

Acquisitions rarely fail on price alone. They stumble on risk. The seller wants certainty that the check will clear and that post-closing drama will not claw back value. The buyer wants to avoid paying full freight for value that might not survive in new hands. Earnouts, holdbacks, and escrows are the practical tools we use to bridge that divide. Get them right, and you align incentives and shrink unknowns. Get them wrong, and you set the stage for disputes, stranded capital, and regret on both sides.

I have negotiated these structures in deals as small as a dentist’s office and as complex as cross-border industrial rollups. The mechanics look similar on paper, yet each mechanism serves a different purpose and deserves its own judgment calls. Let’s pull apart what they do, when they work, and the traps that catch smart people.

What these mechanisms actually do

Earnouts tie a portion of the purchase price to future performance. They answer the buyer’s question, “Will this business perform after I own it?” They also let a seller participate in upside if the story proves out. You pay later, contingent on agreed metrics. The flip side: you need clean measurement rules and a path to operate the business without tripping into a dispute.

Holdbacks are amounts the buyer withholds from the closing cash to cover specific risks. Think unpaid sales tax exposure, a customer rebate that was booked light, or a small lien that will take time to release. A holdback is usually time-bound and targeted. When the risk clears or expires, the money releases.

Escrows are funds placed with a third party, typically to secure indemnities. If the seller’s warranty about, say, compliance with wage laws turns out false, the buyer claims against the escrow rather than chasing the seller in court. Escrows reduce friction and give both sides a clear path to resolution.

A simple way to remember it: earnouts price the future, holdbacks plug identified leaks, and escrows insure against unknown breaches.

Where these fit in the deal timeline

During early diligence, the tools look interchangeable. By the time you draft the purchase agreement, each one occupies a defined role. You propose the headline price and structure in the letter of intent; you sketch whether any earnout is contemplated and hint at escrow size. After diligence sharpens risks, legal teams formalize the guardrails: representations and warranties, covenants, indemnities, and the related financial instruments. In practice, lenders and insurance brokers also weigh in. Lenders may cap earnouts relative to cash at close, and reps and warranties insurers may reduce or replace general escrows.

If you are Buying a Business with financing, expect your lender to press for adequate protection. Debt funds prefer some cash cushion. They do not want an earnout that siphons cash flow away from debt service, and they do not love contingent fights. In Business Acquisition Training, this is often framed as debt service coverage first, seller second.

Earnouts: why they attract and why they bite

An earnout makes the unprovable, provable. I once advised a buyer evaluating a niche software company that had recently shifted to annual subscriptions. Revenue looked stable, yet the renewal curve was untested. We split the gap: 60 percent cash at close, 40 percent over two years, contingent on net revenue retention holding above 95 percent and new bookings hitting modest thresholds. That deal would not have closed without an earnout. It worked because the metric was measurable, the seller stayed engaged for twelve months under a light-touch consulting agreement, and we defined adjustments with surgical precision.

The pain point with earnouts is friction after the honeymoon ends. The buyer wants to integrate, cut fat, or pivot go-to-market. The seller wants continuity until the targets are met. I have seen more disputes about “ordinary course” decisions than any other clause. Was the sales comp plan changed? Did marketing spend get cut? Did the buyer push a strategic price increase that juiced margins but hurt volume, thereby missing a unit-based earnout? These arguments are predictable and avoidable if you nail the mechanics.

Key design choices matter more than headline dollars. Decide whether your metric is revenue, gross profit, EBITDA, or something operational like units shipped or installed base growth. Revenue is easy to measure but easy to manipulate with discounts or channel stuffing. EBITDA captures value creation but invites a wrestling match over allocations, management fees, and post-close integration costs. Operational metrics can work in focused businesses, yet they risk losing the link to enterprise value.

How much of the price should be contingent? In lower mid-market deals, I often see 10 to 40 percent, with the upper end reserved for turnarounds or businesses with customer concentration risk. In deals backed by a lender, staying under 25 percent is more palatable. Duration typically runs 12 to 36 months. Go longer, and fatigue sets in. Go shorter than a full cycle, and you might be measuring noise, not performance.

You also need to decide whether the earnout is all-or-nothing or stair-stepped. Binary triggers invite bitter outcomes, so most experienced buyers prefer tiers, caps, and collars. I once structured a consumer products earnout with three tranches tied to trailing twelve-month revenue at the first and second anniversaries. We built in a catch-up so the seller did not lose a full year’s potential just because a key retailer pushed a reset into the following quarter.

Finally, plan for the [buying a business in London](#) effect of acquisitions and divestitures. If you bolt on another business, how do you treat its results when scoring the earnout? Exclude it, include it, or include it with a pro forma adjustment? Put it in writing. The day you close a tuck-in is not the day to renegotiate the earnout math.

Holdbacks: a scalpel, not a sledgehammer

Holdbacks are simple in concept and delicate in practice. Use them to cover discreet, near-term issues. The best holdbacks have three attributes: specificity, documentation, and a clear release timetable.

Suppose diligence flags a potential \$250,000 sales tax exposure in three states. The seller believes they were under the threshold for economic nexus in two, and voluntarily compliant in the third, but the facts are messy. Rather than delay the deal, you withhold \$250,000 at close. The purchase agreement describes the tax risk, references the voluntary disclosure program plan, and states that the holdback will release in two stages: \$150,000 upon filing and acceptance of VDPs, and the balance 180 days later if no assessment exceeds the reserved amount. If assessments do arise, the buyer can offset them against the holdback with notice and support.

Common targets for holdbacks include working capital true-ups, delayed lien releases, open litigation with a known cap, and cleanup of legacy HR or payroll corrections. Working capital is its own rabbit hole. Many deals require a post-close true-up, comparing target net working capital to actual at closing. Some buyers confuse the true-up with a holdback. They are related but not the same. A true-up is a formulaic adjustment to price. A holdback is cash withheld to secure performance or resolve a known item. Keep them separate in documents and in your mental model.

Size your holdback to the identified exposure, plus a margin if resolution costs are uncertain. If you cannot bound the risk with a reasonable cap, you are probably dealing with an escrow or a price reduction, not a holdback.

Escrows: the backbone of indemnity

Escrows sit at the intersection of legal promises and practical recourse. The seller promises that the financial statements are accurate, that the company is not breaking laws, that there are no undisclosed debts. If a promise proves false and the buyer

suffers a loss, the buyer seeks indemnification. An escrow provides a ready pot of money to satisfy that claim without lawsuit or collection headaches.

Typical sizes vary by market. In sub-\$50 million enterprise value deals without reps and warranties insurance, a general escrow of 8 to 12 percent of price is common, with a survival period of 12 to 24 months for general reps and longer for fundamental reps such as title and authority. In deals with reps insurance, the general escrow might fall to 0.5 to 1.5 percent, functioning more as a retention or to cover excluded matters. Numbers move with competition, industry risk, and the seller's negotiating leverage.

Escrow release mechanics sound dull until you need them. Specify partial releases, not just a single drop date. If the general reps survive 18 months, schedule an interim release at 12 months if there are no pending claims beyond a threshold. Include a clear process for notice, objection, and disbursement. A well-run escrow agent can resolve undisputed amounts quickly and hold only the contested slice, which keeps goodwill intact.

One more point that trips newer buyers: baskets and caps. An indemnity basket is the amount of aggregate losses the buyer must absorb before recovering from the seller. It comes in tipping (first dollar after threshold) or deductible (only amounts above threshold) forms. Caps limit total seller liability, often tied to escrow size for general reps and much higher, sometimes uncapped, for fundamental reps and fraud. Match these to your risk assessment. A light basket and high cap in a heavily regulated business may be warranted even if the market data argues for something softer.



Combining mechanisms without creating knots

The cleanest deals separate purposes. The earnout prices uncertain growth. The escrow backs indemnities. The holdback covers a discrete, documented risk. Problems start when one mechanism tries to do another's job. I have seen escrow funds earmarked to pay an earnout if a claim does not arise, which invites a perverse incentive to dispute minor matters just to keep cash on hand. I have also seen sellers demand that the holdback be the sole recourse for a known issue and refuse escrow coverage for adjacent unknowns. Both create brittleness.

When combining, draw clear lines. If you must use a holdback for a specific tax exposure and a general escrow for reps, name them differently, place them with separate accounts, and give them different release conditions. That reduces cross-talk in negotiations later. When lenders are involved, ensure the intercreditor or subordination agreements acknowledge the existence of contingent seller payments like earnouts and clarify priority.

Choosing metrics and definitions that survive real life

The most durable earnouts rely on unambiguous inputs drawn from standard reports. This is not just about good faith. Staff turnover, system migrations, and ordinary chaos can undermine even friendly deals. If you tie an earnout to "net revenue," define revenue recognition policy, refund and discount treatment, bad debt write-offs, and the date a sale is considered booked. If you

choose EBITDA, schedule an exhibit with an example bridge from revenue to EBITDA, including how you will treat corporate allocations, owner compensation normalization, transaction-related costs, and extraordinary items.

Forecast bias deserves mention. Sellers almost always believe the business will sprint after close. Buyers carry a skeptic's realism and plan for a stumble. A fair earnout narrows that gap. In practice, I like to test metrics with three scenarios using the seller's historicals: a 10 percent downside, base case, and 10 percent upside. If the seller only gets paid in the upside, the earnout functions less as price and more as a lottery ticket. That is fine if everyone admits it. If not, you are setting up a fight.

A quick note on seasonality. Many businesses breathe with the calendar. If your earnout window ends just before a peak season, you incentivize sandbagging into the next period. Use trailing periods, rolling averages, or a final stub period that includes the season to neutralize timing games.

Governance, access, and reporting

Sellers paid on future performance deserve visibility. Buyers running the show deserve freedom to operate. You can hold both truths with a light governance layer. Commit to provide monthly or quarterly financials, KPI dashboards, and reasonable access to the finance lead for earnout questions. If the seller is staying on in an operating role, carve out authority levels and change-approval thresholds during the earnout period. Avoid handcuffs that prevent routine improvements. Instead, prohibit only material changes that would be reasonably expected to depress the earnout without business justification, and include a carve-out for good-faith integrations, legal compliance, and lender-required actions.

Dispute resolution belongs in the contract. Appoint an independent accountant for measurement disagreements. Require timely notice, set short windows for data exchange, and agree that the accountant's decision is final and binding except for manifest error. That framework turns what might become litigation into a professional, mostly apolitical process.

Tax angles that change economics

Taxes turn nominal dollars into different after-tax outcomes. In an asset deal, a properly structured earnout can be treated as additional purchase price, which affects both installment sale treatment and the buyer's basis. In a stock deal, the tax treatment shifts again. Jurisdiction matters. So does whether the seller is an individual, a pass-through entity, or a C-corp. I am not giving tax advice here, but I will emphasize that early input from tax counsel can unlock or kill a structure.

A common pitfall is ignoring payroll tax and withholding on earnouts paid to sellers who stay on as employees. If the earnout is tied to employment or services, you may have compensation treatment and a very different tax result than anticipated. To avoid surprises, separate true purchase price earnouts from any bonus plan for ongoing employees, and label them accordingly in both the agreement and the 1099 or W-2 reporting.

Practical negotiation guidance

There is no perfect market term. There is your deal, your leverage, and your risk appetite. A few patterns have served me well across industries and sizes.

- When proposing an earnout, lead with the business logic, not a haircut. Show how the earnout pays the seller more if their growth story materializes. Anchor on metrics that both sides already use to run the company, and bring sample reports to the table.
- With holdbacks, pair the amount with a path to release and the evidence needed. Sellers accept friction when they can see the finish line.
- Escrows go down easier when baskets, caps, and survival periods are calibrated to the business. If the company sells regulated medical devices, a 12-month survival on compliance reps may be unrealistic. Show data, cite comparable deals if you have them, and be prepared to flex on price or other terms if you push for longer coverage.
- Keep the math simple enough for a busy CFO to calculate in under an hour. Complexity breeds error and suspicion. If you cannot explain the calculation out loud without looking at notes, it is too complicated.

- Do not starve the business to hit an earnout. I once worked with a seller who delayed hiring two account managers because they feared missing their EBITDA target due to onboarding costs. We amended the earnout to exclude specified growth hires and then watched revenue leap. Everyone won because we aligned incentives with reality.

Common failure modes and how to avoid them

Earnouts tied to vanity metrics tend to implode. Top-line revenue without quality-of-revenue safeguards invites discounting and channel stuffing. If you choose revenue, add constraints on minimum gross margin or collectability.

Another failure mode is using an earnout to solve a seller's strained valuation without agreeing on operational guardrails. The buyer integrates aggressively, rationalizes SKUs, and migrates systems. The seller sees their future payment evaporate and alleges interference. The cure is not to freeze the business. It is to define reasonable operational discretion and to create a methodology for pro forma adjustments if the buyer's actions materially affect the chosen metric.

On the escrow side, vague claim procedures cause avoidable logjams. I have seen buyers lose valid indemnity claims because notice did not include required detail or was not sent to the address in the contract. Follow the process you agreed to. Train your team. Calendar survival periods and notice deadlines.

Holdbacks fail when they are misused as leverage rather than risk management. If a buyer withholds funds for a risk already covered by indemnity and escrow, you double-dip and poison trust. Use the right tool for the right job.

Real examples that illustrate the edges

A manufacturing acquisition in the Midwest featured a single customer that accounted for 38 percent of revenue. The customer had issued a letter of intent to renew for three years, contingent on continued on-time delivery. The buyer felt exposed but did not want to crater the headline price. We built a two-year earnout tied to gross margin dollars from that customer alone, with a cap equal to 15 percent of the purchase price. We set a narrow definition of margin, excluded steel surcharges to avoid noise, and allowed the seller to consult on key customer meetings for the first six months. The customer renewed. The seller collected the full earnout. The buyer slept at night.

Contrast that with a creative agency deal that went sideways. The earnout was based on EBITDA, but no one documented how to treat founder bonuses that had been historically discretionary. The buyer continued a smaller year-end bonus, which reduced EBITDA below the threshold. The seller argued those bonuses should be added back because they were "owner perks." No one could prove the historic pattern with enough clarity, and the dispute burned goodwill and legal fees. The fix would have been a schedule listing historic discretionary payments and a clause stating explicitly which would be add-backs.

An e-commerce rollup presents a final lesson. We negotiated a modest escrow, just 5 percent of price, and reps insurance to cover the rest. Six months in, the platform suffered a data breach that pre-dated closing but was discovered post-close. Claims went to the insurer. Because the policy excluded certain IT hygiene failures, the buyer still needed to pursue the seller for a portion. The small escrow was not enough to cover costs. The buyer recovered only a fraction and learned a hard lesson: exclusions matter more than the headline policy limit, and your escrow should reflect the practical recoverability of excluded items.

How these tools influence culture after closing

Earnouts can keep sellers engaged, transfer tacit knowledge, and smooth handoffs. They can also create shadow management if poorly structured. I recommend a defined advisory period with set meeting cadences and clear decision rights. Celebrate joint wins, share dashboards, and call out progress toward earnout targets transparently. When trust is high, minor hiccups do not escalate.

Escrows and holdbacks rarely affect day-to-day culture, yet they shape tone. If the seller believes you will use every technicality to yank funds, collaboration suffers. If the buyer believes the seller hid skeletons, every surprise becomes a suspicion. Deal hygiene and clarity during negotiation carry into the post-close relationship more than most people expect.

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When to walk away from contingent structures

Not every business lends itself to an earnout. If the drivers of performance are outside management's control, like commodity prices or regulatory approvals, the earnout starts to look like a bet, not a measure of execution. If you cannot define the metric without footnotes, you may be forcing a structure that will only harm both sides. In those cases, cut the price or change the scope rather than contort the deal.

Similarly, if a seller refuses a reasonable escrow for representations that underwrite the entire deal, ask yourself why. Sometimes the answer is innocuous, such as a seller's need for immediate cash for estate reasons. Often it hints at risk you have not fully priced. Reps and warranties insurance can be a bridge, but it is not a free pass, and its exclusions can bring you back to the table anyway.

A brief checklist you can use in the room

- For any earnout metric, write the precise calculation, data source, and timing on a single page. If it does not fit, simplify.
- Align the earnout period with business cycles. Avoid windows that reward timing games.
- Match holdbacks to documented, bounded risks and set specific release milestones.
- Size escrows with regard to survival periods, caps, and any reps insurance exclusions. Plan partial releases and clear claim procedures.
- Coordinate with lenders and tax advisors early so structure does not collide with covenants or create tax surprises.

The bottom line for buyers and sellers

These mechanisms do not replace trust and diligence. They sit on top of them. In the best acquisitions, earnouts feel like a shared scoreboard, not a punishment. Holdbacks fade quickly because the team knocks out the punch list. Escrows sit quietly in the background, ready if needed and otherwise forgotten.

If you are Buying a Business for the first time, or refreshing your playbook through Business Acquisition Training, you will find that mastery here is not about memorizing market ranges. It is about understanding what you are insuring, pricing the right risks with the right tool, and writing definitions that survive real life. Deals close on certainty. These mechanisms, used well, create it.