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AN INTRODUCTION TO EARNOUTS FOR THE SELLER OF A REGISTERED INVESTMENT ADVISOR

The sale of a Registered Investment Advisor (RIA) involves various critical considerations, with the purchase price being one of the most significant. In connection with the purchase price, the seller of an RIA will often encounter the concept of a contingent purchase price, commonly called an "earnout." In a business acquisition, an earnout is a payment arrangement where (i) a portion of the consideration paid by the buyer to the seller is not delivered until after the closing and (ii) the amount of such post-closing consideration is dependent on events that occur after the closing.

The payment structure of an earnout contrasts with the traditional payment structure of a business acquisition in which the total consideration (whether in cash, stock, or debt) is delivered by the buyer to the seller *at closing* in *a fixed amount*. In such a payment structure, delivery of the cash is typically executed by a wire transfer of immediately available funds, and delivery of stock or debt is completed by the exchange of signed documents at closing. Once the funds reach the seller's bank account, the transaction is considered complete. The seller's business is transferred to the buyer.

In the case of an earnout, the transfer of the seller's business to the buyer is still complete at closing. The crucial difference is that payment of a portion of the purchase price depends on the performance of the acquired business during a specified period following the closing. The earnout payments are typically spread out over several years. In the case of an acquired RIA, the performance metrics that determine the amount of those payments commonly include Assets Under Management growth, revenue growth, profitability, client retention, and client acquisition.

In certain situations, the use of an earnout in the sale an RIA can be a strategic and beneficial arrangement for the seller. An earnout can benefit the seller by providing a higher total consideration received, a smoother transition for clients and employees, more flexibility in exit timing for the seller, and, in the event of valuation disparities between buyer and seller, the opportunity for the seller to realize the full enterprise value of the RIA. Careful planning is essential to achieving the desired outcomes of an earnout and protecting the interests of the seller.