

■ Top Six Legal Issues in Earnout Lawsuits

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An “earnout” is an agreement between the buyer and seller of a business where a seller can obtain an additional payment if the business later achieves a financial performance target. The earnout is typically memorialized in a purchase agreement and is sometimes expressed as a contingent purchase price, meaning that the buyer must pay an additional purchase payment contingent on future performance of the business. Earnouts can be an effective way to bridge the gap between a buyer and seller at the deal stage, but these provisions frequently spawn lawsuits when the earnout payment is not made. As one court commented, an earnout reflects “a disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time . . . But since value is debatable and the causes of underperformance equally so, an earnout often converts today’s disagreement over price into tomorrow’s litigation over the outcome.” *Aveta, Inc. v. Bengoa*, 984 A 2d 126, 132 (Del. Ch. 2009). A review of the caselaw reveals recurring legal issues, and suggests that there is uncertainty in these cases, and no easy path to resolution.

Alternative dispute resolution versus court: Where should the parties litigate the issue? The first recurring issue in earnout litigation is choice of forum. Most earnout agreements have an alternative dispute resolution (“ADR”) provision (such as a referral of disputes to an arbitrator or independent accountant). Parties nevertheless often litigate whether particular issues must be

resolved in court. In many cases, parties are surprised to find that both courts and arbitrators weigh in even when the contract requires mandatory ADR for earnout disputes.

In a case where a disappointed seller who does not receive an earnout sues for claims arguably not covered by the ADR language, the parties can become embroiled in litigation to determine jurisdiction over the claim. For example, the plaintiff may claim that the dispute does not involve the earnout calculation itself, but instead whether the buyer acted in bad faith to artificially burden the acquired company (for example by loading the company with affiliate expenses in order to depress profitability, or delaying consummation of lucrative transactions until just after the expiration of the earnout period). As another example, a disappointed seller could allege the violation of duties outside the contract; for example, a fraudulent inducement claim based on representations that the buyer had the skill, expertise, and commitment to competently operate the acquired business – representations that were allegedly false when made and which prevented the business from reaching the earnout target.

Plaintiffs who want to avoid ADR can argue that the dispute does not implicate the power the contract gives to the arbitrator or accountant, or is beyond the expertise of the accountant and requires court evaluation. For example, one court permitted the parties to litigate, notwithstanding a mandatory ADR clause requiring referral to an independent accountant:

[I]t makes no sense to assume that accountants would be entrusted with evaluating disputes about the operation of the business in question. Yes, operational misconduct may well affect the level of earnings and therefore the schedules, but the misconduct itself would not be a breach of proper accounting standards. Nor would one expect accountants to have special competence in deciding whether business misconduct unrelated to accounting conventions was a breach of contract or any implied duty of fair dealing.

Fit Tech, Inc. v. Bally Total Fitness Holding Corp., 374 F.3d 1, 8 (1st Cir. 2004). Likewise, the court in *Hodges v. Medassets Net Revenue Systems, LLC*, 2008 WL 476140 (N.D. Ga. 2008) concluded that a mandatory ADR provision requiring an independent accountant “does not apply to the claim of contract and duty breach at issue here; rather, it only applies to disputes over objections to earn-out consideration calculations and not claims regarding Defendants’ software sales business conduct.”

This debate is driven in part by the contract language. For example, a contract that requires a neutral accountant to determine whether the earnout “calculation was prepared in accordance with GAAP” is very narrow (and therefore subject to an end-run to court) as distinguished from a contract that requires ADR for “any and all disputes relating to the earnout rights and obligations arising under, or relating to, this agreement, including disputes regarding whether the acquired business is operated in good faith during the earnout period.”

Given that public policy favors the enforcement of ADR provisions, courts usually resolve close calls by dismissing the case in favor of ADR. But, by that time, the parties have often already engaged in a substantial battle before ADR even begins. Besides deciding the merits of a case, courts sometimes get involved in collateral issues, such as actions to compel the buyer to provide access to financial records so that the seller can verify an earnout calculation and actions to resolve deadlock in the ADR process (such as a dispute over the procedure to select the neutral). Even after ADR, the losing party often appeals to a court where the parties debate how deferential the court must be to the ADR result.

Implied covenant of good faith and fair dealing: Even where the performance target is not achieved, did the buyer violate the implied covenant by preventing the achievement of the performance target? The covenant of good faith and fair dealing, which is implied in every contract, “precludes each party from engaging in conduct that will deprive the other party of the benefits of their agreement.” *Orange County Choppers, Inc. v. Olaes Enterprises, Inc.*, 497 F. Supp. 2d 541, 560 (S.D.N.Y. 2007). In earnout cases, sellers will argue that buyers may not undermine the attainment of a performance threshold and thereby deprive the seller of the “fruits of the bargain,” i.e., the earnout payment. Sellers also may go a step further and argue that the implied covenant obligates sellers take reasonable or even best efforts

to maximize their chances for attaining the earnout. See *Sonoran Scanners, Inc. v. Perkinelmer, Inc.*, 585 F.3d 535; 2009 U.S. App. LEXIS 23852 (1st Cir. 2009) (discussing this as an implied contract term).

How well such arguments fair is uncertain and the issue is typically based on factual disputes that preclude motions to dismiss or for summary judgment. For example, in *Hodges v. Medassets Net Revenue Systems, LLC*, 2008 WL 476140 (N.D. Ga. 2008), the seller argued that the buyer “failed in their implied duty of good faith and fair dealing to operate the company in a manner providing Plaintiffs a reasonable opportunity to maximize the earn-out provision by ‘sun-setting’ Plaintiffs’ former products in order to supplant them with Defendants’ comparable products, as well as converting Plaintiffs’ contracts and intellectual property to products not subject to the earn-out.” The buyer defended by saying that it “had no obligation under the [contract] to sell or distribute the products in a manner of the Plaintiffs’ choosing” and that it exercised legitimate business judgment in phasing out “inferior” products. The court denied the buyer’s motion for summary judgment, holding that the factual dispute had to be resolved by the jury at trial.

Buyers can be expected to defend against “implied covenant” attacks by emphasizing that the implied covenant is limited to a gap-filling mechanism, it cannot be used to contradict a contract—or even apply at all when “the subject at issue is expressly covered by the contract.” *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 146 (Del. Ch. 2009). For example, in *Rubin Squared v. Cambrex Corp.*, 2007 WL 2428485 (S.D.N.Y. 2007), the seller complained that the buyer took actions that impaired the earnout, including diversion of business and support “to another unit not covered by such profit-sharing obligations.” The court rejected plaintiff’s attempt, holding that “[n]one of these practices appear intended or likely to frustrate Plaintiff’s achievement of the earn-out, and indeed were foreseeable consequences of [the] acquisition by a larger corporation.” Likewise in *Hydra-Stop, Inc. v. Severn Trent Environmental Services, Inc.*, 2005 WL 2035584 (N.D. Ill. 2005), the seller argued that the buyer made post-close decisions regarding personnel that “hamstrung the company into earning profits below the thresholds required for him to garner additional payments under the earnout provisions.” The court rejected this claim: “Because Murphy cannot show that Environmental took any action not allowed under § 2.3 and because it is not possible to show Hydra-Stop would have achieved the profit thresholds but for Environmental’s decisions, Environmental is entitled to summary judgment.”

Condition precedent: Dressing up implied covenant theories under a different doctrine. Under basic contract law, a “condition precedent” signifies an event that must occur before contract performance is due. Earnouts are classic conditions precedent. An earnout is payable if—but only if—the plaintiff-seller can prove the occurrence of a condition precedent (the attainment

of the performance threshold). Parties often debate who bears the burden of proof under the condition precedent doctrine, with buyers arguing that the non-occurrence of a condition excuses contract performance. Sellers typically argue that they do not have the burden to prove the occurrence of the condition because the buyer has control over the business operations and the financial documents and data that show the results.

If it is determined that the condition precedent has not occurred, a second question arises regarding whether the buyer acted improperly to prevent or frustrate the occurrence. The arguments under this doctrine are virtually identical to the arguments under the implied covenant of good faith and fair dealing (discussed previously), and provide an avenue to air these issues even in those few jurisdictions that do not have an implied covenant doctrine, or which narrowly construe the implied covenant.

Even where there is arguably buyer interference, the buyer has a final rebuttal if it can prove that the condition would not have occurred even if the buyer had taken all necessary steps to make the occurrence of the condition a theoretical possibility. Restatement (Second) of Contracts § 245. As with implied covenant arguments, these arguments are intensely fact-bound determinations that are not susceptible to early motions practice.

Books and records: How much access or discovery does buyer have to provide? Sellers are often at the mercy of buyers in obtaining documents and financial data necessary to pressure-test the earnout calculation, and will have to use discovery tools, to the extent available, to compel production. Sellers' right to inspect the business records may be limited, particularly if the purchase agreement requires ADR for earnout disputes, such as an independent accountant proceeding and where full-blown discovery is not usually available. Sellers will need to be tenacious in pursuing financial data. Buyers certainly will possess the financial records and general ledger data that underlie an earnout calculation and will also have historical data based on the buyer's obligations to track the earnout value and make periodic adjustments to the value of the contingent earnout payment. See, e.g., Financial Accounting Standards 141. Buyers would argue that as with any discovery obligation, reasonableness and proportionality should predominate and that sellers should not be permitted to propound unduly burdensome discovery obligations as a tactic of extortion.

Business judgment versus canons of contract interpretation: Can the buyer defend by alleging that certain actions are within its business judgment? Lawyers will pour over the specific language of the earnout provisions and apply canons of contract interpretation that sometimes conflict. The fact finder may ultimately have to "harmonize" contract language that is inconsistent in order to effectuate the intent of the parties, to interpret the contract as a rational business instrument, and to avoid hyper-technical readings.

Parties often can rely on the absence of contract language to justify actions not prohibited by the contract. For example, in a case where a seller argues that the buyer took actions that impaired profitability and therefore failed to use best efforts to maximize the attainment of the earnout, the buyer can respond that its business operation and judgments are legitimate and that the challenged actions (such as firing a key employee or changing strategic direction) could have been addressed in the contract but that the seller failed to include such provisions.

This defense does not always work. For example, in *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188 (10th Cir. 2004), the court concluded that the buyer violated the "spirit" of the contract and earnout obligation by taking a series of actions that increased costs and delayed revenue. The buyer protested that such actions reflected its legitimate judgment and were not precluded by the contract itself. But the the court's evaluation of the language, logic, and structure of the contract led it to conclude that the parties "would" have prohibited the buyer's actions "had they actually thought about it" at the time of the contract drafting.

Battle of the experts: Whose expert is more credible? Earnout cases are almost always fought and won with experts, especially with regard to valuation and financial accounting issues. For example, a contractual requirement that the earnout calculation be performed in accordance with GAAP will lead to experts opining on what GAAP requires in a particular setting, a highly judgmental exercise that requires marshaling evidence and accounting guidance. Given that both parties tend to be experienced business people who are very familiar with the acquired business, there is a temptation to delay or avoid hiring experts. In cases where substantial earnouts are at stake, this impulse is "penny wise and pound foolish." Early involvement of experts will ensure that issues and potential lines of attack are spotted early, with time to develop the arguments and discover the support. Experts should be substantively qualified but also have prior testifying experience. Parties also should be prepared to use "Daubert" principles to ferret out unreliable approaches and methods used by proffered opposing experts. Having your own expert onboard early is indispensable to these efforts.

Conclusion ■ ■ ■

The issues in earnout litigation often cut both ways, with both sides able to advance fact-based arguments that preclude a fast resolution. Earnout litigation is not easily resolved and it can be very burdensome and require litigation all the way through an expensive trial. Quick victories are rare. The cases tend to be fact intensive, expert dependent, and tedious. Good experts, arbitrators, lawyers, and other consultants are expensive, and can cost more than the earnout at issue.

Given the foregoing, sophisticated parties with a thorough understanding of the business and reliable expectations for how the business is to perform may decide to avoid earnout agreements altogether, or attempt to anticipate possible scenarios with extremely detailed contractual provisions. When a dispute emerges, both sides should evaluate and discuss settlement options. However, when a potential earnout is significant, and the circumstances of a case justify it, parties are advised to fight the cases aggressively and tenaciously to win, including by retaining qualified experts and experienced counsel early, and by digging in for a long fight.

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