The Earnout Trap: Hidden Post-Closing Risks in M&A Transactions

August 3, 2026
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Earnouts are often presented as a solution that can help get a deal across the finish line. If a buyer and seller disagree on valuation, an earnout can help bridge that gap by tying a portion of the purchase price to the future performance of the company post-closing. It's a simple concept in theory. If the company performs as expected, the seller will receive additional payments. If the company does not meet the established metrics, the buyer pays less.

However, in practice, earnouts can introduce a significant layer of complexity, and they are one of the most heavily litigated provisions in M&A transactions. Why does this happen? Because after closing, the seller is no longer in control of the business – something that is often seriously underestimated during negotiations.

Founders generally have a belief that the company they created and built is poised for substantial growth. And while that might have been true pre-sale, once there is an ownership transfer, things can change significantly. The seller no longer has the ability to make decisions to achieve growth targets. Hiring decisions, sales strategy, marketing budgets, staffing levels, pricing models, operational priorities, and integration efforts are all solely in the hands of the buyer once the deal is done.

To further complicate matters, the acquired company may be integrated into a larger platform business or combined with another portfolio company. Revenue streams may be reallocated, expenses may be shifted, and key employees may choose to leave. Long-term integration might also be a higher priority for the buyer as opposed to short-term profitability.

Each of these decisions can directly impact whether earnout metrics are achieved. And this is where disputes arise. Sellers must carefully negotiate earnout provisions to avoid losses or even the courtroom down the road.

Establishing Clear Standards

One of the biggest mistakes sellers make when negotiating earnouts is agreeing to vague or subjective standards. The more discretion the buyer has post-closing, the greater risk to the seller that they will never receive their full earnout payment. This is why sellers should work with legal counsel to establish objective, clearly measurable performance metrics. For example, revenue-based earnouts are typically easier to evaluate than EBITDA or profitability metrics because profit calculations can be heavily influenced by post-closing decisions.

And even the most straightforward revenue metrics need to be carefully drafted. Sellers must understand exactly what counts toward the target, how revenue is recognized, whether certain contracts are excluded, and how deferred or recurring revenue will be treated.

Properly Structuring Earnouts

The structure of earnouts also matters, because when these are not structured properly, a seller could forfeit millions in earnout consideration if targets are barely missed. Therefore, the following provisions must be heavily negotiated or there can be a dramatic sway in the ultimate economics of the transaction:

- Is the earnout all or nothing? Will missing the target by a small margin result in no payment at all?
- Is there a sliding scale that allows for partial payments if performance reaches certain thresholds?
- If the company exceeds projections, does the seller benefit from that upside?

Post-Closing Information and Enforcement Rights

Another critical factor to consider are the seller's post-closing information and enforcement rights. Sellers should negotiate their access to financial information, reporting obligations, audit rights, and dispute resolution procedures before signing any deal documents. Without having these kinds of protections in place, it becomes increasingly difficult to determine whether a buyer appropriately calculated the earnout or if operational decisions unfairly impacted performance.

The Broader Financial Risk

It is common for sellers to underestimate the broader financial risk that is tied to variable consideration structures such as earnouts and rollover equity. These can be extremely valuable tools in the right transaction, but they also shift risk back to the seller. The more price is tied to future performance, the less certainty the seller has regarding their proceeds from the sale.

This is why legal counsel and deal advisors encourage sellers to limit the percentage of total deal value that is tied to earnouts whenever possible. Cash at closing equals certainty. While earnouts can provide an upside, they can also establish a continued dependency on a business that the seller no longer controls.

These risks do not mean earnouts should be avoided in every situation. They do have value in their ability to bridge valuation gaps, align incentives, and move deals forward that otherwise would have stalled out. But sellers must approach earnouts with caution and a clear understanding of these risks.

In M&A transactions, much of the important negotiations center on the purchase price. But remember, the most important disputes occur post-closing, with earnouts being at the center of them. Negotiate earnouts wisely.