# *The Enduring Allure and Perennial Pitfalls of Earnouts*— Tutor Perini *and Practice Points*

An "earnout" is a deal mechanism that provides for a buyer to pay additional consideration after the closing if specified post-closing performance targets are achieved by the acquired business or specified post-closing events occur. An earnout can be instrumental in bridging the gap when, based on divergent views by the buyer and the seller about the likely future operating performance or the likelihood of the occurrence of certain contingencies, the parties cannot agree upfront on a purchase price. In situations where the seller will remain involved in the post-closing operation of the business, an earnout can also be a useful mechanism to incentivize the seller to grow the business for the buyer's benefit after the closing.

Notably, earnouts often prevent disagreements during the negotiation of the deal price only to result in post-closing disputes over the earnout itself. These disputes often lead to litigation or, if the parties have provided for it, arbitration. A critical factor in avoiding disputes is setting forth (typically, in the acquisition agreement) clear, specific, business-contextualized provisions and procedures relating to the calculation of the earnout and the parties' respective earnout-related obligations.

In *Tutor Perini*, a buyer (Tutor) who had agreed to an earnout based on pre-tax profits of the acquired business (GreenStar) ceased making payments when it came to believe that the former CEO of GreenStar (who remained post-closing as the CEO of a major subsidiary) was providing fraudulent information to inflate the earnout payments. The Court of Chancery ordered Tutor to make the earnout payments, stating that the earnout provisions did not expressly provide for Tutor to withhold payments if it doubted the information being provided to calculate them. The decision provides a stark illustration of the need for parties to seek to provide clear, specific earnout-related provisions and procedures (including for calculating the earnout amount and for resolving disputes that may arise)—and to follow the provisions and procedures precisely.

In this Briefing we discuss:

- The *Tutor Perini* decision;
- Key Points relating to earnouts;
- Practice Points relating to earnouts; and
- Other major earnout decisions.

### The *Tutor Perini* Decision

***Background.*** Tutor Perini Corp. acquired GreenStar Services Inc. and its subsidiaries for approximately $208 million. The purchase agreement also provided for earnout payments to be made by Tutor to GreenStar's Interest Holder Representative (the "IH Rep"), in each of the first five years after closing. Each payment would be equal to 25% of GreenStar's "Pre-Tax Profit" in excess of $17.5 million for the prior year, up to a cap of $8 million per year (with excess amounts not paid due to the cap being applied as a credit to any future earnout payments that fell short of the cap). The agreement provided that, within specified time periods after each year-end, Tutor was required to calculate Pre-Tax Profit and to provide a Pre-Tax Report to the IH Rep. (There were apparently no requirements with respect to the procedure for Tutor's determining Pre-Tax Profits other than that Tutor would do so in accordance with GAAP.) If the IH Rep accepted the Report, or did not object to it within a specified time period after receiving it, Tutor was required to pay the earnout amount it had calculated. If the IH Rep objected to the Report, then the parties were required to try to resolve the dispute for a specified time period, and, if they could not, to submit it for binding arbitration by an independent accountant.

After each of the first and second years, Tutor prepared the Pre-Tax Report, which was based in large part on the numbers provided by the former CEO of the acquired business ("G.S.") and who had remained employed post-closing as the CEO of a main subsidiary within the acquired business. In each of these first two years, the IH Rep did not object to the Report and Tutor paid the earnout amount, which (in each year) was the $8 million cap. A total excess of $9.2 million was carried over for possible payment in the future years if the earnout amount did not reach the cap. After each of the third and fourth years, Tutor again prepared the Pre-Tax Report (again, based in large part on the information provided by G.S.) and delivered the Report to the IH Rep. However, Tutor did not pay the earnout amounts reflected as due for those years. Instead, Tutor withheld the payments, purportedly because it had reason to believe that G.S. (who also was the person who was entitled to receive the largest share of any earnout payments) had been providing fraudulent information to Tutor that inflated Pre-Tax Profit (and, thus, the earnout amount). After the fifth year, Tutor neither prepared a Report nor made any earnout payment.

Vice Chancellor Slights held that the agreement did not provide for Tutor to withhold earnout payments if it doubted the accuracy of the information that was utilized to calculate Pre-Tax Profit. Rather, the Vice Chancellor emphasized the precise procedure laid out in the agreement—which required that an earnout amount be paid, based on the Pre-Tax Profits stated in the Report, unless the IH Rep objected to the Report. As the IH Rep had not objected to Reports delivered to it, the court ordered that earnout payments be made with respect to the third, fourth and fifth years. The court determined the amount due to be $20 million (thus, payment of a total of $36 million by Tutor out of the $40 million maximum possible earnout for the five years).

***Analysis.*** The court emphasized that the procedure set forth in the agreement for determining and resolving disputes relating to the earnout had not been followed by the buyer. The court stated that the parties easily could have—*but did not*—provide that Tutor could withhold an earnout payment any time that it doubted the accuracy of the information on which it was calculating Pre-Tax Profits. Therefore, the court held, Tutor did not have the right to withhold payments even though it believed that the information on which the calculations were based was fraudulent. While the opinion indicates that the ruling was based strictly on a straightforward interpretation of the clear language of the agreement relating to the resolution of disputes, we note that a number of aspects of the case may have led the court to be skeptical as to Tutor's claim of fraud by G.S. and to have viewed Tutor's reluctance to pay any earnout after the second year as primarily motivated by "buyer's remorse." Specifically, we note (although the court did *not* note in the opinion) that:

- *Tutor could have simply obtained non-fraudulent information.* When Tutor doubted the accuracy of the information being provided by G.S., there was no reason that Tutor could not have checked the information or obtained it from someone other than G.S. (a self-interested party)—in which case it could have been in a position to calculate Pre-Tax Profits which it believed to be accurate. The IH Rep, if it disagreed with the calculation, then could have objected; and the dispute then could have been resolved by the independent accountant—in accordance with the procedure set forth in the agreement.

- *The fraud claims were not pled with specificity.* The court found that Tutor's allegations of fraud by G.S. lacked specificity. Moreover, we note, Tutor's continued employment of G.S. (until midway through the fifth year) may have belied a belief by Tutor that he had been committing fraud against Tutor.

- *The acquired business experienced a significant decline.* Moreover, we note, Tutor only doubted the information once the Pre-Tax Profits had declined significantly. The calculation of Pre-Tax Profits had been $75.4 million and $65.5 million in the first and second years, respectively, and then was down to $31.6 million and $49.4 million in the third and fourth years. Thus, earnout payments for the third and fourth years would not only have had to be made on the Pre-Tax Profits for those years but also would have included applicable payments of the $9.2 million in excess carryover amounts from the previous years—at a time when the business had declined significantly.

While the decision highlights the need to comply with the earnout procedures expressly set forth by the parties, one may question whether the result might have been different in this case if (i) there had been specific, credible allegations of actual fraud by G.S., (ii) Tutor had taken steps to verify the information that G.S. was providing, and/or (iii) Tutor had worked within the procedure set forth in the agreement and prompted an objection by the IH Rep to the Pre-Tax Reports, which could have then been resolved by the independent accountant contemplated by the agreement.

**Key Points about Earnouts**

- **Earnouts are used frequently and frequently lead to disputes.** Earnouts were utilized in about 28% of the private target transactions entered into in 2016 and the first half of 2017 (according to the 2017 ABA Private Target Deal Study of the 139 deals with purchase prices between $30 million and $500 million). This is consistent with the rate generally over the past decade, which has ranged from 20-30% (with a spike to 38% in 2014). While earnouts are often thought of as a relatively easy, shorthand fix to a major valuation problem, a well-crafted earnout provision involves significant challenges in terms of both negotiation and drafting. Earnouts implicate numerous inter-related provisions involving the metrics for the earnout formula, the accounting principles that will be applicable to calculation of the formula, the process for making the earnout determinations, and the seller's rights and the buyer's obligations with respect to the operation of the acquired business during the earnout period (including the general level of efforts, and any specific efforts, by the parties that will be required with respect to enabling the business to reach the targets). When an earnout takes the form of "milestone payments," which are payable upon the occurrence of specified events (such as, in pharma deals, regulatory approvals being received for drugs in development), the nature of the trigger events, specificity as to the parameters relating to the trigger events, and the parties' respective obligations (if any) in promoting the occurrence of the trigger events, need to be addressed. In addition, an earnout will create special considerations for the governing law, remedies and many other sale agreement provisions.

- **A buyer does not have any duty to ensure or maximize the earnout—but the buyer cannot purposefully frustrate the earnout.** Generally, in Delaware, except to the extent that the parties expressly provide otherwise in their agreement, the buyer has no obligation to take or refrain from taking action, and no implied obligation to use any form of best or reasonable efforts, to ensure or maximize an earnout. However, the courts have held that the implied covenant of good faith and fair dealing requires that the buyer not take any affirmative action for the purpose of frustrating the achievement of earnout targets. The courts tend not to view actions as having been taken for the purpose of frustrating payment of an earnout if (i) there is any basis for the actions to be viewed as legitimate business decisions and the sellers' complaint as a dispute concerning business strategy and/or (ii) there are countervailing factors indicating efforts by the buyer that supported the relevant business (such as the investment of funds in the business, the hiring of additional sales people for it, and so forth). Thus, there is a generally high bar to succeeding on a claim that a buyer frustrated an earnout—but, because the factual context is critical, and because earnout provisions often are not sufficiently specific, the result of litigation relating to earnouts has a relatively high degree of uncertainty. (Note that the law of other states varies, with some states, such as California and Massachusetts, imposing an implied obligation that a buyer take "reasonable efforts" to achieve an earnout—at least in the absence of an express disclaimer to the contrary.)
- **Clear, specific, business-contextualized drafting—and strict adherence to the procedures set forth—are critical.** To mitigate the risk of disputes, earnout provisions should be drafted with as much clarity and specificity as possible, and the provisions and procedures should be contextualized for the specific business at issue. Lawyers and business people who understand the specific company and its industry, its business operations, and its accounting practices should work closely together in crafting these provisions. Further, as *Tutor Perini* illustrates, the courts generally interpret earnout provisions narrowly and will not "read in" terms that the parties did not specifically negotiate for and express in the agreement. Accordingly, the parties should follow the earnout provisions—and, in particular, the dispute resolution procedures—scrupulously.

**Practice Points**

- **Earnout provisions.** As noted, based on the 2017 ABA Private Target Deal Study, about 28% of private company acquisition agreements entered into in 2016 and the first half of 2017 included earnouts. Of the agreements with earnouts:
  - 8% included an express covenant requiring the buyer to seek to maximize the earnout;
  - 21% included an express covenant requiring the buyer to run the business consistent with past practice; and 33% expressly permitted the buyer to operate post-closing in its discretion;
  - 5% included an express acceleration of the earnout payment(s) on a change of control (in recent prior years, 11-27% of agreements with earnouts included this type of acceleration);

  - 51% of agreements expressly permitted the buyer to offset indemnity payments against the earnout (in recent prior years, 58-81% of agreements with earnouts expressly permitted offsets); and
  - 32% provided for calculation of the earnout based on revenues; 27% based on earnings/EBITDA; and none based on a combination of revenues and earnings.

- **Consider whether an earnout is appropriate.** The parties' specific objectives in adopting an earnout should be scrutinized. For example, in some transactions the earnout is utilized to bridge a relatively small valuation gap as to which the parties may have been better served with a compromise upfront rather than risking later litigation (or even arbitration) with respect to the earnout. We note that, in *Tutor Perini*, the maximum possible earnout amount of $40 million represented 16% of the purchase price paid plus the maximum possible earnout amount—and the disputed $20 million represented just 8% of that amount.

- **The implied covenant of good faith is narrowly applied.** The implied covenant of good faith and fair dealing adheres to every contract; however, the Delaware courts have tended not to invoke the implied covenant to "read in" to a contract provisions that were not specifically negotiated for and agreed to by the parties. The implied covenant may be invoked, however, where, in the court's view, (a) a development occurs that could not have been anticipated and it is clear what the parties would have provided had they been able to anticipate it, or (b) the buyer took action for the purpose of frustrating the earnout (such as diverting revenue from the acquired business to a subsidiary which was not subject to the earnout, without any valid, non-earnout-related business reason for doing so). Notably, where, in the court's view, there is a valid business reason for an action, the court generally does not consider the implied covenant to have been breached (even if the action diverted revenue or otherwise frustrated the earnout).

- **Earnout provisions should be clear, specific and contextualized for the specific business.** The parties should specify who will prepare the initial financial statements and calculations for the earnout (*e.g.*, the party in control of the business post-closing or an independent accounting firm); what participation, review and/or objection rights the other party will have in the process, and how and when they may be exercised; the timetable for the process; and how disputes will be resolved. The accounting principles that will be used when preparing the financial statements and calculations should be clearly specified and *should relate to the specific business*. (For example, if the accounting principles as applied to the business provide wide latitude to the persons responsible for the financial statements, consideration should be given to circumscribing that latitude.) The required general level of support that the buyer, and/or the seller, must provide to the acquired business with respect to enabling it meet the earnout targets should be set forth. An appropriate metric and procedure should be set forth; the covenants should cover all reasonably anticipated events; and specific covenants *relating to the specific business at issue* should be included. Litigators should review the provisions to ensure clarity and an effective dispute resolution mechanism. Review by tax and employee benefits lawyers is also advisable, as issues relating to the treatment of items such as tax or employee expenses, accruals, rebates, reserves, and so on, often arise and can have a significant dollar impact on an earnout formula. The parties may also want to consider providing general statements of the parties' intent with respect to the earnout. In addition, hypothetical examples of earnout calculations for illustrative purposes should be considered.

- **The metric selected should capture the value to be measured and should not be subject to manipulation.** When selecting a metric for the earnout target, the parties should consider which metric best captures the value that is to be measured. However, the parties also should consider how complicated it will be to track that metric and whether a metric with less risk as to execution and litigation could be substituted (even at the risk of some loss of precision in the tracking measure). Often, the earnout formula that has the most compelling rationale is one that is based on the valuation premise utilized in determining the consideration paid at closing (*e.g.,* EBITDA if the buyer valued the business based on a multiple of EBITDA). A seller may prefer to base the earnout target on revenues—because the result is less affected by costs and expenses and, correspondingly, less subject to manipulation. A buyer may disfavor a revenues-based target—precisely because it does not take costs and expenses into account (and, if the seller remains involved in the post-closing operations, the seller will not be incentivized to control costs and expenses and may be incentivized to grant unprofitable deals to customers). Consideration should be given to including covenants that will limit possible manipulation of the formula. For example, if EBITDA (which takes into account operational costs and expenses, but excludes non-operational items such as interest, tax, depreciation and amortization) is the metric selected, to prevent manipulation of the earnings result through the buyer's front-loading expenditures, the expenditures that the buyer can make during the earnout period can be limited by specific covenants or can be capped for purposes of the earnout calculation. Relying on audited financial statements, and requiring accounting methods that are consistent with the acquired business's past practices, can reduce the risk of disputes. Parties should consider excluding the effects of purchase accounting, increased capital expenditures, and/or other specified items from the earnout calculation.

- **The dispute resolution mechanism should be clear and specific—and should be followed precisely.** Given the prevalence of earnout disputes, a dispute resolution mechanism that deters litigation should be included in the acquisition agreement. The Delaware courts will not lightly intervene in post-closing disputes, including over earn-out payments, when an agreement provides a mechanism for an alternative dispute resolution such as arbitration. Instead, a court is likely to treat a third party resolution as final, even when the third party is an accounting firm or other expert lacking the legal training of an arbitrator. Relevant concerns in drafting a dispute resolution procedure involving arbitration by an independent accountant will include: how the accountant will be selected; who will pay for the accountant; whether the accountant is bound by the methodologies provided in the sale agreement; whether the accountant is limited to considering the specific disputes identified by the parties or can raise other issues; whether the accountant is limited to choosing between the parties' respective results or can do a de novo calculation to derive its own result (or a result within a specified range of the parties' results); whether a party would be bound by its original earnout estimates and/or original arguments in support of those estimates (so that a party could not offer different estimates or new arguments in any dispute resolution proceedings); a timetable for the accountant's process; whether the accountant's determination will be final and binding on the parties; the basis (if any) on which a party could bring a claim to dispute the accountant's determination—such as fraud or manifest error (subject to the Federal Arbitration Act (FAA), if applicable). *Tutor Perini* highlights that, if there is a dispute regarding the earnout, a party should take all possible steps to resolve the dispute *within the process set forth in the agreement* for dispute resolution. For example, in *Tutor Perini*, Tutor could have forced resolution of the fraud issue by calculating the earnout amount to be zero, which would have prompted an objection by the IH Rep, which then could have been resolved by the independent accountant.

- **Risk of obtaining information from "carryover" employees.** If the buyer is obtaining information from "carryover" employees of the acquired business, and even more so if those employees will receive a significant portion of any earnout payments made, the buyer could consider providing for a specific right to object to or double-check the information provided, or a process for correction, if it believes that the information provided is fraudulent or inaccurate.

- **Risk of waiver of objections to arbitrator's decision when the parties have provided for it to be non-binding.** To mitigate the risk of litigation, the parties should consider providing for arbitration of disputes to be the exclusive method of resolving disputes, with the arbitrator's decision being final and binding on the parties. We note that, when the sale agreement provides that an arbitrator's decision will *not* be final and binding, each party should be mindful that considerations not reflected in its initial calculations of the earnout, and/or in the initial objections it makes to the arbitrator's decision, may later be deemed to have been waived and therefore not capable of being raised in future proceedings. Some acquisition agreements require that the buyer and the seller prepare and agree on a written description of the accounting issues in dispute and that the arbitrator limit its decisions to those issues, with the decisions based solely on the arguments and theories raised by the parties.

- **Distinguish earnout disputes from other disputes.** If a post-closing earnout dispute arises, the sale agreement should be carefully analyzed to distinguish and separate from the earnout dispute any issues that actually give rise to claims of breach of non-earnout-related representations and warranties, fraud, indemnification, or other issues. The agreement also should provide whether the buyer can offset indemnity claims against earnout payments.

- **A seller generally has some leverage as a practical matter.** A buyer should consider ways in which a seller may have the practical ability to exert pressure on the buyer to make earnout payments—even if earnout targets are clearly not met and there are no issues about the buyer's post-closing actions. For example, a seller, if it continues to play a major role in the company post-closing, may be able to exert influence on customers and suppliers or other aspects of the operations, or to trigger negative publicity about the financial situation of the business. (Indeed, a seller may itself also be a customer of or supplier to the acquired business.) Buyers should consider specific covenants relating to post-closing actions by the seller or persons who will benefit from the earnout payments. These could include, for example, specified consequences relating to the earnout if a person who will benefit from earnout payments competes during the earnout period.

- **The parties should address the general standard of efforts, as well as specific covenants, relating to post-closing operations.** The parties should clearly state the standard that will govern the buyer's (and, if applicable, the seller's) obligations with respect to the earnout. A buyer may seek to provide that its only obligation is that it not take affirmative actions for the purpose of preventing or reducing the earnout payments or may agree to define its general obligation more broadly with a "commercially reasonable efforts" standard. A seller may seek to provide that the buyer must conduct its businesses following the closing so as to maximize the earnout payments or must use "reasonable best efforts." (Parties should try to avoid provisions that are merely "aspirational statements," "gossamer definitions," or "nebulous requirements," as then-Vice Chancellor Chandler, in a 2007 Court of Chancery case, described the earnout-related agreement provisions that he characterized as "too fragile to prevent the parties from delving into [an earnout] dispute.") The buyer may seek to clarify that it will have sole and absolute discretion over the acquired business after the closing, subject only to provisions of the agreement that expressly provide otherwise. The buyer may seek to bolster this general statement by reference to specific areas of potential concern (for example, specifying that the buyer will have the right, in its sole and absolute discretion, to determine the terms and conditions of any and all relevant sales, including the decision to make or not to make any particular sales and the preference for certain customers over others, irrespective of the effect on the potential of achieving the earnout). The parties should consider providing specific covenants covering certain aspects of the post-closing operations of the acquired business—such as those areas that are most critical to the acquired business's operations or to the achievement of the earnout targets, or those areas that may be most susceptible to manipulation or dispute. If the parties have discussed particular actions that they anticipate will have to be taken to ensure or maximize earnout payments, the parties should not assume that the implied covenant of good faith and fair dealing will require that those actions be taken. Rather, they are likely to be required only if specific covenants requiring that they be taken are explicitly included in the agreement. From the point of view of the buyer, the desire to limit impingements on its discretion in running the business post-closing must be balanced with consideration as to the extent to which certain specified parameters for operation of the business during the earnout period can limit the potential for earnout-related disputes. For example, the parties should consider specific covenants governing capital contributions, adequate capitalization, and dividend policy; hiring or firing of key personnel, employee compensation or pension costs, and appointment or removal of directors; sharing of opportunities, imposing costs on the acquired business that relate to the buyer's other businesses, allocation of overhead costs, and intracompany or affiliate transactions; sales and marketing efforts, size of sales force, rebranding of products, and priority of certain customers over others; restrictions on disposing of all or a portion of the acquired business or on acquisitions or other M&A transactions; if acquisitions are permitted, allocation of the costs of the acquisition, such as interest expense, and of the benefit of the income; and R&D expense, technology expense, and other specific expenses.

- **Disclaimers should be included.** The parties should explicitly disclaim any and all obligations relating to the acquired business's achievement of the performance targets *other than those specifically set forth.* A buyer should disclaim any obligation to ensure or maximize the earnout payments; conversely, a seller may seek to negotiate to include a provision to the effect that the buyer must conduct its businesses following the closing so as to seek to maximize the earnout payments. Generally, a seller will want to include an integration clause with an explicit anti-reliance statement by the buyer (*i.e.*, a provision stating that the written agreement is the sole agreement between the parties with respect to the subject matter of the agreement and supersedes any previous agreements, and that the buyer is not relying on any representations made or information provided to it other than as expressly set forth in the agreement).

- **Other earnout terms.**

  - **Length of earnout period.** Determining the optimal length of an earnout period will involve, for either party, a balancing of factors. Perhaps most importantly, a longer period will provide a more reliable look into how the business performs, but will also entail a longer period during which there are restrictions on the business and a longer wait for the earnout payment.

- **Offset rights; carrybacks; etc.** The parties should specify whether there will be any right to use the earnout payments as an offset against any required payments under indemnification claims or otherwise. A seller may seek to delay other payments being made until the earnout is finally determined. The parties should consider whether there will be any adjustment with respect to payments made (or missed) in previous installments based on subsequent performance (*e.g.*, carryback or carryforward of EBITDA from one measurement period to others, or, as in *Tutor Perini*, carryforward of excess earnout amounts above a specified cap). Notably, as illustrated in *Tutor Perini*, carryforwards of excess earnout amounts over an annual cap can lead to significant payments having to be made when the business has taken a negative turn and is in decline.

- **Governing jurisdiction law.** Parties should take into account the effect on the earnout of the governing jurisdiction for the acquisition agreement. Most importantly, as noted, state laws vary as to the interpretation of the implied covenant of good faith. (By contrast with Delaware, in California and Massachusetts, for example, absent clear language to the contrary in the acquisition agreement, courts have found that, under the implied covenant of good faith, the buyer has an implied obligation to seek to maximize the seller's earnout.) In any event, the parties should include specific provisions to effect their intentions, rather than relying on a choice of law provision. The parties should select an exclusive jurisdiction and court for any litigation.

- **Tailored remedies.** As it is difficult to prove that benchmarks would have been achieved but for breaches by the buyer, the seller should consider seeking to specify remedies for breaches of the sale agreement—such as liquidated damages (which, as a stimulus to compliance with the earnout provisions, could be in the excess of the aggregate payments that could be earned under the earnout formula); specified adjustments to the metrics of the earnout formula; or payment of all or a specified percentage of the earnout payment. A seller may wish to seek additional remedies in the event of a change in management or change in control of the acquired business (such as liquidated damages or the acceleration of earnout payments).

- **Floor or cap.** The parties should consider including a floor or a cap on the earnout payments so as to limit the range of discrepancy that can be subject to dispute.

- **Graduated formula.** A graduated formula (*i.e.*, a percentage payment on partial satisfaction of performance targets), as opposed to an all-or-nothing structure (*i.e.*, a single payment, triggered only if performance targets are fully met), may avoid an incentive for the buyer to just miss achievement of the target or an incentive for the seller to stretch to just make the target (albeit to the detriment of the business) to the extent that doing so is within the party's control. A graduated formula could also reduce the amount of discrepancy that could be subject to dispute.

- **Optional acceleration of payment.** In the case of an earnout period that is relatively lengthy, the parties could consider including a provision that permits the buyer and/or the seller to elect to accelerate payment of the earnout after a specified period of time (or upon occurrence of a specified event or a specified performance target being reached)—*i.e.*, earlier payment in exchange for eliminating uncertainty going forward.

  - **Buyout right.** The parties may wish to consider providing the buyer with a right to terminate the seller's earnout right, for payment of a specified amount, at one or more specified points of time during the earnout period. This right would enable the buyer to "buy its way out of" an earnout dispute (if one appears inevitable) at a pre-arranged price. Similarly, targeted buyout rights could help bridge a difficult negotiation over post-closing covenants. For example, if the buyer is concerned that agreeing to a particular post-closing covenant could become problematic, the parties might agree to a right of the buyer to terminate specific (or all of the) post-closing covenants in the future in return for a specified payment.
  - **Putback right.** The parties could consider, as a possible route to resolution of a material earnout dispute, the right of one or both parties to elect to have the acquired business sold back to the seller at a specified price (although we have not seen any such provision to date).
  - **Information rights.** A seller may wish to have the right not only to periodic written reports but also to in-person meetings for earnout-related information.
  - **Escrow.** A seller may seek to negotiate to hold all or some portion of the potential earnout payment in escrow or to be guaranteed by a third party (or for the buyer to grant a security interest in the target company, although this generally would not be permitted under the company's debt).
- **Consider possible alternatives to an earnout.** Parties should consider whether any alternative would accomplish the objectives of the earnout while mitigating the risk of future disputes. For example, when (as often is the case) the seller will be involved in the management of the acquired business, performance-related employee compensation or bonuses may be a preferred mechanism to accomplish the parties' objectives, rather than an earnout (subject to tax and other considerations). Alternatively, contingent value rights (CVRs) or milestone payments that are tied to specific non-financial targets, such as the outcome of pending litigation or obtaining regulatory approval, might also be considered as an alternative.

**Other Major Earnout Decisions**

- ***No duty to ensure or increase earnout payments—****Winshall v. Viacom* (2013) (Del. Sup. Ct.). The Delaware Supreme Court upheld the Court of Chancery's dismissal of the sellers' complaint that the buyer had breached the implied covenant of good faith by deciding not to take advantage of an opportunity to negotiate lower distribution fees under a distribution agreement with a third party that would have been applicable during the earnout period, and, instead, negotiating for the reduction of the fees to commence just after the earnout period ended, in return for other benefits. The court noted that the sale agreement had not obligated the buyer to ensure or maximize payment of the earnout. The court explained that, if, hypothetically, the buyer had agreed to pay double the distributor's ask in distribution fees in 2008 in return for paying no distribution fees in 2009, such an agreement arguably would have been a breach of the implied covenant of good faith because the buyer "would be depriving the [seller] of [its] reasonable expectations under the [sale agreement] by actively shifting costs into the earn-out period that had no place there…" (*i.e.*, the buyer would have purposefully frustrated the earnout). However, here, in the court's view, there was no reason to doubt that the buyer had simply made a business decision to delay the fee reduction in exchange for the other benefits to the company being offered—*i.e.*, that, although the earnout was affected, frustration of the earnout was not the sole basis on which the buyer could have been making its decision. The court explicitly rejected an interpretation of the implied covenant that encompassed “not only a duty not to harm the [acquired] business so as to reduce Gross Profit for purposes of calculating the earn-outs, but also to do everything it could to increase the earn-out payments.” The court emphasized the limited scope and function of the implied covenant, and explained that the covenant “cannot properly be applied to give the plaintiffs contractual protections that they failed to secure for themselves at the bargaining table.”

- ***Implied covenant was not breached by the buyer’s failure to make technological adaptations necessary for the earnout targets to be met—****American Capital Acquisition v. LPL Holdings* (2014) (Del. Ct. Ch.). The sellers contended that the implied covenant imposed on the buyer an obligation to make the technological adaptations necessary to enable one of its affiliates to provide certain services to the acquired business. The sellers argued that those adaptations were “reasonable and necessary” for the acquired business to have any potential to generate revenue sufficient to hit the earnout (and employee bonus) targets and thus it had been “anticipated and assumed” by the parties that the adaptations would be made. The court dismissed the claim at the pleading stage, reasoning that the implied covenant could be applied only to fill gaps in the agreement provisions and that, here, the parties had clearly contemplated the need for the adaption but had not negotiated any contractual commitment. (The court did *not* dismiss the claim that was based on the sellers’ allegation that the buyer had diverted revenue from the acquired business to another subsidiary of the buyer in order to prevent the earnout targets from being met.)

- **Implied covenant may have been breached by the buyer’s high pricing of the product it was obligated to “commercialize”**—*SRS v. Valeant* (2013) (Del. Ch. Ct.). The buyer, Valeant, acquired Sprout Pharmaceuticals, which had developed the drug Addyi (the “female Viagra”). The merger agreement, which provided for earnout payments, specifically obligated Valeant, postclosing, to use “Diligent Efforts” to develop and commercialize Addyi. The agreement included a lengthy definition of “Diligent Efforts” and four specific obligations (involving compliance with an asset transfer and license agreement, expenditure of at least a specified amount of funds for marketing and development, hiring a specified number of sales representatives, and satisfying FDA-imposed conditions for marketing the drug). In addition to other claims, the selling shareholders’ representative claimed that Valeant had breached the Diligent Efforts covenant and the implied covenant of good faith by “increas[ing] Addyi’s price to a cost that made it unaffordable to millions of women and at which payors would not cover the drug.” The Court of Chancery found that the following claims potentially implicated the implied covenant of good faith: (i) the pricing claim noted above (given that the Diligent Efforts standard might not “occupy the field” with respect to Valeant’s specified obligation to “commercialize” the drug, as the concept of commercialization “turns on measure of what other similar companies would do with similar drugs”; and that the Diligent Efforts definition, together with the specific covenants, “maps imperfectly onto the idea of pricing, making it reasonably conceivable that there would be a gap to fill” by the implied covenant); (ii) the claim that no steps had been taken to remove the FDA-imposed “alcohol co-use restriction” on the drug (given that the removal conceivably fell outside the contract’s language that related to complying with FDA-related conditions to marketing and “is not a concept that fits easily within the definition of Diligent Efforts”); and (iii) the claim that Valeant intended to market the drug through its former specialty pharmacy which it knew was under criminal investigation. While one typically would expect the court to leave the pricing of products and other such business decisions to the buyer’s discretion absent express provisions in the agreement to the contrary, it should be noted that the overall factual context in this case appeared to suggest [possible bad faith (based on, for example, the criminal investigation of the pharmacy and alleged breaches by the buyer of its express obligations set forth in the contract (such as its not hiring the required number of sales persons).

- ***Decision not to expend marketing funds was based on business exigencies, not a purpose to frustrate the earnout—****Airborne v. Squid Soap* (2009) (Del. Ct. Ch.). The court stated that a buyer cannot arbitrarily or *in bad faith* refuse to expend resources and thereby deprive the seller of the prospects for an earnout, but found that, in this case, the buyer's decisions not to expend funds were the result of its having suffered a "corporate crisis" and being restrained by significant legal and financial burdens. The sale agreement provided for a $1 million payment at closing and up to $26.5 million in possible earnout payments. After closing, the buyer suffered litigation and negative publicity that was unrelated to the acquired business, but which negatively affected all of the buyer's businesses, including the acquired business, and the earnout targets were not achieved. The court granted the buyer's motion on the pleadings to dismiss the seller's claim that the buyer had breached the implied covenant by failing to expend resources to market the acquired business's product. The court noted that the sale agreement did not include any requirements that funds be expended on marketing; that the sale agreement provided that, if specified levels of advertising spending and sales were not made, the buyer was required to return the assets it had acquired; and that the reason the buyer had not expended marketing funds was the overall financial position it was in, unrelated to the acquired business. Thus, although unexpected events occurred that affected the earnout, the court declined to "read into" the agreement specific covenants that the parties did not negotiate for, as it found no bad faith element to the buyer's conduct.

- ***Implied covenant was breached—in the context of possible bad faith by the buyer—****O'Tool v. Genmar* (2004) (10th Cir., applying Del. law). The court found that a jury verdict finding that the implied covenant of good faith and fair dealing had been breached was reasonable. The sale agreement provided for retention of the sellers' management and an earnout that was twice the amount of the payment made at closing. Post-closing, according to the sellers, the buyer had required that they immediately change the names of the products, discontinue certain products that were subject to the earnout, give priority to sales of products that were not subject to the earnout, and impose costs on the acquired business for one of the buyer's other product lines (that was not subject to the earnout). Although there were no specific agreement provisions relating to the post-closing operation of the business, the court reasoned that the buyer had violated the "obvious spirit of the earn-out arrangement…to give the sellers a fair opportunity to operate the acquired business in a manner to maximize the earn-out." We note that *O'Tool* was decided in the context of the court also stating that the evidence indicated that the buyers may have acted with "dishonest purpose" and "furtive design" in apparently having had the ulterior motive of acquiring the business to remove it as a competitor. In *Hodges v. Medassets* (2010) (N. Dist. Ct. Georgia, applying Del. Law), the court adopted the reasoning in *O'Tool* and found that the buyer had breached the implied covenant of good faith and fair dealing by developing products not subject to the earnout and converting the sellers' contracts to those products. The decision is notable in that, not only did the purchase agreement not cover the actions complained of, but, unlike in *O'Tool*, the sellers (who did not remain with company post-closing) had no rights to participate or expectations of participating in the operation of the business post-closing.)

- ***Business strategy disputes did not indicate breach of the implied covenant—****Fireman v. New America Marketing In-Store* (2009) (Dist. Ct. Mass., applying NY law). The court held that the buyer of a marketing business did not breach the implied covenant by rebranding the acquired business' product, removing key talent from the acquired business, and refusing to use the buyer's sales force to market the acquired business' product. None of these actions was specifically addressed in the agreement. The court found that the buyer's actions were best viewed as legitimate business decisions and the plaintiff's complaints as "disputes concerning strategy between sophisticated business people." The buyer had not "intentionally or recklessly caused [the acquired business] to lose money," the court stated.

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This briefing is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this briefing, please call your regular Fried Frank contact or an attorney listed below:


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