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# Earnout Provisions and Covenants of Good Faith:

## *What's Left Unsaid Says It All*

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Buyers and sellers struggling to agree on valuation have often turned to the earnout. Earnout provisions, which make a portion of the purchase price contingent on the purchased business hitting post-closing earnings targets or other milestones, are attractive and frequently used tools for M&A dealmakers because they can align incentives, allow buyers to reduce downside exposure to the target company's results, bridge valuation gaps and reward sellers who fulfill rosy pre-signing projections.

Yet earnouts provisions are also notoriously challenging to negotiate and susceptible to future dispute. Part of what makes these provisions so difficult is not just what goes into them, but also what is necessarily left out. No contract can address every conceivable future scenario, even when negotiated in the best of times or drafted by the most skilled counselors. And in the press to sign, it is often simply impractical to attempt to anticipate (much less negotiate and draft terms for) the myriad of considerations relating to the post-closing operation of the target business.

Two cases in the Delaware courts as of the date of this article — *ev3, Inc. v. Lesh* and *American Capital Acquisition Partners, LLC v. LPL Holdings, Inc.* — offer guidance on how a court might interpret a dispute over post-closing, earnout-impacting conduct that is not specifically governed by the agreement's terms. In ev3, the agreement contained only a reference to "good faith" to govern the buyer's operations post-closing. In American Capital, the agreement did not directly address how the buyer was to operate the acquired business post-closing. Each of these cases, by dealing with gaps in the parties' written agreement regarding how the earnout should operate, offer lessons for dealmakers turning to the earnout.

### ev3, Inc. v. Lesh

In *ev3, Inc. v. Lesh*, ev3 acquired a medical device from Appriva and agreed to make earnout payments to the Appriva shareholders based on the achievement of regulatory milestones. The parties' merger agreement did not contain any specific guidelines as to what efforts ev3 was required to take to achieve the milestones. The agreement simply contained a provision that the funding to pursue achievement of the milestones would be at ev3's "sole discretion, to be exercised in good faith." When the milestones were not achieved by ev3, the Appriva shareholders filed suit.

A key issue in the ongoing litigation, which began in 2005, is whether ev3 breached its obligation to act in good faith. The Appriva shareholders contend that ev3 intentionally delayed development of the medical device to avoid the earnout payments. Interestingly, while the agreement contains a standard "integration" clause

*Earnouts* ➔

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# Earnouts

*continued*

providing that the agreement supersedes all previous understandings of the parties, the integration clause specifically excludes a pre-signing letter of intent. The LOI states that ev3 would "commit to funding based on the projections prepared by its management to ensure that there is sufficient capital to achieve the performance milestones." The trial court allowed the admission of the LOI to inform the jury's determination as to whether ev3 had met its obligation to act in good faith. The jury found for the former Appriva shareholders and awarded them the entire $175 million of earnout payments, plus interest. The case is currently on appeal before the Delaware Supreme Court.

**American Capital Acquisition Partners, LLC v. LPL Holdings, Inc**

In *American Capital, American Capital Acquisition Partners, LLC*, among other former owners, had sold its subsidiary, a provider of technology and investment management technology, to defendant LPL Holdings, a provider of investment advisory technology and services. When the acquired business failed to meet its earnout targets, American argued that LPL's post-closing actions had denied American the benefit of its earnout.

American made two main arguments: (1) that LPL misrepresented that it had, or would obtain, the systems technology necessary to sufficiently integrate the acquired business to allow it to meet the earnout targets, and (2) that LPL diverted clients, personnel and opportunities from the acquired business to a different subsidiary, denying American the opportunity to meet its targets. According to American, during pre-signing meetings, LPL executives provided assurances that ample efforts were being made to integrate the acquired business, but then failed to follow through after closing.

Unlike in ev3, the parties' agreement in American Capital did not contain any relevant requirements on how the buyer was to operate the acquired business. Consequently, American's case was based in part on a claim that LPL had breached the implied covenant of good faith and fair dealing. Under Delaware law (and the law in many other jurisdictions), courts will read the implied covenant into every contract as a prohibition on the parties from engaging in arbitrary or unreasonable conduct that has the effect of preventing the other party from receiving the fruits of its bargain. The implied covenant serves a "gap-filling" function: it is not a license for a court to rewrite an express provision of the agreement; rather, it may apply where the parties' contract is incomplete and does not reflect their reasonable expectations at the time of contracting.

The Court of Chancery, in ruling on LPL's motion to dismiss, dismissed American's claim regarding LPL's pre-signing assurances that it would integrate the acquired business but allowed the claim for a breach of the implied covenant for shifting resources away from the acquired business to proceed. The key distinction the court identified was the parties' discussions leading up to the agreement and what those discussions revealed about the deal. With respect to integration, the court found that American Capital had clearly anticipated a need for LPL to make adjustments to its computer system, but had failed to bargain for a requirement to that effect in the agreement. In contrast, the court found that the earnout provision demonstrated that, had the parties contemplated that LPL might affirmatively act to gut the acquired company to minimize its earnout payments, the parties may have contracted to prevent LPL from diverting revenue and resources from the acquired company.

## Conclusion

The claims in ev3 and American Capital reflect classic scenarios in which the parties' intentions are disputed in the absence of more specific contractual language. In each case, the parties' pre-signing negotiations informed how a court viewed a buyer's post-closing obligations in operating the acquired business. And in each case, the results ran contrary to at least one party's expectations of what it had bargained for.

Dealmakers can reduce the risk of a future dispute by being mindful of some basic parameters regarding post-closing operations during the earnout period:

- For sellers, are there certain basic conditions or assumptions about the post-closing operation of the acquired business upon which the seller based it analysis of the earnout and the likelihood it would be paid? If so, the seller should memorialize these conditions or assumptions in its agreement, particularly if the parties specifically discussed them during the pre-signing negotiations.



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- For buyers, if they want the freedom to run the acquired business unfettered after closing, even if some operational decisions may put an earnout target at risk, they should memorialize this intention in the final agreement. If they don't, they risk a claim from the seller that the buyer's decisions deprived the seller of the benefit of its bargain.

- Both buyers and sellers would do well to consider the following points: (1) To what degree will the buyer operate the business consistent with seller's past practices? (2) To what extent will the seller be involved, or have information regarding, the post-closing operations? (3) What discretion will the buyer have to hire and fire employees? Are there certain key employees, or a certain number of employees, who the seller considers to be critical to achieving its earnout? (4) Should the buyer be free to make operational decisions even if those decisions jeopardize achieving the earnout targets, such as prioritizing other business units? (5) How will an acquisition or divestiture relating to the acquired business impact the earnout? (6) Will the buyer be required to keep separate financial records relating to the acquired business during the earnout period and, if so, will the seller have the right to review or audit these records?

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