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'Glidepath': Guidance for Extra-Contractual Principles in an Earn-Out Context

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The Delaware Court of Chancery recently issued an opinion that provides guidance for the application of extra-contractual principles in an earn-out context, further stressing the importance of precise drafting of earn-out provisions.

In *Glidepath v. Beumer* (C.A. No. 12220-VCL) (Feb. 21, 2019), the court refused to apply the implied covenant of good faith and fair dealing in an earn-out context where the subject at issue (the operation of the acquired company during the subsequent earn-out period) either could have been anticipated by the parties or was expressly covered by a contractual agreement between the parties. Additionally, the court found that when analyzing a potential breach of fiduciary duties in an earn-out context in a situation where the seller continues as an equity holder in the company, the conflicting interests arising from an earn-out arrangement (namely, the company's interests in maximizing company value vs. the buyer's interests in minimizing the earn-out payments) may give rise to the more stringent entire fairness standard of review.

The dispute in *Glidepath* arose after Glidepath LLC (the company), controlled by defendant Beumer Corp. (the buyer), took certain actions during the earn-out period following the acquisition of the company by the buyer, which actions resulted in lower than anticipated earnings by the company and no earn-out payments becoming payable to Glidepath (the seller).

Prior to the buyer's acquisition of the company, the company and the buyer were both players in the airport baggage-handling industry, which consists of both traditional and next-generation baggage-handling systems. Historically, the bidding process for traditional systems has been more price competitive, often leading to lower margins, while the bidding process for next-generation systems has not been as price competitive and has often led to higher margins (although the upfront costs are more substantial for next-generation systems). The buyer's parent was a leading player in foreign markets dominated by the next-generation systems, but the buyer had struggled to gain market traction in the U.S. market dominated by traditional systems. The buyer identified the company, a leading player in the U.S. market, as an ideal target to boost its presence in the U.S. market. During the negotiation of a potential transaction, representatives of the buyer and the seller discussed goals focused on reorienting the company's business toward next-generation systems following the buyer's acquisition of the company—specifically pointing to potential opportunities at Denver International Airport (the Denver project) and San Francisco International Airport (the San Francisco project), each of which would include both a next-generation component and a traditional component.

Courtesy photo

(L to R) Robert B. Little and Steve Wright of Gibson Dunn & Crutcher.

The buyer and the seller agreed to a transaction in which the buyer would initially purchase 60 percent ownership of the company, with a potential option to purchase the remaining 40 percent following a three-year period of shared ownership (the earn-out period). The bulk of the purchase price was structured as a contingent earn-out payment based on the company's performance during the earn-out period.

The buyer and the seller entered into an operating agreement governing the operation of the company during the earn-out period. The operating agreement established a form of governance in which an appointee of the buyer (the manager) would manage the business and affairs of the company, subject to specified restrictions (including the requirement that the manager adhere to a business plan detailing the company's budget and business strategy). The business plan was to be updated by the manager on a yearly basis, and a designee of the buyer was empowered to authorized material deviations from the business plan. The operating agreement did not modify or eliminate the manager's fiduciary duties.

During the earn-out period, as permitted under the operating agreement, the manager updated the business plan to reflect previously discussed goals of migrating the company's business toward the more profitable next-generation systems.

While adhering to the updated business plan—and largely with the support of the seller—the company pursued the Denver project and the San Francisco project. However, doing so meant devoting significant resources to pursuing such opportunities, while turning down some (but not all) traditional system opportunities that the company would have historically pursued. Although the Denver project and the San Francisco project projected higher financial performance following the earn-out period, the company's financial performance during the earn-out-period was significantly lower than initially anticipated.

When it became clear that no earn-out payment would become payable to the seller, the seller brought suit against the buyer, arguing, among other things, that the buyer and its representatives violated the implied covenant of good faith and fair dealing by not using best efforts to maximize the earn-out payment. The court rejected this argument, stating that the implied covenant of good faith and fair dealing "cannot be invoked where the contract itself expressly covers the subject at issue," and is not a remedy for "rebalancing economic interests after events that could have been anticipated, but were not, that later adversely affected one party to a contract." In this context, the subject matter at issue (operation of the company during the earn-out period) both could have been anticipated by the parties and was in fact expressly covered by the earn-out provision. Given the provisions in the operating agreement relating to the operations of the company during the earn-out period (particularly provisions that effectively granted the buyer control over the business plan), the court found that "there [was] no gap for the implied covenant to fill."

Separate from the implied covenant argument, the seller argued that the buyer and its representatives "breached their fiduciary duties by engaging in a bad-faith scheme to raise costs, lower profitability, divert opportunities and to employ the company resources to pursue next-generation projects for the primary benefit of [the buyer] (and to the detriment of the company)."

Unless their fiduciary duties are modified or eliminated, the fiduciaries of a Delaware limited liability company must act in the best interests of their beneficiaries. The court agreed with the seller that the manager and the buyer, as majority owner of the company, owed fiduciary duties to the seller, but only in connection with the seller's interests as an equity holder in the company (not in connection with the seller's contractual rights to the earn-out payment). The buyer's duty was therefore not to maximize the value of the seller's contractual claim to the earn-out payment (as the seller had argued), but rather to act in good faith to "maximize the value for the the company over the long term."

Importantly, in determining the standard of review for analyzing whether such fiduciary duties were breached, the court highlighted the conflict between the buyer's interest in minimizing the earn-out payment and the company's desire to maximize company value. Because this conflict "undermined [the buyer's] ability to make disinterested and independent decisions," the court applied the entire fairness standard of review. The heightened standard of review requires that the fiduciary's course of action be "objectively fair." The court determined that the buyer's actions in pursuing opportunities involving next-generation systems were part of a "sound business strategy" to maximize the long-term value of the company by seeking higher profit margins and less competition. The court found that neither the buyer nor its representatives breached their fiduciary duties, but rather they acted at all times to promote the long-term value of the company, despite that their actions contributed to the loss of the earn-out payment. As a result, Seller was left with little recourse against Buyer for its loss of the potential earn-out payment.

Glidepath confirms that Delaware courts generally respect a party's "right to enter into good and bad contracts" and reflects an unwillingness by Delaware courts to apply the implied covenant of good faith and fair dealing as an extra-contractual principle in an earn-out context. Additionally, *Glidepath* suggests that a failure to maximize earn-out payments (or other contractual claims) alone will not violate the standard of conduct required in an entire fairness review.

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