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M&A Update

Delaware Court Allows Claims for Breach of Implied Good Faith Covenant in Earn-Out Case

February 19, 2014

A recent Delaware Chancery Court opinion in *American Capital Acquisition Partners, LLC, et. al. v. LPL Holdings, Inc., et.al*. held that a seller's claim that its buyer diverted opportunities from the acquired business to a different subsidiary of the buyer, thereby denying the business the opportunity to meet post-closing earn-out payment thresholds, could survive the buyer's motion to dismiss. The case highlights the need for careful drafting of earn-out provisions in transaction agreements.

Background

Under the transaction agreements for American Capital Acquisition Partners' sale of its Concord Capital subsidiary to LPL Holdings, sellers and senior officers of Concord could receive additional earn-out consideration if Concord met certain gross revenue or margin targets post-closing. When Concord failed to meet the performance metrics, American Capital and three former Concord officers brought suit claiming, among other things, that LPL was required to improve its computer systems to make it possible for Concord to generate additional revenue and that LPL diverted revenue opportunities and resources to another subsidiary so Concord would not meet the earn-out targets.

Decision

The court dismissed the sellers' claim that the implied covenant of good faith and fair dealing imposed on buyer an obligation to enhance its own technology to allow Concord to expand its business. In dismissing the claim, the court focused on the fact that the stock purchase agreement did not include a provision requiring buyer to make the *anticipated* technical enhancements. The court, however, did allow sellers' claim for breach of the implied good faith obligation not to divert revenue and resources away from Concord finding that sellers would have insisted that protective provisions be included in the agreement had they anticipated that buyer would "gut" Concord.

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The court also dismissed the sellers' claims that they were fraudulently induced to enter into the SPA by buyer's pre-signing statements. The court dismissed these claims because the SPA contained a "non-reliance" clause, whereby each party expressly acknowledged it was not relying on any representations other than those contained in the SPA.

Takeaways

For buyers and sellers alike, the *American Capital* decision illustrates pitfalls and areas of focus for drafting and negotiating transaction agreements, including when an earn-out is part of the business agreement.

1. Particularly in the context of earn-outs, there is a heightened need for advisors to understand the business rationale for the earn-out and take care to incorporate into the agreement provisions that specifically address the business model for the earn-out. If seller anticipates the buyer will need to take additional measures to realize earn-out targets, the transaction agreement should expressly impose that obligation on buyer. A court will not read a "best efforts" provision into a contract when none exists.
2. Both sellers and buyers should negotiate specific provisions related to buyer's operation of the business post-closing.
    - Sellers should negotiate specific protections against the buyer's implementation of changes to the business that would negatively impact the earn-out payments, which could include restrictions on:
        - disposition of assets or changes in the nature of the business;
        - diversion of business opportunities to other areas of the buyer's business;
        - reduction of capital expenditures or other operating expenses;
        - allocation of overhead or other accounting changes; and
        - transfer, or reduction in compensation, of employees key to operation of the business.
    - Buyers should negotiate specific provisions allowing for flexibility to run the acquired business post-closing, particularly to ensure that buyer will be able to make any anticipated changes to the business to realize expected synergies or to otherwise expand or contract the business and resources devoted to it. The extent of these provisions will be affected by the length of the earn-out period.
3. As was the case in *Cooper Tire (see* Cadwalader M&A Update, Nov. 14, 2013), parties' efforts to seek relief based on strained interpretations of contract provisions often fail. The court

rejected sellers' argument that the buyers had an obligation to invest in technology enhancements based on an agreement provision requiring buyer to track revenues and expenses of Concord post-acquisition on the ground that such a housekeeping type of provision did not create an affirmative obligation for buyers to generate revenue. Courts have consistently refused to bail out parties regarding known risks or contingencies that they could have anticipated and addressed. Implied covenants are meant to serve a gap-filling function with respect to unanticipated facts or events only, and then only to determine how the parties would have addressed the situation had they anticipated it.

4. A transaction party, such as the buyer here, that wishes to eliminate claims that the other party was deceived into entering into a deal must negotiate for and include an express non-reliance provision in the transaction agreement as well as each ancillary agreement. A provision stating that the agreement reflects the entire agreement of the parties and that no representations have been made other than those that are set forth in the agreement (otherwise known as an "integration clause") will not suffice for these purposes.

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