Earn-out provisions in Canadian cross-border M&A: Risk management or post-closing misalignment?

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As market conditions remain uneven and valuation gaps persist between buyers and sellers, earn-outs continue to emerge as familiar tools in private M&A, especially in cross-border transactions. But their use should not be mistaken for universal appeal. In Canada, earn-outs are being deployed selectively – and strategically – as dealmakers look to manage and allocate risk, align incentives, and move transactions across the finish line.

They should not be utilized as a shortcut to consensus, however. Nor are they without consequence.

For corporate leaders, institutional investors and business owners pursuing Canadian acquisitions, earn-outs require a more nuanced conversation: when they help, when they hinder, and how to ensure they support the deal, not undermine it.

The valuation gap hasn't gone anywhere

In the current deal environment, valuation misalignment remains one of the top reasons deals stall. Sellers point to growth potential. Buyers point to softening margins. Add cross-border uncertainty (regulatory delays, FX pressure, tariff impact, economic divergence), and it is easy to see why a contingent pricing mechanism may be appealing.

Earn-outs offer a tactical option to bridge this gap: part of the price is paid up front, and the rest is tied to the company hitting agreed-upon financial metrics post-close. But while this approach can protect downside risk and preserve upside potential, it also pushes key deal risk into the future, particularly when control has shifted hands on closing the deal.

Where earn-outs are gaining ground, and where they're not

Earn-outs are gaining particular traction in sectors where future value is hard to measure, such as:

- **Life sciences and MedTech**, where clinical milestones or regulatory approvals sit years down the road.
- **Fintech and SaaS**, where early revenue may be modest but user acquisition and recurring ARR may tell the real story.
- **Critical minerals and energy transition plays**, where projected yield is speculative but strategically vital.
- **Consumer brand roll-ups**, where founders bring intangible brand equity and the buyer needs them to stay.

By contrast, earn-outs are less frequent in sectors where integration risk is high or where post-closing performance could be too easily manipulated. In traditional manufacturing, for example, or logistics-heavy acquisitions, buyers may prefer a price adjustment mechanism or working capital true-up over a multi-year earn-out.

Aligning without entangling

One of the reasons earn-outs are under greater scrutiny is that they are no longer just financial engineering: they are behavioural contracts. If the seller is staying on post-close and future payouts depend on performance, the parties need to be aligned not just on numbers, but on culture, autonomy, and strategic priorities.

This raises important questions:

- Will the seller retain operational or other measures of control?
- What happens if the buyer restructures the business, exits a product line, or reallocates resources?
- What if a downturn impacts performance, even if the business is well run?

The answers should be reflected in the legal drafting, but also in the negotiation mindset. A misaligned earn-out can create post-closing resentment, as well as interfere with integration and potential litigation.

The deal within the deal: Drafting for precision

Canadian M&A lawyers have seen this play out before. Courts tend to enforce what is written, especially in the private M&A context. If the earn-out provisions are vague or grant the buyer broad discretion over operational decisions, the seller may be left with limited recourse.

This is where legal precision becomes essential:

- **Performance metrics** should be objective, measurable, and industry-appropriate (Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA), revenue, regulatory milestones). The metrics and the methods of calculation should be consistent in the pre-closing and post-closing periods.
- **Timeframes** should reflect operational realities: 12 to 36 months is typical, but not one-size-fits-all.

- **Covenants** should address business continuity, budget approval, and operational discretion post-closing.
- **Dispute resolution** mechanisms should be pragmatic, enforceable, and proportionate to the size of the deal.

Too often, parties spend more time on the headline price than on the structural clarity of the earn-out. That approach often introduces risk in the post-closing period – to both sides.

When an earn-out signals a deeper problem

There's a fine line between using an earn-out to align interests and using it to avoid hard conversations. Experienced deal teams will often ask: if the parties cannot agree on value today, should the deal proceed at all?

Earn-outs should never be a default. They work best when the seller is staying on, the buyer has confidence in the underlying business model, and the parties are willing to be specific – and fair – about how success is measured.

Where earn-outs are used reflexively, or as a way to paper over fundamental misalignment, they often lead to post-close disputes and damaged relationships.

What this means for deal teams and boards

For dealmakers with M&A on their mandate, the use of earn-outs is not a trend to blindly follow, but a tool to understand in context and to use judiciously. Whether you are on the buy or sell side, the conversations with your Canadian M&A counsel should include:

- Are we using an earn-out to incentivize, or to hedge?
- What impact will this structure have on post-close culture and autonomy?
- Can the seller realistically influence the outcome under the buyer's control?
- What would this earn-out look like in litigation, and how would it be interpreted?

These are not checkbox issues. They go to the fundamental of transaction strategy, governance, and value realization.

Contact us

Used wisely, earn-outs can unlock alignment, incentivize performance, and close valuation gaps without compromising the deal. BLG lawyers help clients structure these tools to reflect not only legal precision, but strategic intent. To ensure your transactions are set up for long-term value, not short-term fixes, reach out to any of the professionals below for assistance.

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