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Earnouts in Acquisitions: Structure, Evidence, Disputes

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What an earnout is and why buyers and sellers use one

An earnout splits the purchase price of a company into two parts: a fixed amount paid at closing, and further payments that become due only if the business reaches agreed targets after closing. The short earn-out definition in our glossary covers the term itself. This article covers what the terms of real earnouts have looked like, how a buyer reports them, and where they have been litigated.

The standard explanation is a valuation gap. A seller who believes the next two years will be strong, and a buyer who is not yet convinced, can agree on a lower fixed price and let the contested part of the value depend on results. Matthew Cain, David Denis and Diane Denis put it this way in their 2006 working paper: by tying consideration to future performance, "the earnout can bridge a valuation gap between the target and the acquirer that is caused by disagreements about the target's expected future performance" (Cain, Denis and Denis, Purdue working paper 1196, 2006). The same authors list the costs as well. The seller bears more uncertainty about the premium. The buyer gains an incentive to manage the performance measure downwards, for example through the allocation of joint costs. A seller-manager paid on short-term earnings may cut spending that would have built long-run value (working paper, pp. 1-2).

An earnout is one of several ways to defer or condition part of the price. A seller note defers payment without making it contingent on performance; rollover equity keeps the seller exposed to the whole enterprise rather than to one metric. The choice among them is a commercial and legal question for the parties and their advisers. Nothing below is legal, tax or accounting advice; it describes sources and their limits.

What the empirical evidence shows about structure

The most detailed public study of earnout terms is Cain, Denis and Denis, published as "Earnouts: A study of financial contracting in acquisition agreements" in the *Journal of Accounting and Economics* in 2011 (DOI 10.1016/j.jacceco.2010.05.001). The published version is paywalled. Its abstract, as indexed by RePEc/IDEAS, reports "considerable heterogeneity" in earnout size, performance measure, measurement period, form of payment and payout sensitivity, and concludes that the tests "yield support for the view that earnouts are structured to minimize the costs of valuation uncertainty and moral hazard in acquisition negotiations." The abstract states no figures, so every figure below comes from the September 2006 Purdue working paper, which we read in full. The published figures may differ.

The sample and what it does not cover

The authors started from 25,213 acquisitions completed by publicly traded US corporations between 1994 and 2003, as listed in the Securities Data Corporation (SDC) mergers database. Of these, 990 (3.9%) included an earnout. Usage rose from 3.1% of deals in 1994 to 6.8% in 2003 (working paper, p. 5). Fewer than 2% of the targets were publicly traded: 74% were private companies and 23% were subsidiaries of public companies (p. 6).

Three limits matter for a private equity (PE) reader. First, every acquirer in the sample was a public company, so sponsor-to-founder and private-to-private deals are not represented. Second, the contract details came from the acquirers' Securities and Exchange Commission (SEC) filings, and were available for only 447 to 535

of the 990 deals, depending on the item (p. 7). Third, the sample ends in 2003, before the accounting guidance described later in this article. The study describes what disclosed earnouts by public acquirers looked like twenty years ago. It does not establish what is "market" in a 2026 lower-middle-market deal.

Size, payoff shape and form of payment

Term (working-paper sample)	Finding
Maximum earnout per deal	Mean $21 million, median $5 million
Maximum earnout as share of total transaction value	Mean 33%, median 28%; interquartile range 16% to 47%; full range 1.4% to 161%
Whose performance is measured	Target only 90%; target and acquirer combined 9%
Payoff shape	Linear with a cap 42%; stepwise with a cap 40%; concave 9%; convex 6%; linear with no cap 3%
Form of payment	Cash only 39%; acquirer stock only 29%; cash and stock 26%; debt or preferred stock under 7%

Sources: working paper, pp. 7-12.

The paper's central conclusion is that earnout terms are not boilerplate. The working paper's abstract states that "we conclude that earnouts are structured to minimize the costs of adverse selection and moral hazard in acquisition negotiations" (working paper, abstract); the published abstract says "valuation uncertainty" where the working paper says "adverse selection." Concretely, greater uncertainty about the target's value was associated with larger earnouts, shorter earnout periods, payment in stock and the use of sales as the metric. Targets with more growth opportunities had larger earnouts, more often paid in stock and measured over longer periods (pp. 4, 25). These are associations in a regression sample, not drafting rules.

The earlier academic work points the same way. Datar, Frankel and Wolfson's abstract reports that earnouts are more likely when the target is "a smaller, private company in a different industry than the acquirer", and when targets have more private information (Datar et al., *Journal of Law, Economics, and Organization*, 2001).

Metrics and measurement periods

In the working-paper sample, some measure of profitability (cash flow, pre-tax income, gross profit, net income or earnings per share) was used in 261 of 498 identifiable cases (52%). Sales were used in 157 (32%) and non-financial milestones, such as clinical trials, regulatory approvals or specific customer contracts, in 61 (12.2%). Stock price appeared in six cases (p. 9). The typical earnout measured performance annually (77% of cases) over about two years: the mean was 2.57 years, the interquartile range one to three years, and the longest twenty years (p. 9).

The authors explain why the metric matters. Net income might be expected to be the most informative measure of value. But once the target is integrated, the acquirer has "some discretion in allocating expenses to the target", and measured income starts to reflect synergies rather than the target's own contribution. They therefore expected sales or non-financial measures where integration is deep (pp. 14-15). In practice:

- **Revenue** is harder for the buyer to depress through cost allocation, but rewards volume regardless of margin.
- **EBITDA** (earnings before interest, taxes, depreciation and amortisation), usually adjusted EBITDA, is closer to value but depends on every cost policy the buyer controls after closing.
- **Milestones** are binary. The Delaware case below shows how much can turn on how a milestone is worded.

How earnouts are accounted for

For the buyer, an earnout is not only a future payment; it is a balance-sheet item. The SEC's Financial Reporting Manual (FRM), the staff's guidance for registrants, summarises the treatment under Accounting Standards Codification (ASC) Topic 805, Business Combinations. Contingent consideration is recognised at the time of the transaction. Contingent consideration "classified as an asset or liability is remeasured to fair value at each reporting date until the contingency is resolved, and these changes in fair value are generally recognized in earnings" (SEC FRM Topic 3, section 3250.1).

The same section says pro forma financial information should not include adjustments for changes in the fair value of contingent consideration. It also says registrants should disclose the terms of issuable contingent consideration and its potential impact on future earnings (FRM Topic 3). The page was last reviewed on 18 November 2020, and the paragraph itself is marked as last updated on 30 September 2010.

The practical consequence is that a liability-classified earnout moves the buyer's reported earnings in every period until it is settled. That is one reason buyers care about how precisely the metric is defined. The FRM is written for SEC registrants. A private buyer reporting under US generally accepted accounting principles should confirm the treatment with its auditor. Tax treatment of earnout payments, for buyer and seller, is outside the scope of this article.

Where earnouts go to court: the Auris case

Johnson & Johnson v. Fortis Advisors LLC, decided by the Delaware Supreme Court sitting en banc on 12 January 2026, is the most significant recent earnout appeal. The summary below is drawn from the Court's opinion, and it is deliberately narrow.

The deal. Johnson & Johnson (J&J) acquired Auris Health, a medical robotics company, for $3.4 billion in upfront cash plus up to $2.35 billion in earnouts tied to ten milestones. The regulatory milestones were each expressly conditioned on obtaining "510(k) premarket notification" from the US Food and Drug Administration (FDA) (opinion, pp. 1, 13). No milestone was achieved. The sellers' representative sued for breach of the efforts obligation and for fraud. The Court of Chancery entered judgment for the sellers "in excess of $1 billion in contract and fraud damages, plus prejudgment interest" (p. 2).

The efforts clause. The merger agreement defined "commercially reasonable efforts" by reference to J&J's "usual practice ... with respect to priority medical device products of similar commercial potential at a similar stage in product lifecycle". It then listed ten factors J&J could consider, and separately forbade acting "with the

intention of avoiding" an earnout payment (pp. 16-17). The Supreme Court adopted the trial court's reading: the ten factors let J&J calibrate its efforts within the "priority medical device" baseline, not fall below it. It upheld the finding that J&J breached that obligation for the remaining iPlatform milestones (pp. 3, 63-71).

The implied covenant. The trial court had used the implied covenant of good faith and fair dealing to require J&J to pursue an alternative FDA pathway after the 510(k) route closed for the first milestone. The Supreme Court reversed. It held that there was "no genuine contractual gap for the covenant to fill", because the agreement repeatedly conditioned the milestones on 510(k) clearance and allocated the risk of FDA "developments" to the sellers (pp. 2-3).

Fraud. The Court affirmed that J&J, through its chief executive, fraudulently induced Auris to accept a $100 million contingent payment for a lung-ablation milestone instead of a higher upfront payment. It held that the exclusive-remedy clause did not bar the claim "in the absence of an express anti-reliance provision running against Auris". The agreement's anti-reliance clause bound J&J only (pp. 2-3, 17). The case was remanded for recalculation of the judgment.

The lessons are about drafting, not about any particular sector. A benchmarked efforts standard can be enforced as written. A milestone tied to one regulatory route stays tied to it. And a fraud claim survives unless the anti-reliance language runs against the party making it.

Drafting checklist

Each item names the question the documents should answer. Points not tied to a source above are general drafting practice to confirm with counsel.

1. **Metric definition.** Name the metric (revenue, EBITDA, a milestone) and define every adjustment in writing. If EBITDA, list which add-backs count and which costs are allocated to the business.
2. **Accounting policies.** State whether the target's historical policies, applied consistently, govern the calculation, and how a later change in the buyer's policies is neutralised. The working paper's point about expense allocation after integration is the risk here (pp. 14-15).
3. **Measurement period.** Fix the periods, the measurement frequency, the cap and the payoff shape (linear, stepwise or other), and say whether a shortfall in one year can be caught up in the next.
4. **Operating covenants and efforts.** Specify what the buyer must or must not do: keep the business separate, fund it, retain key staff. If an efforts standard is used, benchmark it to something observable, as the Auris agreement did, and consider an express anti-avoidance clause (opinion, pp. 16-17).
5. **Acceleration.** Say what happens to unpaid earnout amounts on a resale of the business, a change of control of the buyer, a breach of the operating covenants or termination of the seller-manager.
6. **Dispute resolution.** Set out the statement delivery date, the objection window, the independent accountant's scope (accounting questions only or also legal ones) and the fee allocation.
7. **Set-off, payment and transfer.** Say whether indemnity claims can be set off against earnout payments, whether payment is in cash or stock, and whether the right can be transferred. The working paper notes that agreements typically prohibit transfer of the earnout right and state that it is not a security (p. 6, n. 3).

8. **Reliance and remedies.** Check whose reliance the anti-reliance clause disclaims, and whether an exclusive-remedy clause reaches statements made in negotiation (opinion, p. 3).

How to read an earnout as the seller or as the buyer

The worked example below is **illustrative**. "Harrow Valve Services" is a fictional company, and none of the numbers are drawn from market data.

The buyer pays $24.0 million at closing. A further $8.0 million is available, up to $4.0 million in each of two annual periods. The metric is adjusted EBITDA for each year. The threshold is $5.0 million and the target is $6.0 million. Under the linear schedule, the payment grows in proportion between threshold and target and is capped at the target. Under the stepwise alternative, $2.0 million is paid at or above the threshold and $4.0 million at or above the target.

Illustrative payout table, one annual period (fictional company)

Adjusted EBITDA for the year	Linear schedule payment	Stepwise schedule payment
$4.8 million	$0	$0
$5.0 million	$0	$2.0 million
$5.4 million	$1.6 million	$2.0 million
$5.75 million	$3.0 million	$2.0 million
$6.0 million	$4.0 million	$4.0 million
$6.8 million	$4.0 million (capped)	$4.0 million

The table shows the leverage. Between threshold and target, each $100,000 of EBITDA moves the linear payment by $400,000. A $250,000 disagreement over allocated head-office cost is therefore a $1.0 million dispute. Under the stepwise schedule, the same $250,000 matters only if it moves the result across $5.0 million or $6.0 million, and then it is worth $2.0 million. A seller should model which schedule leaves its likely outcomes away from a step. A buyer should note that a stepwise schedule concentrates dispute risk on the step points.

Illustrative worksheet for the reader (fictional company)

Scenario	Year 1 EBITDA	Year 1 payment	Year 2 EBITDA	Year 2 payment	Your probability	Probability-weighted payment
Downside	$4.8M	$0	$5.0M	$0	___	___
Base	$5.4M	$1.6M	$5.75M	$3.0M	___	___
Upside	$6.0M	$4.0M	$6.8M	$4.0M	___	___

The probability column is left blank deliberately. Its value depends on the seller's forecast, on how much control the seller keeps after closing, and on the buyer's ability to pay when the amounts fall due. Compare the weighted total with the fixed price, not with the $8.0 million headline maximum.

Red flags for either side

- The metric is "EBITDA" with no list of adjustments or reference to historical policies.
- The buyer may integrate the business but the metric still assumes stand-alone results.
- The efforts standard has no benchmark, or the agreement contains no anti-avoidance clause.
- Nothing addresses a sale of the business during the earnout period.
- The seller's reliance on statements made in negotiation is disclaimed one way only, and nobody has checked which way.

What public records can and cannot show

Earnout terms are mostly visible when the buyer is an SEC registrant. Form 8-K Item 2.01 requires a registrant that completes a significant acquisition to disclose, among other things, "the nature and amount of consideration given" (SEC Form 8-K, Item 2.01). Cain, Denis and Denis found detailed earnout descriptions mainly in 8-K filings (67%), 10-Q filings (12%) and 10-K filings (8%). They also warned that press-release figures sometimes report the maximum earnout and sometimes the acquirer's estimate (working paper, pp. 7-8). A headline earnout figure is not evidence of what was, or will be, paid.

Where both parties are private, these filing obligations do not arise, and the terms usually stay in the data room. Litigation is the main exception: the Auris opinion quotes the efforts definition and the price term from the merger agreement. For research records, we treat a disclosed earnout term the way our evidence standards treat any other fact: quote the filing or opinion that states it, record its date, and leave the field open when no source states it.

Docket's research agents follow the same rule, quoting a retained page for each answer and leaving a term open when no source states it.

Sources

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Source links

Links cited in this article, in order of first appearance. Full addresses are provided for readers using extracted text.

1. https://krannert.purdue.edu/research/working-papers-series/2006/1196.pdf
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