

## Lessons From Del. On Good Faith, Fair Dealing In Earnouts

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An “earnout” in a merger and acquisition transaction conditions a portion of the purchase price on the acquired business’ performance after its acquisition, with payment contingent upon meeting defined milestones or metrics in a specified post-closing period. Earnouts bridge valuation gaps between buyers and sellers, and are more frequently implemented when the nature of the business or other conditions undermine the transaction parties’ ability to agree on the future prospects and ultimate value of a business. Impending elections, macroeconomic uncertainty, volatile equities markets and geopolitical tensions currently provide fertile ground for increased reliance on earnout structures to complete M&A deals.



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Earnouts not only establish performance metrics or other conditions that must be met for payment, but also may include certain obligations or restrictions on the buyer’s operation of the business during the earnout performance period to protect or enhance a seller’s opportunity to realize the earnout consideration. The inherent complexity of earnouts and the ever-present challenge of predicting all relevant eventualities can lead to disagreement after the fact as whether the buyer complied with its covenants. The Delaware Chancery Court has observed such disputes often involve the claim that the buyer breached the implied covenant of good faith and fair dealing, and thereby impeded achievement of the earnout. Some recent Delaware decisions review the treatment of the implied covenant and emphasize that parties should seriously consider whether and how post-closing operational requirements are to be articulated in agreements.

Under Delaware law, the implied covenant of good faith and fair dealing attaches to every contract by operation of law and requires a party to a contract to refrain from arbitrary or unreasonable conduct that prevents the other party from receiving the fruits of the bargain.[1] However, Delaware courts reject using an implied covenant to “maximize” earnouts, or to establish an objective requirement for specific actions where the agreement includes provisions governing an issue or where the parties could have contractually addressed an anticipated contingency. Specifically, Delaware courts have held that the implied covenant serves a gap-filling and clarifying function when an unanticipated issue arises post-closing, with deference to the explicit and unambiguous contract terms bargained for by the parties.

Recently, in *Haney v. Blackhawk Network Holdings Inc.*, (Del. Ch. Feb. 26, 2016), the plaintiff, representing the selling stockholders of Cardlab Inc. (“seller”), sued Blackhawk Network Holdings Inc. (“buyer”) for, among other things, breach of the implied covenant of good faith and fair dealing, when the buyer failed to generate enough revenue to reach an earnout target.[2] The seller alleged that the buyer deliberately prevented the business from achieving the earnout by failing to devote required

resources to the business.[3] The seller argued that the agreement's terms that "key personnel" were required to "dedicate a commercially reasonable" amount of time and resources to the generation of net revenues did not specifically provide a standard for evaluating the conduct of the buyer's personnel in attempting to generate revenues.[4] This was done to distinguish the facts from those in *Fortis Advisors*, in which the court held that the agreement's "best efforts" standard and specified obligations of the buyer barred application of the implied covenant. The court disagreed, finding the express terms controlling and stressing that the implied covenant "only applies where a contract lacks specific language governing an issue and the obligation the court is asked to imply advances, and does not contradict, the purposes reflected in the express language of the contract." [5] Accordingly, the court dismissed the claim.

In *Fortis Advisors LLC v. Dialog Semiconductor PLC*, No. 9522-CB, (Del. Ch. Jan. 30, 2015), the agreement provided that the buyer "use commercially reasonable best efforts" in successfully managing the acquired business, to achieve and pay the earnout payments in full.[6] The merger agreement also included several specific obligations and prohibitions on the buyer's operation of the business during the earnout period. The court acknowledged that, under Delaware law, the implied covenant of good faith and fair dealing requires each contracting party to refrain from arbitrary or unreasonable conduct in an effort to prevent the other party from receiving "the fruits of the bargain" applicable where an agreement lacks provisions governing the issue in question.[7] As the merger agreement expressly obligated the buyer to use commercially reasonable best efforts to achieve and pay the earnout, and the contract terms explicitly restricted the buyer from taking certain actions, the court rejected the assertion that the implied covenant could be used as an alternative theory to contractual breach with respect to the earnout provisions in dispute.

In *Lazard Technology Partners LLC v. QinetiQ North America Operations LLC*, 114 A.3d 193 (Del. 2015), the plaintiff, representing the former stockholders of the acquired company (the "sellers"), asserted that the buyer failed to take actions that would have increased revenue sufficient to meet an earnout condition. As a result, the sellers claimed that the buyer breached an express covenant prohibiting it from "tak[ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment" as well as the implied covenant of good faith and fair dealing.[8] The Delaware Supreme Court affirmed the Court of Chancery's bench ruling, holding that the buyer did not breach the express covenant nor the implied covenant. The court found no breach where the buyer merely was aware that its actions would adversely impact the acquired business' ability to meet the earnout revenue targets. Rather, to prevail, the seller would need to show that the buyer acted with intent to avoid an earnout payment as literally required by the express covenant.

Similarly, the Supreme Court upheld the Chancery Court's conclusion that the implied covenant did not require the buyer to affirmatively take actions that would have resulted in sufficient revenue to meet earnout targets. The court rejected the position that the implied covenant imposes an objective standard that would avoid the burden of proving that the buyer intentionally violated the earnout covenants. Instead, the courts reinforced the view that a party may invoke the implied covenant, not to grant unspecified rights, but rather when it is clear from the contract that the parties would have agreed to restrict alleged actions to provide the benefit of the bargain had it been foreseen to negotiate.

The Supreme Court stated that the Court of Chancery "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," as it held that the implied covenant must be read consistently with any explicit contractual restrictions in the merger agreement that affect conduct concerning the earnout.[9] Notably, the court concluded that no further obligations were imposed on the buyer because the contract included no efforts-specific

covenant of the buyer and the presigning negotiating history showed that the buyer rejected the sellers' attempts to negotiate for additional affirmative post-closing obligations.[10]

Delaware courts have applied the implied covenant in the context of post-closing operation of a business subject to an earnout under other circumstances. In *American Capital Acquisition Partners LLC v. LPL Holdings Inc.*, No. 8490-VCG, (Del. Ch. Feb 3, 2014), the stock purchase agreement contemplated contingent earnout consideration if certain gross margin targets were met by the acquired business post-closing. The agreement included no post-closing covenants obligating the buyer to operate in a specified manner or to take or refrain from taking specific actions. The seller alleged that the buyer intentionally diverted clients, personnel and opportunities from the acquired business to another division of the buyer, impairing the seller's opportunity to meet the earnout targets.[11]

In denying the buyer's motion to dismiss the seller's claim of breach of the implied covenant of good faith and fair dealing, the court held that it would apply where a contract is incomplete and does not reflect the contracting parties' reasonable expectation at the time of contracting. The court found that the earnout provision demonstrated that, had the parties contemplated that the buyer might have actively tried to steer sales away from the acquired business to avoid paying the earnout compensation, the parties would have contracted to prohibit such behavior. Therefore, it would be appropriate to read the implied covenant into the agreement to require a contracting party to refrain from unreasonable conduct that prevents the other party from receiving the benefit of the arrangement. In contrast to the court's treatment of such unanticipated conduct, the court dismissed claims alleging breach of the implied covenant where the sellers had discussed technology integration, anticipating that the earnout targets would depend upon the buyer's ability to integrate its technology with the acquired business, but failed to impose any contractual obligation on the buyer to make technological changes necessary for successful integration.

Accordingly, those involved in drafting and negotiating earnout provisions governed by Delaware law — but logical in any jurisdiction — should understand that implied covenants are no surrogate for contractual specificity for matters that can be anticipated by the parties when determining the approach to take in covenants (or disclaimers of such covenants) regarding operation of an acquired business. Counsel should not expect a liberal application of the implied covenant to do this work for the parties.

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[1] *Fortis Advisors LLC v. Dialog Semiconductor PLC*, No. 9522-CB, 2015 WL 401371, at \*3 (Del. Ch. Jan. 30, 2015) (citing *Dunlap v. State Farm Fire and Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (quoting *Wilgus v. Sale Pond Inv. Co.*, 498 A.2d 151, 159 (Del. Ch. 1985) (construing Restatement Section 205))).

[2] *Haney v. Blackhawk Network Holdings Inc.*, 2016 WL 769595, at\*1 (Del. Ch. Feb. 26, 2016).

[3] *Id.* at \*3, 8-9. The seller also sued the buyer for breach of the implied covenant on the grounds that the buyer knew of and failed to disclose an exclusivity provision between a significant customer and the

buyer's competitor.

[4] Id. at \*8.

[5] Id. at \*8.

[6] Fortis Advisors LLC v. Dialog Semiconductor PLC, No. 9522-CB, 2015 WL 401371, at \*1 (Del. Ch. Jan. 30, 2015).

[7] Id. at \*3.

[8] Lazard Technology Partners LLC v. QinetiQ North America Operations LLC, 114 A.3d 193, 194 (Del. 2015).

[9] Id.

[10] Id.

[11] American Capital Acquisition Partners LLC v. LPL Holdings Inc., No. 8490-VCG, 2014 WL 354496, at \*1 (Del. Ch. Feb 3, 2014).