LEGAL LINGO

The Earnout Illusion

What every veterinary practice seller needs to know before signing.

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The veterinary transaction market remains highly active, with corporate consolidators, private equity-backed platforms, and independent buyers continuing to pursue acquisitions across the country. As competition for quality practices persists, deal structures have evolved to bridge valuation gaps and align incentives between buyers and sellers. One of the most commonly used, yet most misunderstood, tools in that process is the earnout.

What Is an Earnout?

An earnout is a contractual mechanism where a portion of the purchase price is paid after closing, contingent upon the practice achieving certain performance targets over a defined period. Earnouts are typically tied to metrics such as:

- Gross revenue
- Adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization)
- Production levels of the selling doctor
- Staff or client retention

From the buyer's perspective, the earnout mitigates risk. From the seller's perspective, it's typically seen as an opportunity to "share in the upside." On paper, that sounds reasonable. In practice, earnouts frequently become a source of tension, disappointment, and, in some cases, litigation.

The Core Problem

The central issue with earnouts is that the seller is being asked to assume risk without maintaining control. Once the transaction closes, the buyer owns the practice and controls everything from staffing and pricing to vendor relationships and capital expenditures. Each of these decisions can impact whether earnout targets are met. This creates an inherent tension: The seller's earnout depends on performance, but performance depends on decisions the seller does not control.

Revenue-Based Earnouts

Revenue-based earnouts are often considered more straightforward and seller-friendly than EBITDA-based structures. Although revenue is harder to manipulate than profit, these earnouts still carry risk. Consider:

- **Pricing changes:** A buyer may adjust pricing, discount structures, or service bundles in ways that impact revenue.
- **Associate turnover:** If key veterinarians leave post-closing, revenue can decline regardless of the seller's efforts.
- **Scheduling constraints:** Buyers may change scheduling and affect patient volume.
- **Resource allocation:** Marketing support or staffing levels may be reduced or reallocated.

Even if the seller performs at the same level they did pre-closing, the surrounding ecosystem may change in ways that make hitting revenue targets more difficult.

EBITDA-Based Earnouts

EBITDA-based earnouts introduce a significantly higher level of risk for sellers. EBITDA is not just a function of revenue; it's a function of how the business is run. Post-closing, the buyer has broad discretion over expenses.

A buyer can increase expenses and reduce EBITDA, even if revenue remains strong. This creates a scenario where the practice appears to be

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performing well, and the seller is working just as hard as before, but the earnout is missed due to decisions outside the seller's control.

From a legal perspective, this is one of the most common sources of post-closing disputes.

The Illusion of "Good Faith" Protections

Many earnout provisions include language requiring the buyer to operate the business in "good faith" or not to take actions "primarily intended" to avoid earnout payments. These provisions are notoriously difficult to enforce. To prevail in a dispute, a seller would typically need to prove that the buyer took specific actions with the intent of avoiding the earnout obligation. That's a high evidentiary burden.

Buyers can almost always point to legitimate business reasons for their decisions:

- "We restructured staffing to improve long-term efficiency."
- "We adjusted pricing to remain competitive."

Even if those decisions negatively impact the earnout, they are unlikely to be deemed a breach of a general "good faith" obligation.

Earnouts are not inherently bad. In the right circumstances, they can bridge valuation gaps, align incentives, and provide additional upside.

Integration Risk

One of the most underestimated risks in veterinary transactions is post-closing integration. Corporate buyers often implement changes such as new practice management systems, centralized call centers, revised compensation models, and standardized clinical protocols.

While these changes may make sense at a platform level, they can disrupt the operations of the practice and cause staff turnover, declines in client satisfaction, or reduced production.

These disruptions often occur during the exact period when the earnout is being measured. In other words, the seller is being asked to hit performance targets while the business is undergoing structural change.

The "Stay-and-Perform" Trap

Earnouts are frequently tied to the seller's continued employment. While this seems logical, it creates another layer of risk. If the seller becomes dissatisfied with the new ownership structure, disagrees with operational decisions, or experiences cultural misalignment, they may feel compelled to stay to preserve the earnout. This can lead to burnout, reduced morale, and a strained relationship with the buyer.

Worse, many agreements include provisions that eliminate the earnout if the seller resigns, or reduce or forfeit payments if employment is terminated "for cause." This effectively locks the seller into a structure where they bear significant risk with limited flexibility.

Aggregation and Allocation Issues

Sellers often assume they are being measured based on "their" practice. That's not always the case. In larger platform acquisitions, earnouts may be calculated based on the performance of multiple locations, shared financial metrics across a region, or allocations of centralized costs.

This introduces additional complexity and risk. A strong-performing practice may be offset by weaker locations, corporate overhead may be allocated in ways that reduce overall profitability, or financial reporting may lack transparency at the individual practice level.

A Reality Check for Sellers

Earnouts are not inherently bad. In the right circumstances, they can bridge valuation gaps, align incentives, and provide additional upside. But sellers need to approach them with clear eyes. Before agreeing to an earnout, ask yourself:

- Do I control the variables that determine whether I get paid?
- Am I comfortable working under the buyer's system for the duration of the earnout?
- What happens if things don't go as planned?

If the answer to any of these questions is unclear — or uncomfortable — you should think carefully before proceeding. TVB

7 WAYS SELLERS CAN MITIGATE RISK

1. **Favor objective, transparent metrics:** Revenue-based metrics are generally safer than EBITDA. Avoid complex formulas or adjustments, and ensure definitions are clearly tied to pre-closing financials.
2. **Limit buyer discretion:** Include specific covenants regarding how the business will be operated. Address staffing levels, marketing support, and pricing policies, and require consistency with past practices or defined standards.
3. **Define EBITDA carefully:** If EBITDA is used, clearly define permitted and excluded expenses, cap or restrict management fees and overhead allocations, and require consistency with historical accounting practices.
4. **Include reporting and audit rights:** Require regular financial reporting during the earnout period, provide access to underlying data, and include the right to challenge calculations through a defined dispute process.
5. **Address termination scenarios:** Protect the earnout in the event of termination without cause. Consider partial payouts or pro rata calculations, and avoid "all-or-nothing" forfeiture provisions.
6. **Shorten the earnout period:** The longer the earnout, the greater the uncertainty.
7. **Consider alternatives:** In many cases, sellers should evaluate whether a lower guaranteed purchase price is preferable. Seller financing or rollover equity offers a better risk/reward profile.

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