

March 2026

Earnouts in M&A: Risk allocation, incentives, and post-closing disputes

Introduction

Recently, the Delaware Supreme Court issued an *en banc* opinion in a post-closing earnout dispute between Johnson & Johnson and the former stockholders of Auris Health, Inc.¹ The dispute arose from a merger agreement providing for up to \$2.35 billion in earnouts tied to regulatory and commercial milestones for robotic surgical products. When the agreed upon 510(k) regulatory pathway to achieve the milestones was closed by the FDA, the seller alleged that Johnson & Johnson failed to fulfill its obligations by not pursuing an alternate De Novo pathway.²

The Court of Chancery agreed with the seller and awarded more than \$1 billion in damages plus interest. The Delaware Supreme Court partially reversed that ruling, holding that the agreement's text governed and that the implied covenant of good faith and fair dealing could not be invoked to supply protections the parties did not negotiate. In doing so, the Court reaffirmed that the parties bear the economic consequences of foreseeable contingencies, even those that significantly alter the probability of earnout payment.

From an economic perspective, the opinion reinforces that earnouts represent a deliberate exchange: sellers accept contingent consideration in lieu of upfront certainty, and buyers assume operational control subject only to the terms and milestones agreed upon. By declining to reallocate risk *ex post* through expansive implied covenant arguments, the Court preserved the primary purpose of earnouts as pricing mechanisms for uncertainty, particularly in highly regulated and innovation-driven sectors where milestone timing and regulatory pathways are inherently volatile. The decision underscores a central insight for legal and valuation professionals alike: earnouts are not deferred purchase price in disguise, but a structured risk-sharing mechanism.

¹ *Johnson & Johnson v. Fortis Advisors LLC*, Delaware Supreme Court, No. 490, 2024 (Jan. 12, 2026).

² A 510(k) is a simplified FDA clearance pathway based on showing that a new device is "substantially equivalent" to an existing legal predicate, whereas De Novo classification is a more rigorous pathway for novel, low-to-moderate risk devices that have no existing predicate and require a fresh risk-based evaluation.

In this article, I discuss earnouts as a tool for allocating risk and resolving valuation disagreements in M&A transactions. I describe how earnouts function and why earnouts are most prevalent in acquisitions of private firms and in industries characterized by high uncertainty, such as healthcare and technology. I present empirical evidence on the prevalence, size, and industry distribution of earnouts in recent M&A transactions. Finally, I discuss the types of disputes that arise due to incentive conflicts and over the measurement of the performance target.

Key takeaways

- Earnouts are structured risk-sharing mechanisms used to bridge valuation gaps by tying consideration to uncertain future performance rather than representing only a deferred purchase price.
- Delaware Supreme Court recently reaffirmed that earnout outcomes are governed by contract terms, and courts will not reallocate risk ex post through implied covenant arguments.
- Earnouts are most prevalent in private company acquisitions, where information asymmetry between buyers and sellers is greater.
- They are also concentrated in high-uncertainty sectors such as healthcare and technology, where value depends on future outcomes like regulatory approvals and R&D success.
- Empirical evidence indicates that earnouts are consistently used across market cycles, typically comprising ~22–28% of total deal value.
- Earnouts are being used more actively in smaller deals, where information asymmetries are typically greater, providing risk-sharing benefits and bridging valuation gaps between buyers and sellers.
- Post-closing control creates incentive conflicts, leading to disputes over whether missed targets reflect buyer conduct or external factors such as market conditions or regulatory changes.
- Disputes frequently turn on how performance metrics are defined and applied, including disagreements over accounting choices and operational decisions.

Risk allocation, valuation gaps, and disputes

Earnouts are deferred payments in M&A transactions that are contingent on the target's future performance after the deal closes. The performance target is based on either financial metrics tied to post-acquisition performance of the acquired business, such as cash flows, sales, earnings, or non-financial performance thresholds, such as clinical trial success or Food and Drug Administration (FDA) approval.

The buyer is required to pay the earnout amount to the seller if the agreed upon performance target is achieved; if the target is not achieved, the payment could be reduced or eliminated. By making the earnout contingent on future performance, the buyer transfers the risk of failing to achieve the required performance threshold to the seller and protects the buyer from overpayment upfront. Evidence from a survey of investors from private equity firms, investment banks, and corporate M&A shows that 81.6%

of investors consider protection from overpayment as an important or very important motive of including earnouts.³

The deferred payment feature of the earnouts also helps bridge any valuation gaps between the buyer and the seller if the seller believes there is more upside than the buyer. Based on the investors survey, 92% of investors considered bridging the valuation gap between a buyer and seller as an important or very important motive for earnouts.⁴

The post-closing performance of the acquired business is commonly understood to reflect a) factors within buyer's control, such as commercially reasonable efforts, accounting and operational choices, and b) market and industry factors that are beyond the buyer's control, such as adverse demand shocks, regulatory changes, competitive entry, and macro-economic cycles. The external factors could prevent the firm from achieving the performance target, despite buyer's commercially reasonable efforts.

Often, there are disputes when earnout targets are not achieved, where, for example, the seller alleges that the buyer strategically depressed performance of the acquired business post-acquisition in an effort to avoid making potential earnout payments. In such disputes, courts must disentangle causation and determine whether the depressed performance was due to the buyer's actions or due to external factors outside of the buyer's control.

Disputes can also arise in situations where the seller's continuing management team retains day-to-day control of the acquired business post-closing. In such cases, the traditional concern of buyer's actions is replaced by seller driven inflation of financial performance. Buyers may allege that the seller's incentives lead to short-term metric maximization at the expense of long-term value.

Incentive conflicts often turn into disputes related to the measurement of the financial performance target. Although acquisition agreements typically specify the methodology for calculating the relevant performance measure, disputes could arise over whether that methodology was applied correctly, or whether post-closing accounting and operational decisions affected the reported outcome. In such disputes, the focus is not on external market uncertainty, but on the construction and application of the underlying performance metric itself, requiring detailed financial and accounting analyses to assess whether defendant's accounting and operational choices were reasonable given the facts and circumstances of the case.

Empirical evidence on the prevalence, size, and industry distribution of earnouts in recent M&A transactions

Valuation gaps are more likely to exist for private firm target where there is more information asymmetry between the buyer and the seller because of limited information available about the target. Consistent with that hypothesis, a study using data on M&A deals between 1994 and 2003 that include an earnout, finds that "targets are almost exclusively private firms or subsidiaries of public firms" noting that "valuation uncertainty is likely to be most severe in acquisitions of such unlisted targets because of

³ Dahlen N, Lahmann A, Schreiter M (2024) Panacea for M&A dealmaking? Investor perceptions of earnouts. Finance Research Letters 60:104850

⁴ Dahlen N, Lahmann A, Schreiter M (2024) Panacea for M&A dealmaking? Investor perceptions of earnouts. Finance Research Letters 60:104850.

lower standards for information disclosure and the fact that information about subsidiaries may be obscured by the financial reporting choices of corporate parents.”⁵

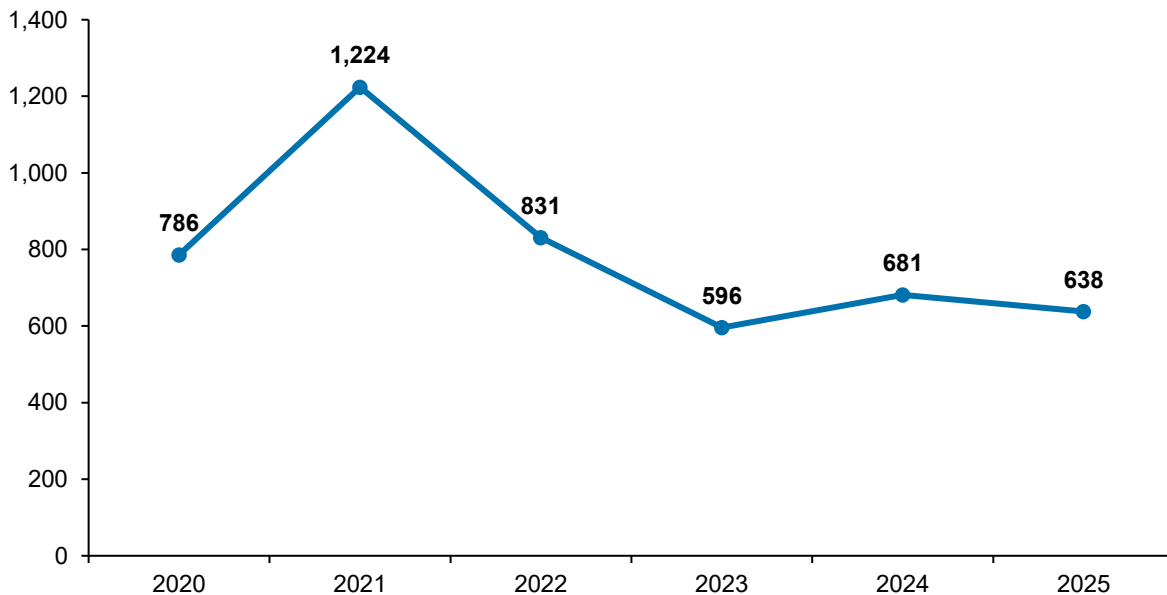
Valuation uncertainty is also high in technology and life sciences firms because a large share of their value is derived from uncertain growth opportunities rather than existing and predictable cash flows. Accordingly, one might expect more earnouts for targets with a larger proportion of risky cash flows; for instance, studies have noted that “earnouts are more likely in sectors with high R&D intensity and growth momentum.”⁶

In this section, I present an analysis on the data of all M&A deals announced or completed between January 1, 2020, to December 31, 2025, which involved the acquisition of private firms with an earnout/contingent payment component in the total deal consideration.⁷

Number and the total value of M&A deals of private firms with an earnout feature from 2020 to 2025

Figure 1 below shows that the number of transactions with an earnout increased sharply from 786 deals in 2020 to a peak of 1,224 deals in 2021, consistent with the post-pandemic rebound in M&A markets. This surge was followed by a decline in volume in 2022 and 2023, reaching a low of 596 deals in 2023, before a modest recovery to 681 deals in 2024 and a subsequent slight decline to 638 deals in 2025.

Figure 1: Number of M&A deals of private firms with an earnout feature from 2020 to 2025



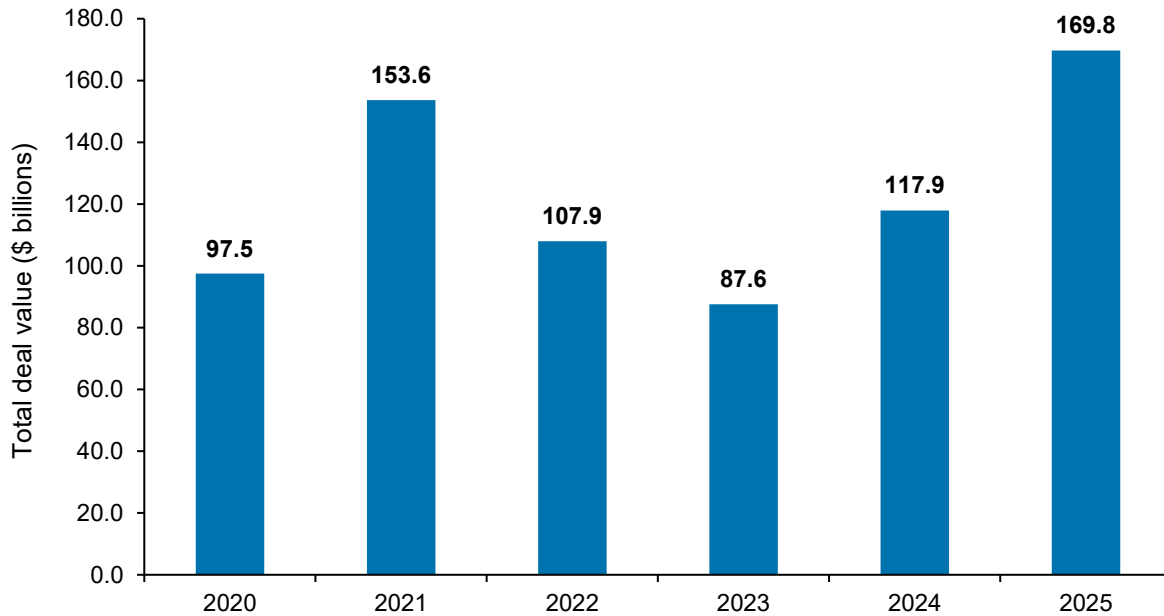
⁵ Cain, Matthew D., David J. Denis, and Diane K. Denis. "Earnouts: A study of financial contracting in acquisition agreements." *Journal of Accounting and Economics* 51.1-2 (2011): 151-170.

⁶ Dahlen, N. Earnouts in mergers and acquisitions: a systematic literature review of a contingent payment mechanism. *Management Review Quarterly* 75, 2107–2146 (2024).

⁷ Data accessed using S&P Capital IQ as of January 22, 2026. The earnout portion of the deal is equal to the nominal value of the earnout payment.

In contrast, the aggregate deal value followed a different path. **Figure 2** below shows the total deal value of M&A deals of private firms with an earnout feature from 2020 to 2025. While aggregate value increased alongside the number of deals from \$97.5 billion in 2020 to \$153.6 billion in 2021, it declined in 2022 and 2023 before rising sharply in 2024 and reaching a new high of \$169.8 billion in 2025. The combination of fewer deals but higher total value in 2025 implies an increase in average deal size, suggesting that earnouts were increasingly used in larger, higher-value transactions.

Figure 2: Total deal value of M&A deals of private firms with an earnout feature from 2020 to 2025

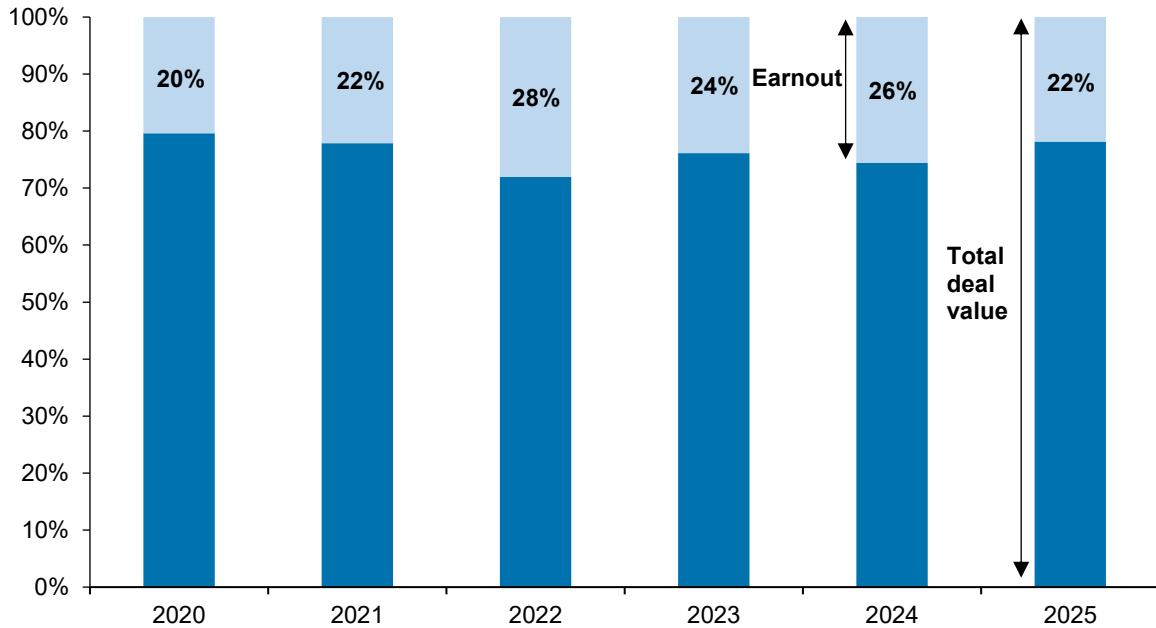


Portion of transaction value represented by earnouts from 2020 to 2025

Figure 3 below shows that earnout amounts as a share of total transaction value have remained relatively stable over time, fluctuating within a narrow band between approximately 22% and 28% over the 2020–2025 period.

Despite year-to-year variation, there is no clear upward or downward trend across the sample period. Instead, the data suggest that earnouts have consistently accounted for roughly one-quarter of deal consideration, even as overall deal volume and total deal value changed materially across years. This stability is consistent with earnouts serving as a persistent risk-allocation mechanism in private-target M&A transactions.

Figure 3: Earnout amounts as a proportion of total deal value from 2020 to 2025



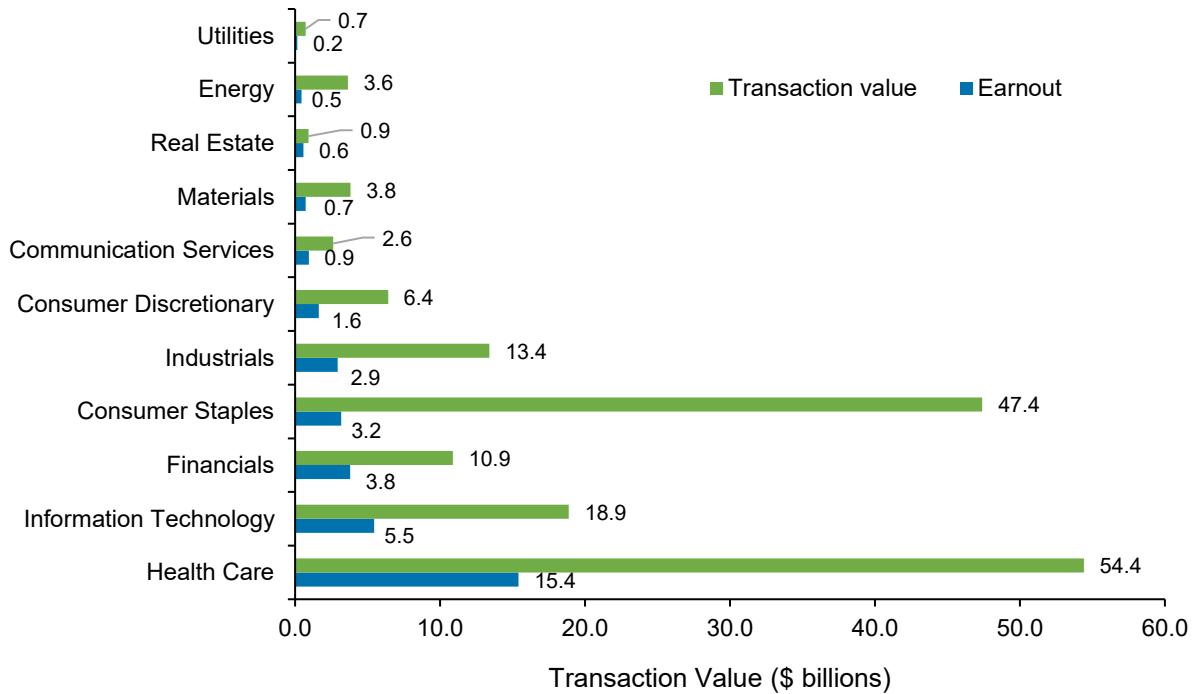
Industry breakdown of deals in 2025

Next, I present the breakdown of all deals with earnouts in 2025 by industry in **Figure 4**. The industry breakdown shows that deals with earnouts are highly concentrated in a small number of sectors, with healthcare accounting for the largest share in 2025. The total value of healthcare transactions with earnout components was approximately \$54.4 billion, of which \$15.4 billion was structured as earnouts, which is approximately 28.3% of the total deal value. This dominance is consistent with the prevalence of valuation uncertainty, regulatory risk, and outcome-dependent cash flows in healthcare transactions, particularly in pharmaceuticals, biotechnology, and medical technology.

Beyond healthcare, the aggregate value of deals that include earnouts is relatively smaller in other industries. Information technology and financials stand out with moderate levels of earnout portion in the deal values (earnouts of \$5.5 billion and \$3.8 billion, relative to total deal value of \$18.9 and \$10.9 billion, respectively), while the consumer staples industry has a relatively higher aggregate deal value with a fairly limited earnout portion.

Overall, the pattern suggests that deals that include earnouts are most common in industries characterized by greater uncertainty in future performance and asset valuation, while the deals with earnouts are more limited in capital-intensive or regulated sectors with more predictable cash flows.

Figure 4: Industry breakdown of M&A deals of private firms with an earnout feature in 2025



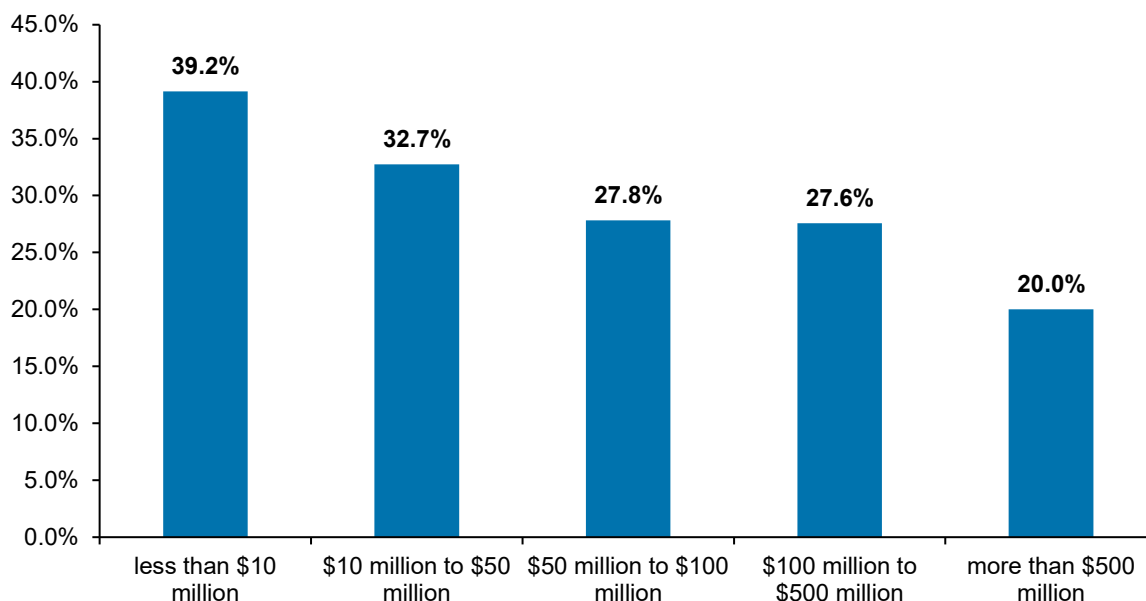
Breakdown of earnout amounts by deal size in 2025

I divide the 2025 deals with earnouts into different size categories and calculate the median earnout percentage within each category and present the results in **Figure 5** below.

The data show an inverse relationship between deal size and the proportion of consideration structured as earnouts in 2025. Smaller transactions rely more heavily on earnouts, with a median earnout proportion of 39.2% for deals under \$10 million. As deal size increases, the median earnout percentage declines steadily, falling to around 27-28% for mid-sized deals between \$50 and \$500 million. The deals exceeding \$500 million have the lowest median earnout proportion of 20%, indicating a more limited role of earnouts in larger deals.

Overall, the data is consistent with earnouts being used more actively in smaller deals, where information asymmetries are typically greater, providing risk-sharing benefits and bridging valuation gaps between buyers and sellers. It's also possible that buyers in smaller deals are financially constrained and deferring payments, as earnouts help alleviate those constraints.

Figure 5: Median earnout percentages by total deal size for all M&A deals of private firms with an earnout feature in 2025



Earnout disputes

Post-acquisition control and incentive conflicts

Post-acquisition, typically the buyer controls operations of the acquired business, which includes operational decisions such as investments, cost allocation, and accounting choices. However, the resulting post-closing performance could also depend on market and industry factors that are beyond the buyer's control, including, for example, adverse demand shocks, regulatory changes, competitive entry, and macro-economic cycles. The external factors could prevent the firm from achieving the performance target, despite buyer's best efforts.

Disputes can arise over the failure to achieve earnout targets, where the seller alleges that the buyer strategically depressed performance of the acquired business to avoid earnout payments. In such disputes courts need to determine whether the depressed performance was due to the buyer's actions or due to external factors outside of buyer's control, or some combination.

If the acquired business's performance is found to have been improperly depressed by the buyer's actions, courts can apply a damages assessment methodology that would put the seller in the economic position it would have been in absent the alleged bad acts. Rather than assuming the earnout would either certainly be paid in full or not paid at all, courts have focused on lost expected value. This approach reflects the parties' reasonable expectations and avoids awarding windfalls in cases where the earnout outcome was uncertain, even absent any misconduct.

For example, in a matter litigated in Delaware Chancery Court, the court noted that "[c]ompensating for lost expected value, rather than with full value whenever earnout payments are likely and zero value

whenever earnout payments are unlikely, strives to hit the mark on the parties' reasonable expectations, rather than award windfalls for some promisees and goose eggs for others.”⁸

Alternatively, in some circumstances, an ex-post approach might be appropriate, when actual performance is observed, but adjustments are made to isolate the impact of the defendant's alleged misconduct from exogenous factors, yielding a corrected “but-for” earnout. If the earnout period is complete, the adjusted amount can often be brought forward to the damages date using simple or statutory interest, rather than discounted, because the cash flows are effectively known.

Disputes can also arise when seller's management retains control of the day-to-day operations of the acquired business post-closing. In such cases, the traditional concern of buyer's actions is replaced by seller driven inflation of financial performance. Buyers may allege that the seller's incentives lead to short-term metric maximization at the expense of long-term value. Disagreements could also emerge over the boundaries of seller's operational control, particularly when the buyer retains control over higher level strategic decisions.

Disputes over measurement of the performance target

Often, there are disputes over the definition of the underlying financial performance target in the merger agreement. For example, if the earnout depends on adjusted EBITDA of the firm, the buyer and the seller could disagree on the calculation of the EBITDA.

Typically, the methodology to calculate the target metric would be specified in the agreement, yet the parties may dispute whether the calculation was performed correctly or if the parties strategically made certain accounting or operational choices to depress the underlying performance metric (or inflate if the seller remains involved in the management). Disputes related to the calculations of the underlying performance metric include, but are not limited to, disagreements about expense or revenue recognition, purchase accounting adjustments, revaluations of assets and reserves, and inter-company cost allocations. Examples of what those disputes may look like are outlined below:

- Expense recognition: a buyer could pull expenses into the earnout period to depress EBITDA, while a seller could defer expenses to inflate earnings. For example, a buyer could accelerate marketing spend just before the measurement date when the earnout is based on profits or EBITDA, while a seller could postpone such discretionary spending to inflate short-term profitability.
- Revenue recognition: a buyer could delay recognition of revenue until after the earnout measurement date, thereby depressing EBITDA, while a seller could accelerate recognition of revenue into the earnout period, thereby increasing EBITDA.
- Purchase accounting adjustments: Under ASC 805 (or IFRS 3), the acquirer must revalue assets and liabilities to fair value at closing.⁹ An inventory step-up (upward revaluation of inventory)

⁸ Shareholder Representative Services, LLC v. Alexion Pharmaceuticals, Inc., C.A. No. 2020-1069-MTZ (Del. Ch. June 11, 2025) (Zurn, V.C.).

⁹ PwC, Viewpoint, Chapter 2, Acquisition method, “2.5 Recognition and measurement on the acquisition date,” May 31, 2025, available at https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_2_acquisitio_US/25_recognizing_and_m_US.html.

relative to pre-deal could increase the cost of goods sold and lower earnings when inventory is sold, while a seller could argue for excluding such adjustments from earnout calculations to preserve higher earnings using pre-deal accounting. Disputes could arise if contracts fail to specify whether the performance metric should be based on pre-deal or post-deal accounting.

- Assets and reserves revaluations: Changes to book value of assets (through write-downs or write-ups) or reserves could shift earnings significantly. Plaintiff often alleges that the defendant chose policies different from those historically used, and the parties will separately justify as to why their approach is more reasonable or appropriate.
- Intercompany allocations: intercompany charges or corporate overhead allocations could affect the acquired business's financial performance. A buyer might assign higher costs to the acquired business to depress performance, while a seller could resist allocations to inflate performance. Disputes often focus on whether such allocations are consistent with historical norms and/or the economic performance of the business.

Conclusion

Earnouts are a commonly used mechanism in M&A transactions to bridge valuation gaps, allocate risk, and address information asymmetries, particularly in acquisitions of private firms and targets with uncertain or highly contingent future cash flows. By deferring a portion of the purchase price and tying it to post-closing performance (measured by financial metrics such as revenue or EBITDA) or non-financial milestones (such as clinical trial success or regulatory approval), earnouts protect buyers from overpayment while allowing sellers to share in upside.

Empirical evidence and recent deal data show that earnouts remain economically significant and are especially prevalent in industries such as healthcare and technology, where uncertainty around R&D outcomes and regulatory processes is greatest. Economic theory supports this design: safer, more predictable cash flows are paid upfront, while riskier growth opportunities are packaged into contingent payments borne by the seller.

The risk sharing, however, has potential to create incentive conflicts when control of the acquired business shifts to the buyer, giving rise to disputes when targets are not met. Courts and tribunals are then tasked with determining whether the underperformance is due to the buyer's actions or due to external factors out of the buyer's control, or some combination. Recently, the Delaware Supreme Court reaffirmed in *J&J v. Fortis*, that the risk allocation is a deliberate choice; once the contract is signed, the court may not provide insurance to sellers based on implied covenant reasoning.

Often, disputes arise not over the uncertainty of certain outcomes, but over how the performance metric itself was calculated, including allegations of expense and revenue recognition, purchase accounting adjustments, assets and reserves revaluations, and intercompany cost allocations. Resolving such disputes therefore requires careful financial and accounting analysis to assess whether defendant's accounting and operational choices were reasonable given the facts and circumstances of the case.

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