Limited Application of Covenant of Good Faith and Fair Dealing in Earn-outs

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In M&A transactions, earn-outs are often used to bridge the gap between buyers and sellers in negotiating the value of the business of the target company, with a portion of the purchase price contingent upon the target's post-closing financial performance. Negotiating the terms of an earn-out can often prove difficult, as a seller will want protections to ensure a reasonable chance that the earn-out targets will be met, while a buyer will want maximum flexibility in operating the business of target post-closing.

Even with extensive negotiations, not every contingency can be planned for, and courts have often applied an implied covenant of good faith and fair dealing to the conduct of the buyer in operating the business of target post-closing when an earn-out is in place. This covenant requires a buyer to refrain from arbitrary or unreasonable conduct which has the effect of preventing a seller from achieving an earn-out. Courts have applied this covenant in various circumstances to protect sellers, such as restricting a buyer from intentionally diverting revenue from, or expenses to, the business of target post-closing, in an effort to avoid payment of an earn-out.

Recently, in *Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC*, the Delaware Supreme Court highlighted the limitations of the implied covenant. This case addressed claims from former stockholders of Cyveillance, Inc. related to an earn-out provision negotiated in connection with the sale of the company to Quintiq North America Operations LLC, based on the revenues of the target post-closing. Specifically, the plaintiffs alleged that the buyer had breached a provision in the merger agreement that prohibited buyer "from tak[ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment," and that even if buyer did not technically breach this provision, the implied covenant of good faith and fair dealing should impose additional restrictions on the conduct of buyer post-closing.

The Delaware Supreme Court reviewed the conduct of the buyer, and affirmed the findings of the Chancery Court that the buyer had not acted with the intent of reducing or limiting the earn-out in taking certain actions related to the business. The court went on to address plaintiff's claims that buyer breached the implied covenant by taking actions that buyer knew would reduce the likelihood that an earn-out would become due. The court disagreed with plaintiff's assertions, stating that the provisions of the merger agreement specifically addressed the requirement for an earn-out payment, and left the buyer free to conduct its business post-closing in any way it chose so long as it didn't act with the intent to reduce or limit the earn-out payment. The court noted that seller had attempted to negotiate a range of additional affirmative post-closing obligations, but buyer had rejected them all, and the court refused to add any additional implied covenants, stating that the agreements regarding the conduct of the buyer post-closing had been fully negotiated and set forth in the merger agreement. The court's ruling was consistent with the long standing notion that the implied covenant is only applied to serve a gap-filling function, where the parties did not anticipate some contingency. Furthermore, a party may only invoke the protections of the covenant when it is clear from the underlying

contract that the contracting parties would have agreed to proscribe the act later complained of had they thought to negotiate with respect to the matter.

Both buyers and sellers in M&A transactions should be aware of the limited scope of the implied covenant of good faith and fair dealing in the context of a fully negotiated earn-out, and act accordingly. Specifically, buyers would be well served to insist on language in the definitive transaction documents that impose very narrow restrictions on the conduct of the business of target post-closing, or that disclaim the application of the implied covenant all together. Sellers on the other hand should insist that the documents set forth specific covenants regarding the conduct of the business by buyer post-closing consistent with the assumptions used to arrive at the earn-out targets. These covenants may include, for example, minimum funding and/or staffing levels, operating the business consistent with past practice, or specific agreed upon capital investments. Additionally, sellers might insist that the earn-out be accelerated in full if the business is closed down or consolidated into another business unit, or if the buyer is subsequently acquired.

For more information on this topic, please contact David M. Czarnecki.

Check out our video on Earn-Outs above!