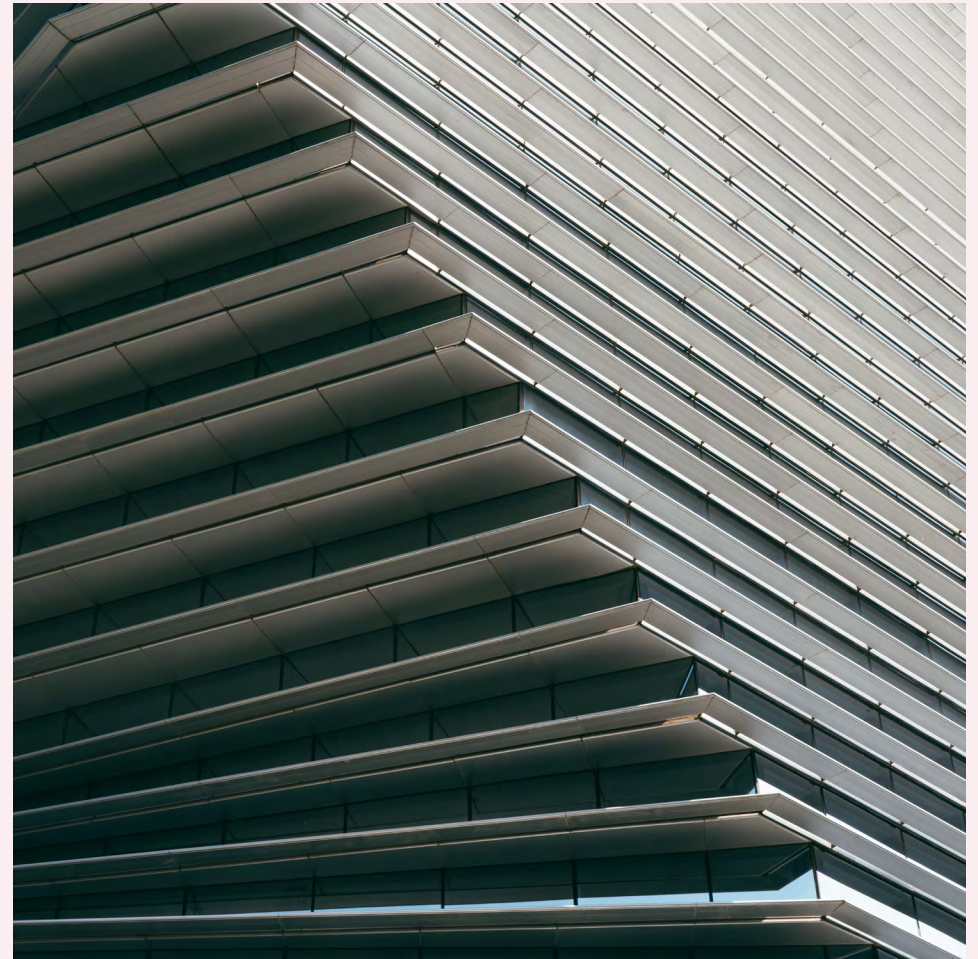


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# What's Market: Earn-outs in Australian M&A



# At a glance

# 1 Earn-outs in Australian M&A

The prevalence of earn-outs in Australian M&A has increased in recent years, mirroring global patterns, due in particular to broader global macroeconomic conditions (including geopolitical instability and uncertainty surrounding US trade policy), as buyers have sought to defer and reallocate valuation and performance risk to sellers.

There has also been an expansion in the use-case of earn-outs, beyond their traditional role as a valuation bridge, with buyers increasingly seeking to use them to mitigate a broader range of concerns, including to:

- enhance bid competitiveness
- incentivise timely achievement of milestones in carve-out transactions
- act as a tool to manage conflicts in continuation fund transactions, and
- re-enforce restraint compliance.

In the absence of any clear inflection point, and noting ongoing conflicts in the northern hemisphere, these trends are likely to remain a feature through 2026 and beyond.

However, earn-outs involve inherent risks, especially when designed to cater for a range of complex eventualities. Even in their simplest form, earn-outs are rarely straightforward to negotiate and in practice, they remain a frequent source of post-transaction litigation. Earn-outs can also have unintended tax consequences and in Australia (unlike many other major economies) an earn-out funded or facilitated by the target will have to navigate financial assistance prohibitions.

It is therefore vital that parties involve experienced advisors at an early stage to maximise the utility of any intended earn-out whilst minimising these risks.

In this article, we consider earn outs by analysing:

- their key benefits and challenges
- emerging trends in earn out usage
- what is market when negotiating earn-outs, and
- practical lessons from recent earn out disputes.

## Key points for dealmakers

- **Trends:** Earn-outs have become increasingly prevalent in Australian M&A, mirroring global patterns. Recently, their use has broadened beyond a simple valuation bridge, to being used to address a broader range of concerns.
- **Triggers:** The performance metrics on which earn-outs are based are usually financial, such as EBITDA or revenue, but can also include non-financial measures relevant to the target business, such as customer retention, the execution or renewal of material contracts, achieving product milestones obtaining regulatory approvals, M&A, etc.
- **Risks:** Earn-outs are complex to agree, can be manipulated and are a frequent source of dispute. Earn-outs may also have unintended tax and regulatory outcomes. Early advice is recommended.

# 2 Key benefits and challenges

Earn-outs offer a number of benefits including that they:

- bridge valuation gaps between buyers and sellers, enabling transactions to proceed that might otherwise stall over price
- operate as an incentive and retention tool for key sellers who are retained by the business post-acquisition, by motivating them to drive growth during the earn out period in order to maximise the value of the earn-out
- have cash flow benefits as the buyer is able to defer a portion of the purchase price, which may eventually be paid out of profits generated by the target or with scrip consideration to a seller
- can be used as security for claims under the sale agreement.

Notwithstanding these benefits, earn-outs present a range of challenges, including that:

- structuring the earn-out, and the financial measures applicable to it, involves many complex legal, tax and accounting issues
- for a buyer, it may ultimately pay a higher price if the business overperforms

(in circumstances where the outperformance is attributable to the buyer's actions) or benefits from unanticipated synergies with the buyer's group

- for a seller, they will not receive a clean break, may not realise the full earn-out amount if the business underperforms (in circumstances where the underperformance is attributable to the buyer's actions) and are subject to buyer default risk during the earn-out period, particularly if an earn-out is unsecured

Earn-outs are also vulnerable to manipulation. For example, if there are retained sellers that continue to operate the business following completion, they may seek to artificially inflate performance in the earn-out period (including by aggressive discounting, non-ordinary course promotions or "channel stuffing") to the detriment of the buyer. On the other hand, a buyer may seek to manipulate business performance by front loading capex, rerouting business to buyer group entities, or manipulating intra group charges and fees to the detriment of the seller. Although parties often negotiate 'good faith' covenants in the sale agreement to mitigate such manipulation

risks, these cannot guard against every behaviour to game the earn-out. Further, such covenants, if overly restrictive, may also unduly curtail the proper operation of the new business and delay the integration of the business into the buyer's group.

In addition, retained sellers that continue to operate the business following completion may be de-motivated if earn-out metrics become unachievable, undermining an earn-out's purpose as a tool to drive performance. And, Australian law restricts a company (including a private company) from financially assisting the acquisition of its own shares or those of its holding company. Where an earn-out is funded by the target, or if the target otherwise facilitates the payment, for example by providing a guarantee or security for the buyer's debt financing, it may fall within this prohibition on the basis that the target is using its own resources to assist the buyer to discharge its payment obligations under the sale agreement. In such cases, shareholder approval (a "whitewash") may be required unless an exemption applies.

## Key benefits and challenges

| Category               | Benefits   | Challenges  |
|------------------------|--|---|
| Valuation              | <ul style="list-style-type: none"> <li>• Bridges valuation gaps by aligning price with future performance.</li> <li>• Protects the buyer against overpayment (particularly where the earn-out is capped), with downside risk borne by the sellers during the earn-out period.</li> </ul>   | <ul style="list-style-type: none"> <li>• For sellers, no clean break</li> <li>• Increased post completion complexity and scope for manipulation (by buyer, or, where a seller remain involved in management post-acquisition, by seller).</li> <li>• Sellers may benefit disproportionately from synergies with the buyer group, artificially inflating the earn-out amount.</li> </ul>   |
| Cash flow              | <ul style="list-style-type: none"> <li>• Reduces the buyer's upfront cash outlay.</li> <li>• Offers funding flexibility if the earn-out is to be satisfied by non-cash consideration, funding from the target's future profits, or by deferral until an exit event occurs.</li> </ul>  | <ul style="list-style-type: none"> <li>• Sellers may require security for the earn-out, to protect against the risk of a buyer default, introducing cross-default risk for the buyer.</li> <li>• Australian financial assistance prohibitions to be considered where the earn out is funded or facilitated by the target.</li> </ul>  |
| Alignment of interests | <ul style="list-style-type: none"> <li>• Aligns buyer and seller interests in the future growth of the target business.</li> <li>• Where sellers remain involved in management post completion, provides an effective incentive.</li> <li>• Offers a non dilutive alternative to a management equity plan for retained sellers.</li> <li>• Supports the retention of key individuals by enhancing job security and continuity.</li> <li>• Potentially creates opportunities for retained sellers to assume expanded roles within the buyer group.</li> </ul> | <ul style="list-style-type: none"> <li>• May encourage short term focus at the expense of long term value creation.</li> <li>• For retained sellers: missed targets can demotivate seller-managers and increase the risk of disputes. COVID-19's impact on the realisation of earn-outs is a well-documented example.</li> <li>• A capped earn out may be less attractive than participation through a management equity plan.</li> </ul> |
| Security for claims    | <ul style="list-style-type: none"> <li>• Provides the buyer with an effective source of recourse by allowing sale agreement claims to be set-off against the earn-out, thereby incentivising seller compliance with the sale agreement.</li> </ul>   | <ul style="list-style-type: none"> <li>• If the buyer has meaningful protection through set off or forfeiture of the earn out, seller may seek to resist additional buyer protections, such as escrows or holdbacks.</li> </ul>   |

# 3 Emerging trends in earn-out usage

**There are a range of novel purposes emerging with respect to earn-outs, including:**

## **Enhancing bid competitiveness:**

We have seen a recent uptick in the frequency of earn-outs in auctions, particularly on large-cap transactions where there is a disparity (even a slight disparity) between seller and buyer price expectations. This gap often stems from concerns identified during the buyer's financial due diligence - typically with regard to quality of earnings risks. In such cases, the buyer may be prepared to agree to a higher valuation, provided the business delivers its forecasted results post-completion. An earn-out is therefore used to guard against the buyer's risk of overpaying should the business fail to perform after completion.

In a highly competitive auction, however, buyers must think carefully about the impact such a proposal may have on the likely success of their bid. Bids with a large earn-out component will be viewed as less competitive, particularly if accompanied by substantial rollover requirements or other reductions to cash consideration. Dependant on context, a buyer may need to consider accepting a higher degree of quality of earnings risk to maximise the success of its bid.

## **Incentivising timely achievement of milestones in carve-out transactions:**

Tying earn-out payments to the prompt and effective completion of separation activities can motivate sellers to ensure that a carve-out (where a segment of a business is separated and sold) is executed on schedule and to a high standard. When properly structured, an earn-out can also eliminate the need for sellers to retain an equity interest in the carved-out business, which might otherwise be necessary to align the interests of buyer and seller in achieving carve-out milestones on time and can be more complex to manage.

## **Managing conflicts in continuation fund transactions:**

We are aware of at least two recent continuation fund (CV) transactions that successfully utilised an earn-out to help manage conflicts of interest and obtain Limited Partner Advisory Committee approval.

Conflicts often arise in CV transactions because it is common for the fund manager to act on both sides of the transaction, representing both the original (vintage) fund and the continuation fund, whilst also being incentivised to maximise the

carried interest generated from the transaction for the fund manager's benefit. The fund manager may also be incentivised to undertake a CV rather than an alternative sale option to unlock ongoing fees and other benefits not available in a traditional sale.

Shifting all or some of the transaction consideration to an objective measure can help mitigate biases that exist in internal valuations of fund assets and is particularly advantageous where the CV is expected to deploy capital immediately after establishment to acquire new assets that are challenging to appraise. This approach complements other best practices in CV transactions that are aimed at achieving fair terms (including valuation) for both the vintage and incoming investors.

## Emerging trends in earn-out usage

### **Re-enforcing restraint compliance:**

An earn-out can be used to reduce key person exposure for a buyer. This is achieved by either conditioning the whole or part of a seller's earn-out entitlement on that seller's compliance with the restraint provisions in the sale agreement (i.e. non-competes and non-solicits) or enabling the buyer to set-off claims for a breach of restraint against any earn-out amount that is otherwise payable to that seller. Structuring the earn-out in this way provides a strong deterrent against poor seller conduct and security for restraint claims.

This mechanism can also be attractive where the buyer wishes to incentivise sellers who remain involved in the business post-acquisition, but for commercial reasons, is not able to expressly condition the earn-out on their continued employment. Employment-based conditions can be more difficult to negotiate in the context of an earn-out because they introduce additional

complexity, including careful consideration or any "good leaver" exceptions (for example, death or permanent incapacity), and may be resisted where there is a material risk that the employment condition could result in the earn-out being treated as employment income rather than capital proceeds for tax purposes (which materially reduces the net-value of an earn-out for a seller). By contrast, conditioning the earn-out on compliance with restraint obligations, or including rights of set-off against restraint breaches, is less complex and presents lower tax risk for sellers.

Where an earn-out is being used to re-enforce restraint compliance, the length of the earn-out and the restraints should be aligned. Parties should also consider the impact of any acceleration rights and tax advice should be obtained to ensure that tax outcomes are clearly understood and appropriately managed by all parties.

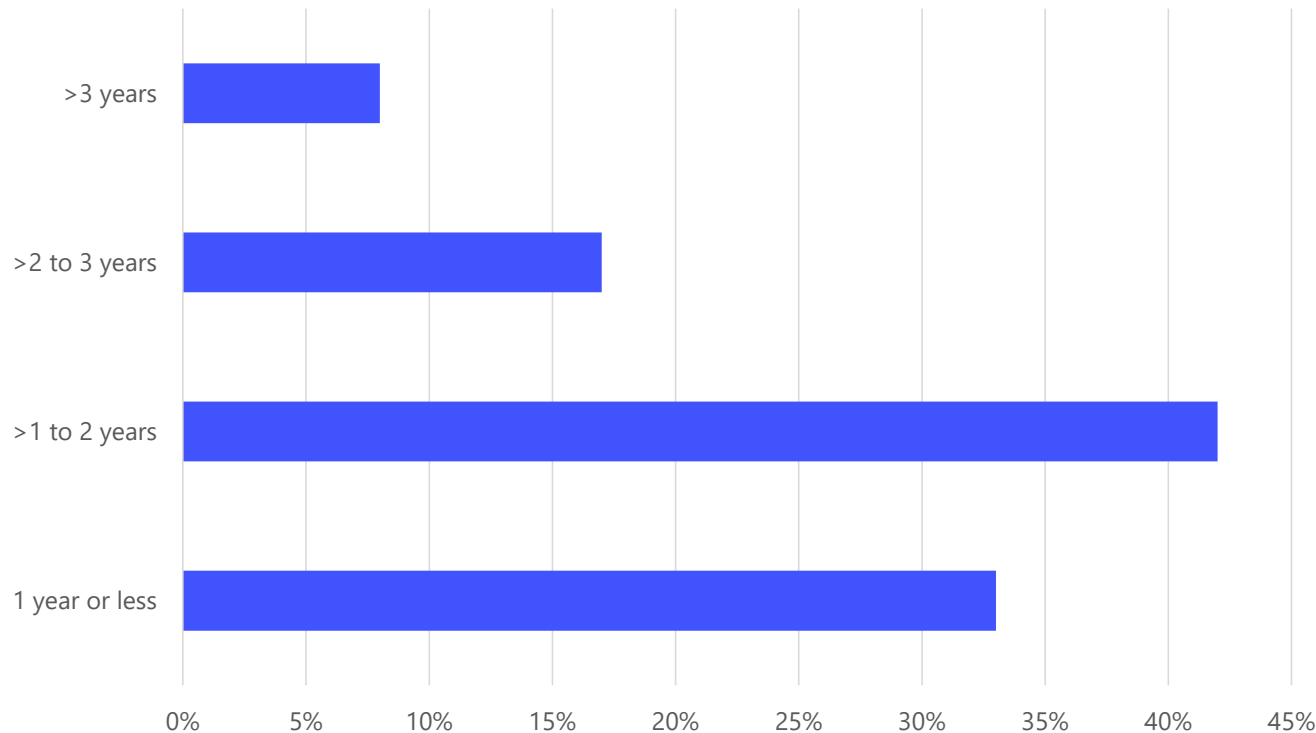
### **Key points for dealmakers**

- These trends reflect a defensive shift in response to the current macroeconomic climate: buyers are increasingly relying on mechanisms such as earn-outs to re-allocate risk to sellers and are employing these provisions across a wider range of transactions.

# 4 What's the market telling us?

A survey of the Australian private M&A transactions on which we recently advised showed the following:

## Earn-out duration



### Key points for dealmakers

- Shorter periods help limit seller exposure to buyer default risk and reduce the duration of any earn-out controls affecting the buyer's use and integration of the target.
- Longer periods increase each party's exposure to risk during the earn-out period and are only used if justified by the target's business plan or if required as result of market outlook.

## What's the market telling us?

### Earn-out trigger criteria

- EBITDA (earnings before interest, tax, depreciation and amortisation) is the most common metric (33%), followed closely by revenue (25%). Buyers commonly prefer profit-based metrics like EBITDA, whereas sellers tend to favour revenue on the basis that it is generally less susceptible to buyer manipulation. In some cases, multiple metrics (e.g. EBITDA and milestones) are used to provide a broader measure of performance and reduce risk of the earn-out being manipulated.
- The use of non-financial measures (e.g. customer retention, the execution or renewal of material contracts, achieving

product milestones, obtaining regulatory approvals, M&A, etc.) on a stand-alone basis is less common and typically appears in transactions involving early-stage businesses, where it is more challenging to set financial targets given insufficient historical information or where standalone operational milestones have a more significant impact on the business.

- Where financial metrics such as EBITDA are used, parties regularly attempt to negotiate adjustments to its calculation, such as exclusions of extraordinary items and of synergistic benefits, to avoid inappropriate distortion of the calculation of business's underlying performance for the purposes of the earn-out.

### Key points for dealmakers

- Irrespective of the chosen performance benchmark, the trigger criteria must be clearly defined, objective, measurable and aligned with the target's operations.
- Parties must consider if the trigger criteria can be determined by target's audited annual accounts, or if accounts prepared specifically for the earn-out will be required and appropriately define the accounting framework and policies governing this.

## What's the market telling us?

### Payment structure

- Payment terms are structured in various ways, most typically as a fixed sum, as a percentage of the target achieved, or a multiple of any excess over the target.
- A fixed sum “all or nothing” payment structure is most common where the earn-out trigger criteria is based on specific milestones or single performance threshold being met.
- A “tiered” payment structure (with increasing payments as higher performance targets are achieved) is predominantly used where parties wish to incentivise outperformance by increasing returns as higher thresholds are met. Tiered payment structure are almost always subject to an aggregate cap.

- Earn-outs are most commonly paid in cash, but are occasionally paid in scrip, or in a combination of cash and scrip. Additional valuation and securities law considerations apply if an earn-out payment is to be made wholly or partially in scrip.
- Payment of an earn-out using a loan note is uncommon in Australia.
- Payment usually occurs within a short period of the end of each earn-out period. However, in cases where the earn-out primarily relates to the incentivisation of retained sellers, a buyer (if in a strong negotiating position) may be able to defer payment until an exit event occurs, such that the earn-out operates similarly to a management incentivisation plan.

### Key points for dealmakers

- Earn-outs structured on an “all or nothing” basis, where payment is only required if a metric is fully achieved, are more prone to dispute as such arrangements create a stronger incentive for parties to challenge calculations or business decisions affecting outcome, particularly if a performance metric has only been narrowly missed (or narrowly achieved).
- Structuring earn-outs with partial or graduated payments for varying levels of achievement, and/or with catch-up rights to take account of improved performance in subsequent earn-out periods, can help mitigate this risk.

## What's the market telling us?

### Buyer protections

- **Preparation of earn-out statement:** It is market for buyers to control the preparation of the earn-out statement (67%) given the buyer owns the business post-completion. This is an important right because the party that prepares the statement controls the initial interpretation of applicable accounting principles and policies. Sellers usually have a short period to review the statement and challenge it, if necessary, with an ability to escalate to an independent expert if agreement cannot be reached.

In a minority of cases (25%), sellers negotiate a compromise whereby preparation of the earn-out statement is delegated directly to an independent expert or to the target board. In some a typical instances, the sellers prepare the earn-out statement, however such arrangements are driven by specific commercial dynamics (such as the parties being related or the earn-out trigger criteria being a flat metric).

- **Set-off rights:** In the majority of the surveyed transactions (67%) buyers may set-off claims

under the sale agreement (e.g. warranty claims, indemnity claims, tax claims and claims for breach of contract) against the earn-out. Set-off rights are limited to agreed claims or claims that are finally determined by a court of competent jurisdiction. Sellers occasionally negotiate conduct of claims rights as a quid pro quo to accepting a set-off right.

- **Employment condition:** An employment condition, meaning that the whole of the earn-out payment is contingent on a retained seller remaining with the business during the earn-out term (unless a “good leaver”), are prevalent in transactions involving smaller family or founder-backed businesses, where much of the business’s value is attributable to the founders, but did not feature in the majority of the surveyed transactions overall (25%). In fewer instances, the earn-out is also conditional on compliance with sale agreement restraints.
- **Aggregate caps:** In the vast majority of the surveyed transactions (90%), the aggregate earn-out amount is capped, even if the business’s performance exceeds relevant targets.

### Key points for dealmakers

- Typical accountant standards are typically inappropriate to be applied, without adjustment, to the preparation of an earn-out statement,
- It is therefore critical to fulsomely set out in the sale agreement the accounting framework and policies governing the preparation of the earn-out statement (just like it is with a completion statement), especially if special purpose accounts are required.

## What's the market telling us?

### Seller protections

**Earn-out controls:** The vast majority of transactions (83%) include earn-out controls/restrictions, but in most cases those protections are limited. Typically, they require the business simply to be operated as a going concern and prohibit the buyer from winding up the target or deliberately taking action in bad faith to depress the earn-out. This indicates that, while some level of seller-protection is market standard, buyers are generally successfully able to resist broad constraints over the operation of the business in the target period.

Where more extensive controls are sometimes negotiated, they address matters such as intra-group charges, capital expenditure and governance, including veto rights over M&A, group restructurings, changes to accounting policies and key personnel decisions. More aggressive formulations may go further and require the buyer to take positive steps to maximise profits. In some cases, earn-out controls

also restrict direct or indirect changes of control of the target group, effectively operating as an alternative to acceleration rights.

**Acceleration:** Acceleration rights, which require the buyer to pay the maximum earn-out amount in full to the sellers, irrespective of the target's actual performance, if there is a direct or indirect change of control of the target group, are not uncommon but are not predominant (33%).

**Security:** In the vast majority of surveyed transactions (over 90%), buyers do not provide specific security for earn-out payments. Buyers generally resist any requirement to provide security due to the additional complexity this requires and the potential cross-default risk this introduces in relation to the buyer's broader security arrangements if enforced. Where a buyer does agree to provide security for the earn-out, cross-default and subordination issues should be considered carefully, with finance counsel involved to ensure the security package is structured appropriately.

**Catch-up / force majeure:** Only 17% of the surveyed transactions include catch-up rights or force majeure protections. Catch-up rights allow any missed earn-out amount to be recovered in a later period if the relevant targets are subsequently met. Force majeure provisions extend the earn-out period automatically on the occurrence of specified events affecting business performance, such as war, natural disasters, pandemics or political instability. These protections are generally more relevant where the target business is seasonal or otherwise subject to fluctuating performance.

### Key points for dealmakers

- Sellers should focus on the protections that address their core downside risks, as buyers are likely to resist anything that unduly fetters the buyers control of the target post- completion.

# 5 From deal to dispute: Lessons in earn-out litigation

We have reviewed recent Australian case law relating to earn-out disputes and summarise below the key recurring themes and practical lessons for reducing dispute risk.

## **Precision in drafting:**

Take the time to get the drafting right. Ambiguity invites conflict – a stray Oxford comma can be costly. The more at stake and the more ambiguously drafted the earn-out (particularly an unconventional earn-out), the more likely a dispute could arise.

Try to structure calculations in a way that minimises the need for experts, as this can add cost and complexity to disputes. For example, appending a worked example of the earn-out formula to the agreement can be helpful.

## **Careful construction of triggers:**

Be careful to manage representations leading up to the drafting of the earn-out to reduce the risk of misrepresentation or rectification claims.

## **Clear dispute resolution procedure:**

An earn-out clause should be complemented by a clear dispute resolution provision. Consider and specify how you would like a potential dispute to be solved. For example, it is typical for disputes over the earn-out amount to be resolved by expert determination. Courts will hold parties to the exact process agreed in the sale agreement. Be clear about the process and parameters applicable to such determination.

## **Funding sources:**

Consider what the source of funding for payment of an earn-out will be, and timing of receipt of that funding. A mismatch between earn-out payout obligations and actual receipt of funds necessary to satisfy that obligation will derail an earn-out being paid as parties originally agreed.

Also consider what approvals are required to be obtained to permit an earn-out payment to be provided to a seller. In particular, if the earn-out payment will be funded by the target, requisite shareholder approval will generally need to be obtained.

## **Key points for dealmakers**

- Earn-outs are won or lost in the drafting: parties should not rely on courts to rescue vague drafting or fill commercial gaps.

## From deal to dispute: Lessons in earn-out litigation

### **Bad faith conduct:**

If the ability to avoid paying an earn-out seems too good to be true, it probably is. Although there is no settled universal implied duty of good faith under Australian law, a party cannot assume that the literal interpretation of earn-out terms will necessarily permit opportunistic conduct designed to avoid payment, as courts may imply good faith obligations depending on the terms, context and commercial purpose of the agreement. Legal advice should be sought prior to taking any action that appears commercially artificial or contrary to the bargain.

If it is intended that the earn-out may be reduced to \$0, or even produce a negative amount (resulting in a repayment obligation on the sellers), that outcome should be stated in clear and explicit terms. Equally, if the seller expects protection in the earn-out period against buyer conduct aimed at defeating or depressing the earn-out, that protection should be expressly documented rather than left to implication.

### **Security rights:**

Be careful about security rights in respect of earn-outs. Enforcement by the sellers, even if only arguable, may trigger cross-defaults in respect of the wider financing arrangements of the buyer group.

### **Payees:**

Although it may seem obvious, it is essential to clarify who, exactly, will receive the earn-out payments. It may not be that all shareholders share equally in the earn-out as a buyer may choose to limit the benefit of an earn-out to rolling sellers and/or retained management sellers.

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