# Earn-Outs: Mitigating Risk and Bridging Value Expectations in M&A

**Taisia Nistorenco**

**Abstract** This article explains what problems dealmakers face when valuing companies and how can contingent payment instruments (such as earn-outs) facilitate them in this task. It provides an analysis of economic and business specifications of earn-outs and demonstrates on a sample of 48 transactions that the use of earn-outs is influenced by the characteristics of the target's industry and market.

**Keywords** M&A · Valuation · Earn-out · Contingent payment

## 1 Introduction

The centre of attention in any trade deal is the price, and in case of mergers and acquisitions when the stakes are high, this statement cannot be overvalued. Entire teams of analysts work on business valuation both on the side of the buyer and on the side of the seller. In the matter of fact, the biggest challenge financial and strategic counsellors face is having to account for the changing conditions (both internal and external) and information asymmetry. One of the instruments protecting them from fatal mistakes is the arrangement of earn-outs and other contingent payments.

Goal of this article is to explain the justifications for the use of earn-out payments from an economic and business point of view and to examine whether they are actually applied in the cases most suitable for contingent payments.

To create a realistic review of earn-outs' application in M&A practice I base upon the interviews and primary on-site research done by Mergermark and Hale M&A 2017 report. Hard-data analysis is combined with detailed financial and economic study of different aspects of the earn-out in M&A, its benefits and risks for both seller and buyer.

T. Nistorenco (✉)
Department of Financial Accounting and Auditing, University of Economics, Prague, Nam. W. Churchilla 4, 130 67 Prague, Czech Republic
e-mail: taisianistorenco@yahoo.com

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In my own research of earn-outs in transactions from different industries I focus on deals in computer software development industry and compare them to deals in agriculture, mining and manufacturing in Central and Eastern Europe region.

## 2 M&A Valuation Challenges

Valuable insight into the world of corporate transactions' valuation provides a recent study by Mergermarket conducted in cooperation with FIRMEX. The study is based upon a research that involved senior corporate executives (20% of respondents), investment bankers (40% of respondents) and private equity investors (40% of respondents) in North America. These dealmakers were asked by Mergermarket's researchers to answer several questions regarding the difficulties they face when valuing companies either on sell or buy side of a deal (Mergermarket 2017).

The first point of interest dealt with precision and bias in valuation. On the scale from 1 to 5 respondents on average stated that the degree of preciseness is 3.28. Thus they do not deny the financial valuation its significance, but the level of trust in the precise numbers is not as high as might have been expected.

When asked to assess the level of adequacy of M&A valuation in case of strategic deals versus financial deals, 72% of respondents acknowledged the difficulty of estimating value in a strategic deal.

Deal makers said that they usually judge if the valuation and the purchase price have been justified by company's performance after 3–4 years (in 52% of cases), and after 1–2 years (in 40% of cases).

Respondents mentioned the following reasons for the valuation gap in seller's and buyer's price expectations: different views on target's growth potential, the fact that each side is focused on maximizing instead of optimizing value, disagreement over the value of the target's brand, intellectual property or any other significant assets (Mergermarket 2017).

It is clear that in cross-industry and cross-border transactions when the buyer does not have enough insight into the specifics of a different country or economic sector the value assessment of both parties can be significantly distorted.

While legal risks of hidden liabilities or violation of pre-agreed conditions are covered by representations and warranties, these do not help the parties come closer on the price and achieve an agreement. Earn-out is the instrument widely used in M&A practice helping to tie business valuation to target company's future progress.

## 3 Earn-Outs

An earn-out is a postponed payment of a part of the purchase price which is tied to fulfilment of certain conditions connected to target company's post-transactional performance. Earn-out does not serve as a replacement of representations and warranties of the seller in the share purchase agreement which protect the buyer from any undisclosed liabilities, but rather as an instrument to close the gap in valuation and reduce the risks. Often at the end of the process of negotiations when the majority of facts have been verified and conditions have been set, price remains an issue of long disputes. Earn-out agreement helps to move the whole process from the freezing point to a successful completion (Creely et al. 2009).

According to Bruner (Bruner 2004, p. 614) earn-outs serve three main tasks:

- bridging the valuation gap,
- retaining managers (sometimes shareholders),
- motivation of the retained management team.

## *Economic Implications of Earn-Outs: Uncertainty or Adverse Selection*

In the matter of adverse selection phenomenon some economists believe that earn-out can serve as signal sent by the seller to demonstrate the "quality" of the target company. As many valuations are based on assumptions dealing with uncertainty and risks and it is very costly for the acquirers to assess the most precise value of a business, the results tend to be "averaged". This benefits the "bad quality" companies in a prosperous industry and damages "high quality" companies. Competent high quality sellers know their real value and realize that the counterparty cannot meet their price expectations mainly due to the lack of some key data and insight (Quinn 2013, pp. 15–20).

Information asymmetry is an inevitable state in M&A negotiations, especially in case that the transaction is contemplated by two competitors. There are different circumstances that do not allow the seller to disclose complete information about the target company (e.g. when the company is on the verge of closing an important long-term agreement with a large customer but the papers have not been signed yet). Nevertheless high quality targets (as compared to low quality companies) are ready to bear the costs of an earn-out to reach the desired value (Quinn 2013, pp. 15–20, 24).

At the same time experts are inclined to think that earn-outs serve mainly to compensate uncertainty (Cain 2010, pp. 6, 31). It arises from the fact, that business valuation is often based on financial plans influenced by expectation of future development. Business predictions are also tied to risk preferences of the parties, which can be different. As sellers cannot prove to a degree of 100% the occurrence of predicted sales/profits or other indicators of progress, they are ready to bear the costs of being wrong and agree to an earn-out. As the earn-out mitigates the risk of inadequately valuing the target and overpaying, the buyers also find it reasonable to spend time and money on structuring earn-out payments and feel more comfortable to pay more in a future moment when the uncertainty is cleared and expectations are/not realized. Thus earn-outs do not provide any new information or signal for the parties, but distribute risks and costs associated with uncertainty (Quinn 2013, pp. 17–20).

From the above described approaches to interpretation of earn-outs role in a transaction it is clear that adverse selection theory considers an earn-out to be a solution of information asymmetry problem and to play a role of a signal of seller's confidence in company's future development. The theory of uncertainty though says that earn-outs help to level the parties' expectation caused by different risk preferences.

As earn-outs are generally more preferred and often proposed by the buyers I tend to believe that the uncertainty creates the economic incentive to use earn-outs. Adverse selection is surely an issue within the M&A business valuation discipline, but there are not enough practical reasons for sellers to make such costly gestures of proposing an earn-out with the only reason of signaling their confidence. Besides that, even low quality sellers might be inclined to take risk and send "the confidence signal" by proposing an earn-out in the hope that their overly optimistic plans might be reached at least with a little degree of probability, which would not help solving the adverse selection problem. The following analysis of earn-out's business aspects will show that the instrument can really be perceived as an uncertainty and risk mitigating agent.

## *Business Aspects of Earn-Outs: Benefits and Risks*

Earn-outs' structure is based upon the following parameters:

- Benchmarks and performance milestones—around 88% of earn-outs are based on financial parameters and are derived from company's financial results such as sales in general or level of recurring sales from long-term customers, net income, EBITDA, EBIT and different modification of these indicators. Besides that, earn-outs can be tied to successful implementation of a new product, completion of a vast investment project, successful entry on a new market or getting a regulatory approval (e.g. in case of pharmaceuticals). The important fact is that not only the benchmark parameter is agreed, but the formula for its calculation as well (Europe Economics 2015).
- Term of earn-out payment—focusing on near-term performance is preferred due to its better predictability, so the earn-outs are usually based on one to five year progress of the target company.
- Disputes resolutions—even with a due care disputes regarding target's meeting of the set conditions cannot be ruled out. It is required to set a method of disputes resolutions ahead (Crimmins 2009, pp. 4–7).
- Seller's position after the transaction—the deciding factor is whether the seller remains a minority owner, manager, external consultant of the target company or completely steps down from any roles, because his level of influence upon the set benchmarks is directly connected to his competences within the company (Bruner 2004, pp. 613–620).

- Payment security—the buyer's obligation to pay once all the conditions are met has to be legally secured (Crimmins 2009, pp. 4–7).

From the point of view of the buyer earn-outs allow him to decrease initial cash payment into the transaction as well as leverage if the transaction is debt-financed. Not having to pay the entire price at the moment offers the buyer a possibility to pay a higher premium in a tender process when there are several bidders pursuing acquisition of the target company. At the same time the risk of overpaying is lower, as part of the price will be performance-based. Incorporating an earn-out into transactional structure can be a good motivational factor for the seller to stay in the company and help reach the planned goals.

Sellers can also benefit from earn-outs, especially because it can mean higher price premium. At the same time through well structured earn-out they can preserve their influence in the company while profiting from synergies created by integration of their business into buyers' entity (Bruner 2004, pp. 612–613).

A research done by Mergermarket and Donnelly (Mergermarket 2017) proved that the pace of modern M&A processes is getting faster, with sellers expecting to receive bids in a matter of weeks after announcing the sale. Based on the dealmakers' responses the seller can convince the buyer to close the deal more quickly by agreeing to a higher break-up fee (payment in case the seller pulls out of the transaction at the last minute), accepting a price decrease and negotiating an earn-out. Thus, some sellers may find earn-outs to be a time saving negotiating instrument.

Bruner (Bruner 2004, pp. 614–617) points out that earn-outs can prove to be ineffective, even damaging in the following cases:

- Extensive integration of the target into the buyer's corporate structure—in this case the results of the target's work are redistributed in the way that benefits the combined entity and can decrease the financial parameters of the target company on which the earn-out is based.
- Overly complex schemes of earn-out calculations—earn-out may contain several conditions in itself, it is important to try to simplify the entire construction so that some of the requirements do not turn against each other.
- Extremely overestimated performance goals—by setting unrealistic high goals in order to boost the value of earn-outs the target company' s owners/management are also preparing a trap for themselves. Overly optimistic goals demotivate the management and can lead to the fact that the sellers will not reach the milestone even for the lowest level of earn-out payments.

The seller can protect himself from these problems by structuring the earn-out to reflect the integration costs and any value (in form of technology, customers, cash) that will be dragged from the target company after the transaction. The buyer on the other hand may want to cap the maximum value of the earn-out so that in case of an unexpectedly good performance the price would not skyrocket. It is crucial to negotiate transparent simple earn-out structures based on well-measurable parameters to prevent disputes about their calculation at the end of earn-out term.

**Table 1** VC-backed deals: type of consideration paid and inclusion of earn-out

| Type of consideration paid | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|---|---|---|---|---|---|---|---|
| Sample size | 15 | 17 | 51 | 26 | 27 | 37 | 27 | 19 |
| Cash | 60% | 71% | 73% | 73% | 59% | 59% | 67% | 47% |
| Stock | 0% | 6% | 4% | 8% | 8% | 3% | 4% | 0% |
| Cash and stock | 40% | 23% | 23% | 19% | 33% | 38% | 29% | 53% |
| Inclusion of earn-out | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 |
| With earn-out | 27% | 29% | 29% | 31% | 33% | 30% | 26% | 37% |
| Without earn-out | 73% | 71% | 71% | 69% | 67% | 70% | 74% | 63% |

*Source* (Hale and Dorr 2017)
*Note* Review of all venture-backed targets in deals with a deal value above 20 m USD closed between 2006 and 2016 according to Dow Jones Venture Source (data gathered by Hale and Dorr 2017)

## 4 Data Research

In a review of venture capital-backed deals financial specialists (Hale and Dorr 2017) have demonstrated the rise in the number of deals that included earn-outs. At the same time cash payments have declined to the benefit of cash and stock combined considerations. VC-backed deals are in their nature risker and are usually based on high ROI expectations, which makes them suitable for an earn-out application into price settlement (Table 1).

According to SRS Acquiom study (SRS Adquiom 2015), which included 720 acquisitions with a private company in role of the target, 77% of all deals in question had some form of instrument for purchase price adjustment incorporated into transactional documentation. In case of 60% of all deals some form of indemnification was claimed, 25% included more than one claim. These claims were raised against the escrow account.

In terms of the size, 6% of claims were equal or exceeded the escrow amount, 9% of claims reached half of the escrow. The common reasons for bringing up of these claims were tax issues (18% of the cases), IPR (11%), undisclosed liabilities (8%). The raised claims were settled at an average time of seven months (SRS Acquiom 2015).

Here we can see that up-front payment of the entire purchase price does not give the parties a head-start. The delays might occur after the closing when the parties will have to resolve indemnification claims which are very frequent as the above data shows.

Research (SRS Acquiom 2015) also shows that 56% of pre-agreed earn-out payments have been paid at least partially (life-science transactions were excluded from the research as the milestones for earn-outs in these transactions are often of a non-financial nature). Out of these deals in 50% of the cases the amount of earn-out met seller's expectations and in 6% of the cases earn-outs were under seller's expectations. In 15% it was first claimed that the conditions for earn-out payment were not met, but through legal and arbitrary disputes it was proved that target's shareholders were entitled to a payment. This makes up to 71% of pre-agreed earn-outs being satisfied to some degree.

## 5 Popularity of Earn-Out in Specific Industries: Testing the Hypothesis

Based on the researched literature and expert opinions (Walton 2007) the following hypothesis can be set up: earn-outs are more common in fast growing industries and in deals that include companies offering a new innovation product/service because of the higher uncertainty involved. This manifests in more deals structured to include earn-outs and well as in the fact that earn-outs ratio to total deal value is higher (bigger part of the value is tied to the future performance of the target company). On the other hand, it is expected that in traditional technology based industries earn-out payment in transactions are used less.

To test the above set hypothesis I have conducted a selection of deals that included earn-outs that took place between 2005 and 2018 in Mergermarket database. I have hand-picked all deals in the Computer software industry (applications, software development, IT solutions) in the CEE region that included earn-outs in purchase price payments and took place in the given time period.

The other selection pattern in the Mergermarket database included deals in the Agriculture, Mining and Manufacturing (such as furniture, packaging, textiles, pulp and paper). These sectors represent the traditional industries with well-known products and relatively clear predictability of future development. These characteristics presumably do not call for use of an earn-out.

The selection in the Mergermarket database resulted in 48 transactions in which the instrument of earn-out was used. Six of them were not analysed due to the fact that the amount of earn-out was not made public (Table 2).

## 6 Results and Discussion

In the category "Computer software development in CEE" the selection brought 16 transactions (five of them are not presented in the table due to the fact that the amount of the earn-out was not made public). The value of earn-out to deal value ratio ranged from 18% to 159%, average ratio being 66%.

For the same industrial category in Austria and Germany 25 results met the criteria (the table demonstrates six most recent for comparison purposes). Earn-outs vary from 4 to 84% with an average of 37%. Here we can see that only in these two Western-European countries the frequency of earn-out installments is higher than in the whole CEE region. The expectation, that earn-out will be more popular in the

**Table 2** Analysis of selected transaction based on earn-out payments

| Buyer | Target | Target's location | Completion date | Target´s profile | Deal Value w/o earnout | Earn-outs | Currency | Ratio of earn-outs |
|---|---|---|---|---|---|---|---|---|
| Alteryx Inc. | Semanta s.r.o. | Czechia | 31.1.2017 | Software development | 3.24 | 2.3 | mil EUR | 71% |
| National IT Centre | BARS Group | Russia | 20.4.2016 | IT solutions | 21.47 | 16.2 | mil EUR | 75% |
| Q-Free ASA | Traffic design d.o.o. | Slovenia | 23.4.2014 | Software development | 2.3 | 1.3 | mil EUR | 57% |
| Asseco Poland SA | Systemy Informacyjne Kapital SA | Poland | 2.2.2009 | IT solutions | 10.51 | 3.47 | mil EUR | 33% |
| Piksel Inc. | Visual Connection a.s. | Czechia | 5.10.2008 | Software development | 0 | 7.36 | mil EUR | 100% |
| Infovide matrix SA | DahliaMatic Sp zoo | Poland | 16.9.2008 | IT consulting | 4.73 | 1.18 | mil EUR | 25% |
| Take-two interactive software | Illusion Softworks a.s. | Czechia | 8.1.2008 | Computer games developer | 22.37 | 8 | mil EUR | 36% |
| Magyar Telecom Nyrt | KFKI Group | Hungary | 15.9.2008 | Software development (holding company) | 30.24 | 5.55 | mil EUR | 18% |
| JET multimedia SA | Avantis SA | Poland | 29.5.2006 | Media services | 8.9 | 10.17 | mil EUR | 114% |

(continued)

**Table 2** (continued)

| Buyer | Target | Target's location | Completion date | Target´s profile | Deal Value w/o earnout | Earn-outs | Currency | Ratio of earn-outs |
|---|---|---|---|---|---|---|---|---|
| Teleca AB | Telma | Russia | 11.4.2006 | Software development | 22 | 35 | mil USD | 159% |
| Ness Technologies Inc | Delta Electronic Services a.s. | Slovakia | 3.10.2005 | IT solutions | 7.75 | 3.25 | mil USD | 42% |
| Chegg Inc. | Cogeon Gbmh | Germany | 16.10.2017 | Applications developer | 12.5 | 7.5 | mil EUR | 60% |
| The Meet Group Inc. | Lovoo Gmbh | Germany | 20.9.2017 | Applications developer | 65 | 5 | mil USD | 8% |
| XING AG | Prescreen Gmbh | Austria | 10.7.2017 | Software development | 17 | 10 | mil EUR | 59% |
| CLX Communications AB | Xura Secure Communications Gmbh | Germany | 16.2.2017 | Software development | 15.5 | 1.5 | mil USD | 10% |
| GPI SpA | PCS Professional Clinical Software Gmbh | Austria | 29.12.2016 | IT solutions | 13.5 | 0.5 | mil EUR | 4% |
| Addnode AB | Transcat PLM Gmbh | Germany | 1.7.2015 | IT solutions | 5.98 | 5 | mil EUR | 84% |

(continued)

**Table 2** (continued)

| Buyer | Target | Target's location | Completion date | Target´s profile | Deal Value w/o earnout | Earn-outs | Currency | Ratio of earn-outs |
|---|---|---|---|---|---|---|---|---|
| Robinson Plc | Madrox Spolka Jawna | Poland | 26.6.2014 | Plastic packaging | 13.2 | 2.6 | mil GBP | 20% |
| Yanskaya Mining nad Geological Company | Omsukchansk Mining and Geological Company | Russia | 30.8.2008 | Mining | 20 | 5 | mil CAD | 25% |
| Aricom PLC | K&S iron-ore project | Russia | 3.7.2006 | Mining | 215.45 | 80 | mil EUR | 37% |
| CGS Management AG | A + F Automation + Foedertechnik Gmbh | Germany | 14.12.2017 | Manufacturing of packaging machines | 20.5 | 4.5 | mil EUR | 22% |
| Heinyel Holding Gmbh | Papierfabrik SCA Graphic Laarkirchen AG | Austria | 2.4.2013 | Production of personal care products | 100 | 100 | mil EUR | 100% |
| CCL Industries Inc | CD Design Gmbh | Germany | 1.2.2008 | Production of films and aluminium solutions | 10 | 4.5 | mil USD | 45% |

*Source* Mergermarket database 2018
*Note* Mergermarket database records as of 16.2.2018

emerging markets due to volatility as well as higher economic growth rates, did not prove to be right.

The explanation may lie in the fact that the level of transactional experience in this region is low and earn-outs were not "tested" on a sufficient number of transactions. At the same time in countries like the Czech Republic, Slovakia and Poland the M&A market is characterized by a high demand from strategic and financial investors, who are employed by the task to manage excessive liquidity combined with cheap bank financing. These conditions play well for the sellers who can demand higher prices paid at closing of the transactions without postponed price installments.

Selection of deals in the Agricultural, Mining and Manufacturing industries resulted in just a few relevant deals that included earn-out. Four deals were found in CEE region and three deals in Austria and Germany. The average ratios of earn-out to deal value were also lower than in Computer software industry.

It is fair to say that the hypothesis stipulating that use of the earn-outs depends on the industry of target has been proven right by the collected data. In both selected regions earn-outs were more common in case of fast growing software development companies with innovative products (41 cases versus 7 cases in the traditional industries). The location of the deals plays a secondary role in earn-outs popularity.

## 7 Conclusion

Valuation in M&A is a complex task which does not necessarily bring precise results. As researches and reports demonstrate, even the most experienced specialists find that assessing a price is complicated due to different views on company's growth and the added value that its brand, IP or talent resources bring. The results of the valuation and the success of an M&A in general can be judged in two to four year after the transaction is closed. These challenges call for the use of an earn-out: a flexible instrument which helps postpone a part of the payment to the moment when the company proves its valuation by turning growth expectation into real performance and demonstrating the value of its brand and know-how through increased revenues or profits.

Different risk preferences and expectations about the development of the target company as well as its market or industry create uncertainty. It is fair to say that uncertainty is higher on the bidder's side, but if the seller desires to get higher price he agrees to contingent payments, thus redistributing the risks of the buyer, while costs of an earn-out are also shared between the parties.

Analysis of earn-outs' business aspects shows that earn-outs have their limitations in terms of deals they can benefit. The key factor is the level of control each party has over the target company after the transaction. In case of deep integration into the structures of the buyer, the seller loses control over the distribution of resources and gains of his company and their outflow can lead to non-fulfillment of the determined milestones. On the other hand, the buyer can invest into the target company or use their distributions channels to provide cheaper inputs to the target company. In this case it is not rational for him to pay the seller for the incremental value created. All these nuances have to be covered in the transactional documentation which sets the conditions and formulas for earn-outs.

We find ourselves today in the Czech Republic in a very competitive sellers' market where demand for investments is higher than the supply. This fact causes the popularity of earn-outs to fall back, because sellers want to receive complete price in cash right away and thus prefer investors who are willing to satisfy their price expectation as soon as possible. Nevertheless if a bidder decides to offer a premium to win over the competition, an earn-out form of price premium is one of the most suitable solutions for him.

Transactional data demonstrate that popularity of earn-outs is less influenced by the geography of deals, but rather by the industry in which the target company operates. Thus earn-outs facilitate M&A activity in risk-related industries with fast growth and enable both parties to agree on the valuation once the buyer is sure that he will pay for actual results and the seller gets a chance to show that these results are achievable.

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