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DELAWARE CHANCERY COURT DECISION UNDERSCORES THE RISKS TO BUYERS WHEN DEVISING EARN-OUTS

To Our Clients and Friends:

Buyers and sellers in M&A transactions sometimes structure a portion of the purchase price as an earn-out. In an earn-out structure, the buyer pays part of the purchase price at the closing and the remainder if and when the target business achieves pre-defined milestones after the closing. An earn-out is often a means to bridge a valuation gap in purchase price negotiations between the buyer and the seller when the seller is confident in the business's future prospects, but the buyer is unwilling to pay full value for the business based on the seller's projections. A compromise can be for the buyer to agree to pay additional consideration for the business if and when the seller's projections are achieved. This additional consideration is the earn-out.

Earn-outs force the parties to anticipate and account for future events while negotiating the acquisition agreement. When devising an earn-out, the parties will need to agree on the milestones that trigger payment; how the earn-out is calculated upon achievement of those milestones; the process for resolving disputes over the calculation; and the mechanism for disbursing earn-out amounts.

The parties also will need to agree on how much freedom the buyer will have to run the business during the earn-out period. The seller will want the business run to maximize the earn-out payment and may push for post-closing operating covenants requiring the buyer to, among other things, provide the business with adequate capital and resources; pursue opportunities on behalf of the business; and refrain from taking actions designed to minimize earn-out payments, such as diverting opportunities from the acquired business to the buyer's other businesses. The buyer, on the other hand, will want to preserve maximum flexibility to operate the business in any way it sees fit.

Earn-Outs and the Implied Covenant of Good Faith and Fair Dealing under Delaware Law

Under Delaware law, the implied covenant of good faith and fair dealing attaches to every agreement by operation of law and prohibits a party from engaging in "arbitrary or unreasonable conduct" that prevents the other party from enjoying the benefits of the agreement.[1] However, a court will not apply this implied covenant if (i) the terms of the agreement already expressly address the conduct at issue or (ii) it is clear that the parties considered the issue at the time of signing but declined to address such conduct in the agreement.[2]

In recent years, Delaware courts have been reluctant to use the implied covenant to require a buyer to take, or refrain from taking, actions that might impact earn-out payments. For example, a buyer does

not have an implied obligation to maximize earn-out payments absent a specific covenant mandating such obligation.[3]

A court might apply the implied covenant where a buyer affirmatively acts to minimize earn-out payments in ways that were wholly unanticipated at the time of signing. However, if the parties considered including specific covenants addressing the buyer's actions, but ultimately declined to do so, a court will not apply the implied covenant.[4]

And even if a buyer affirmatively acts with the "knowledge" that its actions likely will reduce earn-out payments, a court still will not apply the implied covenant if the acquisition agreement only precludes the buyer from acting with the "intent" to reduce earn-out payments.[5]

In light of this judicial landscape, well-counseled sellers typically push for specific and comprehensive operating covenants applicable to the earn-out period. As a result, buyers tend to focus much of their energies on rebuffing sellers' demands, in the hopes of diluting the operating covenants as much as possible.

Sellers are commonly viewed as bearing a greater risk in an earn-out arrangement than buyers because the performance of the business – upon which the earn-out depends – is controlled by the buyer, a party that has an incentive not to make the earn-out payment. A seller who objects to non-payment of an earn-out is left to argue that the buyer did not comply with post-closing operating covenants (assuming the seller successfully negotiated for the inclusion of such covenants) or advocating for the application of the implied covenant of good faith and fair dealing, an argument that is often unsuccessful.

Nonetheless, in a recent Chancery Court decision, *GreenStar IH Rep, LLC v. Tutor Perini Corp.*,[6] a buyer was on the losing end of an earn-out dispute. In this case, the court refused to apply the implied covenant of good faith and fair dealing to excuse the buyer from making earn-out payments that the buyer claimed were significantly over-calculated.

Background

The case arose from Tutor Perini's 2011 acquisition of GreenStar Services Corporation ("GreenStar") and its subsidiaries, including Five Star Electric Corporation ("Five Star").

The merger agreement (the "MA") provided for an earn-out period with five one-year terms. For each term, Tutor Perini was required to make an earn-out payment equal to 25% of GreenStar's consolidated pre-tax profit in excess of $17.5 million, up to a cap of $8 million. Any excess amounts that would have been paid but for the cap were to be applied to any ensuing earn-out payments falling short of the cap.[7]

Within 90 days following the end of each term, Tutor Perini was required to prepare and deliver to the GreenStar interest holder representative (the "IH Rep") a calculation of pre-tax profit for the term, which became binding on the parties if the IH Rep approved Tutor Perini's calculation or failed to object to it within 30 days following delivery. If the IH Rep objected to the calculation, the IH Rep and Tutor Perini were required to work together for 45 days to reach an agreement on the calculation. If they were unable

to do so, the parties were required to engage an independent accounting firm to make a binding determination of pre-tax profit.[8]

For the first and second terms, Tutor Perini calculated pre-tax profits and made the earn-out payments due. For the third and fourth terms, Tutor Perini calculated pre-tax profits but did not make the earn-out payments due. For the fifth term, Tutor Perini neither calculated pre-tax profit nor made an earn-out payment, even though an excess amount of $3.4 million from the second term could have been applied to the fifth-term payment.[9]

The IH Rep sued Tutor Perini for the unpaid earn-out amounts.[10] In addition to raising several affirmative defenses to the IH Rep's complaint, Tutor Perini filed a counterclaim against GreenStar's former CEO and largest interest holder, who remained Five Star's CEO until midway through the fifth term.[11] In its counterclaim, Tutor Perini alleged that, over the course of the earn-out period, the former CEO fraudulently provided Tutor Perini with inaccurate information regarding Five Star's operations and prospects, which Tutor Perini then relied on to calculate GreenStar's pre-tax profits.[12]

According to Tutor Perini, these inaccuracies caused pre-tax profits for the first four terms to be significantly overstated.[13] Tutor Perini asked the court to rule, in part, that (i) it was not obligated to make earn-out payments for the third, fourth, and fifth terms and (ii) earn-out payments for the first and second terms, and any future earn-out payments ordered to be paid, would be offset by the former CEO in an amount equal to the alleged overstatement of pre-tax profits.[14]

Tutor Perini's Arguments and the Court's Analysis

Tutor Perini argued that its pre-tax profit calculations for the first four terms should not have triggered earn-out payment obligations under the MA. The MA required pre-tax profit to be calculated in accordance with GAAP, and therefore to be free from material inaccuracies. Tutor Perini reasoned that, because its pre-tax profit calculations were inaccurate, and thus not GAAP-compliant, such calculations could not form the basis for earn-out payments under the MA.[15]

Alternatively, Tutor Perini argued that the MA contained a gap regarding whether pre-tax profit calculations needed to be accurate. Accordingly, Tutor Perini asked the court to use the implied covenant of good faith and fair dealing to rule that only accurate pre-tax profit calculations could trigger earn-out payment obligations under the MA.[16]

The court rejected both arguments. It held that the MA clearly required any pre-tax profit calculation, if not objected to by the IH Rep within the timeframe specified in the MA, to be binding on the parties, regardless of whether or not Tutor Perini had prepared the calculation in accordance with GAAP.[17] The court noted that allowing Tutor Perini to attack its own pre-tax profit calculations in order to avoid earn-out payments would lead to an unreasonable result.[18]

In addition, the court ruled that the MA did not require any gap-filling and therefore did not merit application of the implied covenant of good faith and fair dealing. According to the court, the parties would have included specific language in the MA if they had "intended to allow Tutor Perini to withhold

earn-out payments whenever it believed it had calculated pre-tax profits based on inaccurate information."[19]

Key Takeaways

For M&A buyers considering earn-outs, this decision offers a few key takeaways. First and foremost, the buyer should be wary of relying heavily on a member of the seller group to calculate earn-out payments and should consider engaging a third-party accountant to review the financials and calculate the earn-out payments. Simply stepping back and asking who will actually be preparing the financials upon which the earn-out will be determined is a crucial exercise. The buyer may want to consider including language in the acquisition agreement specifically requiring that the earn-out calculation be performed by a neutral third-party accounting firm from the outset.

Second, the buyer should be mindful that, once it delivers its earn-out calculation to the seller, generally the buyer cannot later retract the calculation. As a result, the buyer should be completely comfortable with its calculation before delivering it to the seller.

Third, the parties should not expect the implied covenant of good faith and fair dealing to come to the rescue in the event they believe they have been wronged in an earn-out arrangement. Instead, they must negotiate specific language to protect their interests.

Fourth, the parties should recognize that earn-out structures with long earn-out periods have a greater risk of resulting in a dispute. In this case, the earn-out period was five years. A shorter earn-out period, such as a period with a duration through the end of the fiscal year in which the closing occurs if the closing occurs mid-year or earlier, leaves less time for mischief, less time for any action taken by the buyer to sway the financial results of the business, less time for the parties to remain entangled and less time for them to become disenchanted with one another. If an earn-out is necessary to bridge a valuation gap between a buyer and seller, the parties would be well-advised to negotiate as short an earn-out period as possible.

As demonstrated by *GreenStar IH Rep* and other recent cases, while earn-out provisions can be complex and time-consuming to negotiate, both buyers and sellers should strive to anticipate potential issues early-on, including with respect to practical matters such as who will actually calculate the earn-out, and should draft earn-out provisions to be as clear as possible within the four-corners of the acquisition agreement. Taking these steps can spare the parties from further cost, time and uncertainty when the earn-out payment ultimately must be calculated and delivered.

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[1] *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 145-46 (Del. Ch. 2009) (internal quotation marks omitted).

[2] *Id.* at 146.

[3] *See Winshall v. Viacom Int'l Inc.*, 76 A.3d 808 (Del. 2013).

[4] *See Am. Capital Acquisition Partners, LLC v. LPL Holdings, Inc.*, 2014 WL 354496 (Del. Ch. Feb. 3, 2014).

[5] *See Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC*, 114 A.3d 193 (Del. 2015).

[6] *GreenStar IH Rep, LLC v. Tutor Perini Corp.*, 2017 WL 5035567 (Del. Ch. Oct. 31, 2017) ("*GreenStar IH Rep*").

[7] Agreement and Plan of Merger by and among Tutor Perini Corporation, Galaxy Merger, Inc., GreenStar Services Corporation and GreenStar IH Rep, LLC, as the Interest Holder Representative, dated as of July 1, 2011 (available at https://www.sec.gov/Archives/edgar/data/77543/000114036111035619/ex2_2.htm), Section 2.14(a). Thus, the maximum amount payable under the earn-out was $40 million, or five payments of up to $8 million per payment.

[8] *Id.* at Section 2.14(b).

[9] *GreenStar IH Rep* at *3.

[10] *Id.* at *1.

[11] *Id.* GreenStar's former CEO was not a party to the MA, but had earlier joined in the IH Rep's complaint in order to challenge Tutor Perini's initiation of arbitration against him alleging claims for breach of his employment agreement, breach of the implied covenant of good faith and fair dealing, and fraud, among others. Thus, because GreenStar's former CEO had joined the litigation, Tutor Perini was able to file a counterclaim against him as part of the same proceeding in which Tutor Perini defended itself against the IH Rep's claims. *See id.* and *GreenStar IH Rep, LLC v. Tutorni Perini Corp.*, 2017 WL 715922 (Del. Ch. Feb. 23, 2017), at *2.

[12] *GreenStar IH Rep* at *4.

[13] *Id.*

[14] Defendant's Answer to Plaintiffs' Verified Complaint and Verified Counterclaims, 2017 WL 1002090 (Del. Ch. Mar. 9, 2017), Prayer for Relief, ¶¶ B, C.

[15] *GreenStar IH Rep* at *6.

[16] *Id.* at *7.

[17] *Id.*

[18] *Id.*, n. 59.

[19] *Id.* at *8.

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