under which the buyer would pay me X% of revenue for a large number of years, which would ensure that I have plenty of money in retirement. Do you agree?

A: I do not recommend long-term buyouts geared to future events ("earnouts"). The odds are very high that the payouts to you will go down because of loss of sales, revenue or profits in the coming years, depending on the earnout formula.

I concur with my industry colleague Bob Sweeney of Innovative Travel Acquisitions, who recommends that the measurement period for earnouts be limited to the one-year period after closing, although the payout can last two or more years. Here is an example of how this formula works effectively:

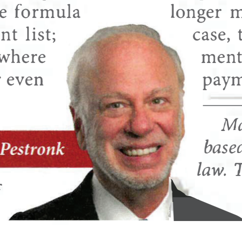
- The earnout is 50% of the location's revenue (i.e., commissions, fees, overrides and markups) during the 12 months after closing.
- The payout is 25% of the revenue each month or quarter during the 12 months after closing.
- At the end the 12 months, the parties can calculate the exact balance remaining, which is then paid in fixed monthly or quarterly installments during the second year after closing.

LEGAL BRIEFS

As long as the earnout measurement period is limited to one year, you can reduce the percentage paid in the first year, and you can extend the fixed installments over more than one year. The key is to limit the earnout measurement period to the year after closing in order to minimize risk for the seller.

There's risk in every earnout, and the longer the earnout-measurement period, the riskier the earnout becomes for the seller.

My example assumes that your agency has a physical location and that it will remain open during the earnout term. However, the formula can be applied to a client list; an employee and IC list where staff work from home; or even a combination.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Once you get beyond a one-year measurement period, the risk of client attrition rises yearly. If your earnout is based on the profits of your book of business or your location, the risks of increased expenses and other adverse developments make multiyear earnouts extremely risky.

In the Legal Briefs column that ran in the Jan. 20 issue, I listed several legal measures to add to a contract to make it less likely that a seller would lose out during an earnout measurement period due to loss of sales, revenue or profits.

Nevertheless, despite a seller's best efforts to negotiate a favorable contract by limiting the buyer's discretion, risks remain in every earnout, and the longer the earnout-measurement period, the riskier the earnout becomes for the seller.

In practice, it is the buyer who sets the payment terms in most acquisitions, so even if the seller proposes a Sweeney-type formula with a one-year measurement period, the buyer may insist on a longer measurement period. In that case, try to get a larger down payment and minimum guaranteed payment floor in the agreement.

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