Bloomberg BNA

Mergers & Acquisitions Law Report™

MERGER AGREEMENTS

Update on Recent Developments in Earn-out Law

BY JONATHAN I. HANDLER

Introduction

In recent years, as parties to merger & acquisition transactions have more frequently relied on so-called "earn-outs" to bridge the gap in valuation between buyers and sellers, there has been a corresponding increase in the amount of reported litigation arising from the use of this form of contingent compensation. This article will outline some of the basic principles involved in these disputes, focus on the key legal cause of action that most disappointed sellers assert, and then analyze several recent appellate decisions from around the country that illustrate the current state of judicial thinking on these disputes.

Most earn-out disputes share a number of key characteristics; indeed, a review of the reported cases over the past 20 years reveals a remarkable consistency to these disputes. These cases often involve an acquired business that is relatively undeveloped with little historical track record of profitability or even with no history of revenue at all. The seller is often the founder of the business who has been unable to fully exploit what may be a brilliant concept and turn it into a profitable operation, whether because of insufficient capital or otherwise. Buyers and sellers therefore often have distinctly different views of the value of the business, which is why an earn-out is such a useful tool. The common use of an earn-out relies in large part on the presumption that both buyer and seller have every incentive to make the newly acquired business succeed (more on this notion of economic alignment of interests below); therefore, a contingent future payment based on defined goals for sales, profits, or some other measurable metric presents an opportunity for both parties to "win" by sharing in this success.

An initial point of disagreement when structuring these agreements often arises over what limitations, if any, will be placed on the buyer's discretion to operate the new business. On the one hand, a buyer wishes to maintain its unfettered ability to operate according to its business judgment, which includes being able to operate in light of the needs of its overall enterprise, not just the newly acquired business, and to be able to respond to unforeseen changes in market conditions. A seller, in contrast, often wants to constrain this discretion by, for example, requiring the buyer to continue to run the business in the same fashion as before or consult the seller before certain types of decisions are made, or even dictating the level of resources that the buyer must devote to the acquired business. Some sellers may even seek to prevent the buyer from shutting down the newly acquired business or saddling it with debt. This early conflict, which often plants the seeds for later disputes, can be resolved in any number of

Jonathan I. Handler is a Boston-based partner in the Litigation Department at Day Pitney LLP. His practice focuses on complex commercial disputes, including those relating to earn-outs.

ways, from contractual clauses that impose on the buyer detailed, affirmative obligations to those that explicitly provide the buyer with unfettered discretion to run the business as it sees fit, with many variations in between. The parties may even decide to remain entirely silent on this issue, in the hopes that it will never become a point of dispute or that the common law will provide appropriate guidance if a dispute arises.

The typical earn-out dispute leading to litigation often looks like this: the time for earn-out payments comes and goes without any payment because the stated benchmark has not been met; the seller complains that his expertise has been ignored in the operation of the business and that the buyer has failed to devote sufficient resources (whether in marketing, R&D, product development, or otherwise) to make the business a success and/or has been incompetent in its operation of the acquired business. The seller's resulting lawsuit will raise a number of causes of action, including for breach of specific terms of the agreement, fraudulent inducement (*i.e.*, the buyer made false promises to lure the seller into the transaction), and breach of the so-called implied covenant (or duty) of good faith and fair dealing. Of these, the last is invariably the most important.

The implied covenant, which is recognized in some form under the laws of most states, precludes a party to a contract from engaging in conduct that deprives the other party of the benefits of the agreement. The implied covenant applies to the performance of the contract and not to pre-contractual negotiations, and it does not provide a party with contractual protections or rights that it failed to secure for itself in negotiations. The implied covenant also does not prevent a party from acting in its own interest in a way that may have the effect of lessening the other party's expected contractual benefit. Often courts view the implied covenant as a means to fill in missing terms, extrapolated from the parties' intent as reflected in the language of their agreement, to determine what the parties would have agreed to had they actually considered the circumstances underlying the issue in dispute. Given that most earn-out cases turn on resolution of the implied covenant claim, it is essential to understand how courts approach these claims. This article will attempt to do that by focusing on several recent decisions by state and federal appellate courts.

Recent Earn-out Cases of Note Focusing on the Implied Covenant of Good Faith and Fair Dealing

A. Lazard Technology Partners, LLC v. Qinetiq North American Operations, LLC

A recent appellate decision of note in this area is the Delaware Supreme Court's opinion in *Lazard Technology Partners, LLC v. Qinetiq North American Operations, LLC*, 114 A.3d 193 (Del. 2015). Given the frequent application of Delaware law in business transactions, earn-out decisions by the Delaware Supreme Court can be particularly significant. In *Lazard*, the plaintiff represented former stockholders of a cyber technology company who had been paid $40 million up front with a potential payment of up to $40 million in addition if the company's revenues met certain targets. The parties' agreement specifically prohibited the buyer from "tak[ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment." *Id.* at 194. After the acquired business's revenues failed to meet the revenue target and no earn-out was paid, the selling stakeholders filed suit against the buyer. Among other things, they argued that the buyer violated the implied covenant of good faith and fair dealing by failing to take particular steps that would have resulted in higher revenues thereby triggering earn-out payments.

After a bench (*i.e.*, non-jury) trial, the Chancery Court in Delaware held for the defendant, concluding that, with respect to breach of the implied covenant, the buyer had a duty to avoid particular conduct only if that conduct resulted from an intent to avoid or reduce the earn out. In affirming the decision, the Delaware Supreme Court went further, suggesting that the Chancery Court "was very generous in assuming that the implied covenant of good faith and fair dealing *operated at all as to decisions affecting the earn-out*" given (1) the way the parties' agreement specifically addressed the subject, and (2) evidence that "the seller had sought objective standards for limiting the buyer's conduct but lost at the bargaining table." *Id.* at 196 (emphasis added). The latter point is worth particular attention. Courts are loathe to use the implied covenant to create new contractual rights that the parties did not bargain for, and that is particularly true where the negotiating history demonstrates that one party sought particular protections that the other party explicitly and firmly rejected. Here, the seller sought to impose various additional post-closing obligations, all of which the buyer rejected. Thus, the only relevant restriction was the language quoted above that prohibited only conduct taken with the intent of reducing the earn-out. In the Delaware Supreme Court's view, this language "left the buyer free to conduct its business post-closing in any way it chose so long as it did not act with the intent to reduce or limit the earn-out payment." *Id.*

Having resolved the case on that basis, the court did not need to consider what it called defendant's "well-reasoned argument" that the contractual language quoted above "addressed the full range of discretionary conduct relevant to the earn-out calculation, *leaving no room for the implied covenant to operate at all.*" *Id.* at 197 (emphasis added). Stated differently, the court appeared to suggest that under the right circumstances, where the parties memorialized a specific, well-defined limitation on the buyer's exercise of discretion as it relates to earn-outs, the seller would have no further rights under the implied covenant of good faith and fair dealing. Among other things, this decision reflects the Delaware Supreme Court's wariness of claims for breach of the implied covenant of good faith and fair dealing, especially where two sophisticated parties have negotiated an agreement that covers the subject matter of the claim.

B. Deom v. Walgreen Company

In another recent case, *Deom v. Walgreen Co.*, 591 F. App'x 313 (6th Cir. 2004), the U.S. Court of Appeals for the Sixth Circuit (covering the states of Kentucky, Michigan, Ohio, and Tennessee) was faced with a dispute arising out of the sale by plaintiffs of the inventory and prescription records from their three pharmacies to Walgreen. The purchase price included a $3.5 million upfront payment plus a $600,000 or $800,000 earn-out

   ISSN 1098-4720

if Walgreen met certain average daily targets for filling prescriptions from Plaintiffs' former customers during the nine-month period following the asset sale. Walgreen did not meet the prescription target and thus paid no earn-out. Plaintiffs filed suit, alleging that Walgreen either lied about how many prescriptions it had actually filled or breached the implied covenant of good faith and fair dealing by "failing to be 'adequately prepared' to serve Deom's former customers after the sale, and instead providing 'substandard customer service,' including 'unhelpful staff' and 'long waiting times.' " *Id.* at 314-15. The District Court had earlier dismissed the implied covenant claim, concluding that Walgreen owed no duty of good faith and fair dealing because it had no discretion over whether plaintiffs' former customers filled their prescriptions at Walgreen or not.

The Sixth Circuit first noted the key principles underlying Illinois law on the implied duty of good faith and fair dealing and, in particular, noted that such a duty is not "an independent source of duties for the parties to a contract," *id.* at 315 (quoting *Beraha v. Baxter Health Care Corp.*, 956 F.2d 1436, 1443 (7th Cir. 1992)), *i.e.*, it is a "guide to the construction of the explicit terms of the agreement" but does not provide new terms to which the parties never agreed. *Id.* (quoting *MJ & Partners Rest. Ltd. P'ship v. Zadikoff*, 995 F. Supp. 929, 933 (N.D. Ill. 1998)). The essence of Deom's allegation was that Walgreen violated the duty of good faith and fair dealing by failing to take the necessary steps to ensure it could retain the seller's customers, including providing the customer service necessary to keep those customers from taking their business elsewhere. In other words, the plaintiff/seller alleged that the buyer had devoted inadequate resources to make the new business sufficiently successful to trigger the earn-out payments. The District Court's decision in Walgreen's favor turned on that court's conclusion that Walgreen had no contractual discretion — a necessary predicate to a claim for breach of the implied duty under Illinois law. That is, the court concluded that Walgreen had no control over whether former Deom customers elected to do business with Walgreen or defect to other pharmacies. The Sixth Circuit rejected this reasoning, however, noting that where "an earnout clause makes a seller's bonus contingent on postsale business success, a buyer may have contractual discretion in how it runs the business so as to meet the target amount needed to trigger the earnout . . . ." *Id.* at 316. Indeed, this level of discretion is frequently present in earn-out disputes. Thus, the Sixth Circuit concluded that the implied duty of good faith did, in fact, provide a limitation on Walgreen's exercise of discretion in how it ran the acquired business.

Regardless, the Sixth Circuit determined that Deom's implied covenant claim failed on other grounds, namely that Illinois required "allegations that Walgreen acted in bad faith, not just unreasonably or negligently." *Id.* at 317. In other words, a party in Walgreen's position must "exercise [its] discretion reasonably and with proper motive, and [not] arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties." *Id.* (quoting *Beraha*, 956 F.2d at 1443). Thus, a plaintiff must allege "improper motive" to survive a motion to dismiss a claim for breach of the implied duty of good faith and fair dealing. (This standard of conduct has variously been described by courts and commentators as acting in "bad faith," or with "dishonest purpose," "ulterior motive," or "intent to harm" the other party. *Id.*) After surveying a wealth of Illinois cases, the Sixth Circuit noted that under that state's law, "unreasonable behavior" does not necessarily violate the implied duty of good faith, and "reasonableness" is not the measure of good faith. Rather, the implied duty imposes an obligation "to avoid taking advantage of gaps in a contract in order to exploit the vulnerabilities that arise when contractual performance is sequential rather than simultaneous." *Id.* at 318 n.1 (quoting *Bank of Am., N.A. v. Shelbourne Dev. Grp., Inc.*, 732 F. Supp. 2d 809, 823 (N.D. Ill. 2010)). "At least in cases like this," the court concluded, "in which well over half of the consideration paid does not turn on a party's discretion, and the contract also includes a merger clause[1], *mere negligence is not enough to show breach of the implied covenant*." *Id.* at 318-19 (emphasis added). Accordingly, Deom's failure to plead "facts supporting a reasonable inference that Walgreen acted in bad faith, not just that it exercised poor — even negligent — business judgment," was determinative. *Id.* at 319. (For example, Deom might have pleaded — but did not — that "Walgreen intentionally mismanaged its pharmacies or purposefully lost customers in order to defeat the earnout bonus," or that Walgreen's alleged mismanagement "was specifically directed at Deom's former customers." *Id.*)

Notably, the Sixth Circuit also found comfort, as have many other courts in similar circumstances, in the notion that where the seller's and buyer's economic interests are aligned, *i.e.*, that both would profit if the acquired business flourished, "it is facially implausible that a business buyer would intentionally drive off customers to frustrate paying the seller an earnout bonus." *Id.* (citing cases). In sum, where Deom set forth allegations that were just as consistent with negligent conduct as with intentional acts, he failed to meet the "plausibility" standard required to survive a motion to dismiss.

C. Security Plans, Inc. v. CUNA Mutual Insurance Society

Finally, the U.S. Court of Appeals for the Second Circuit (covering New York, Connecticut, and Vermont) recently opined on the scope of a claim for breach of the implied duty of good faith and fair dealing in the context of earn-out payments in *Security Plans, Inc. v. CUNA Mutual Insurance Society*, 769 F. 3d 807 (2d Cir. 2014). Here, the court re-emphasized that mere negligence is insufficient to support an implied covenant claim, while also considering the limits placed by the implied covenant on a buyer's exercise of contractually-provided discretion. In *Security Plans*, the plaintiff credit insurer sold its business to CUNA Mutual in exchange for an upfront payment and potential earn-outs over time based on the earnings of the new business. The parties' agreement gave the buyer broad discretion to "operate the business in accordance with its best business judgment." *Id.* at 811. Security Plans ultimately filed suit and claimed among other things that CUNA Mutual's determination that no earn-outs were due was erroneous; it claimed breach of contract and the implied covenant of good faith and fair dealing. The District Court granted summary judgment to the defen-

[1] A "merger" clause typically provides that the written contract constitutes the complete and final agreement between the parties and that any earlier negotiations or oral agreements are superseded.

dant on both claims; with respect to the implied duty of good faith claim, the court pointed to plaintiff's failure to set forth any evidence that CUNA Mutual had acted in bad faith or with wrongful intent.

The Second Circuit took a slightly different view and reversed on one narrow aspect of the implied duty claim (while otherwise affirming dismissal of the plaintiff's claims). While the court recognized that something more than misguided, ignorant, or negligent behavior is required to make out a claim for breach of implied covenant, it held that under New York law allegations that a party " 'act[ed] arbitrarily or irrationally' in exercising [the] discretion" afforded to it under the contract could under certain circumstances constitute that "something more." *Id.* at 818 (quoting *Dalton v. Educ. Testing Serv.*, 663 N.E.2d 289, 291 (N.Y. 1995)). In particular, the court held that plausible factual allegations that the defendant had "refused to provide a revised earnout calculation in light of an alleged systemwide error concerning claim reserves," which directly affected the calculation, *could* bring the claim within the ambit of the "implied covenant's prohibition on arbitrary or irrational exercises of discretion." *Id.* The Second Circuit noted that while courts may not substitute their own business judgment for that of a party, "arbitrary decision-making is incompatible with the exercise of legitimate business judgment." *Id.* at 819. Accordingly, the Second Circuit sent the case back to the lower court to determine whether there was a "genuine and colorable business justification" for the buyer's conduct; if so, "its actions will not have been arbitrary and thus will not have violated the implied covenant." *Id.* at 820. The Second Circuit also noted, without deciding (and echoing the Delaware Supreme Court in *Lazard*), that different contractual language "may constrict or obviate the protections of the implied covenant." *Id.* at 819 n.11 (citing cases).

The facts in *Security Plans* differ from the typical earn-out case. As the Second Circuit noted, this was *not* "a case in which the plaintiff alleges only that . . . the defendant's mismanagement or ineptitude in running the business post-merger damaged its ultimate payment." *Id.* at 820. Rather, the plaintiff presented the evidence that CUNA was aware it had relied on faulty numbers for purposes of calculating the earn-out payments — an area in which the defendant was exercising its discretion under the parties' agreement — but declined to provide a revised calculation. One concern that may arise from the Second Circuit's decision is that the line between the arbitrary exercise of discretionary authority — which may be actionable — and the negligent operation of a purchased business — which is not — may sometimes be a fine one. However, given that after remand of the case the defendant need only make a minimal showing of legitimate business justification for its conduct, the application of an "arbitrary or irrational" standard to the exercise of discretion may make little practical difference.

For example, in a case that did not concern earn-outs, *Go Green Realty Corp. v. Liberty Petroleum Realty, LLC*, No. 11cv5360, 2015 BL 95537 (S.D.N.Y. Mar. 30, 2015), the District Court echoed the Second Circuit by noting that when a contract contemplates one party's exercise of discretion, the implied covenant "includes a promise not to act arbitrarily or irrationally in exercising that discretion." *Id.* at *8-9 (quoting *Dalton*, 663 N.E.2d at 291). But the court further noted that to determine *whether* a party acted arbitrarily or irrationally, "courts often consider whether a party has exercised its contractual right of discretion malevolently or in bad faith in order to deprive other parties of the benefit of their bargain." *Id.* (quoting *Cory v. eBet Ltd.* (*In re Sona Mobile Holdings Corp.*), No. 13cv04702, 2014 BL 314261 at *7 (S.D.N.Y. Nov. 6, 2014)). *See also Miller v. Imaging On Call, LLC*, No.3:13-cv-00679, 2015 BL 5543 at *7 (D. Conn. Jan. 12, 2015) (quoting *Security Plans Inc.*, 769 F.3d at 817, for the proposition that " '[t]he covenant will be breached only in a narrow range of cases' because '[a] plaintiff must show substantially more than evidence that the defendant's actions were negligent or inept' "; concluding that under Connecticut law a breach of the implied covenant requires a showing of bad faith, which "means something more than mere negligence" and "involves a dishonest purpose." (quoting *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d. 961, 986 (Conn. 2013)). This suggests that plausible allegations of bad faith/intent will continue to be essential to maintaining an implied covenant claim; it also suggests a meaningful way to distinguish arbitrary or irrational exercises of discretion from more garden-variety negligence in the operation of an acquired business.

Conclusion

Several important principles are apparent from these recent earn-out decisions. First, the implied covenant remains the most important claim in most of these cases. Second, it is broadly accepted that mere negligence or incompetence is not enough to constitute a breach of the implied covenant, and plaintiffs who allege conduct that does not extend further are at risk of having their claims dismissed at an early stage. Third, courts largely continue to rely on some version of a "bad faith" or "intent to deprive" standard to determine whether a defendant has breached the implied covenant of good faith and fair dealing. Fourth, even when a buyer has the contractual right to run the acquired business according to its own business judgment or in its sole discretion, that authority cannot be exercised in a way that is arbitrary or irrational. Fifth, where a seller has attempted but failed to place certain contractual limitations on a buyer's exercise of post-sale discretion, the courts are disinclined to impose such limitations after the fact via application of the implied covenant.

   ISSN 1098-4720