

Mergers and Acquisitions Alert:

Lazard v. Qinetiq: Important Lessons for Structuring Earn-Outs

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Overview

A recent Delaware Supreme Court case authored by Chief Justice Strine upholds the literal meaning of an earn-out provision that limited the buyer from taking action “intended to reduce or limit an earn-out payment.” The court rejected the argument that buyer’s actions, which it likely knew would reduce the likelihood of an earn-out payment, met the intent-based standard the parties had agreed on in lieu of various affirmative post-closing covenants that had been rejected by the buyer. The court also rejected the seller’s argument that it could rely on the implied covenant of good faith and fair dealing to impose an objective standard and thereby avoid the burden to prove that the buyer intentionally violated such provision. The case has implications for buyers’ and seller’s negotiating strategies around post-closing operations covenants related to earn-outs and as to the impact of such covenants on the interpretation of the implied covenant of good faith and fair dealing. The case is *Lazard Technology Partners, LLC, v. Qinetiq North America Operations LLC*, April 23, 2015, Strine, L., 2015 WL 1880153, and it can be found at <http://business.cch.com/srd/LazardTechnology-v-Qinetiq.pdf>.

Background

The case arose out of an acquisition by Qinetiq North America Operations, LLC (“buyer”) of Cyveillance, Inc. (“seller”). Buyer had agreed to pay \$40 million up-front and, if certain revenue targets were achieved, additional amounts of up to \$40 million.

The earn-out provision in the merger agreement (Section 5.4) provided that buyer was prohibited from “tak[ing] any action to divert or defer [revenue] **with the intent of reducing or limiting the Earn-Out Payment.**” When the earn-out period ended, the revenues had not reached the level required to generate an earn-out.

Lazard sued as the seller’s stockholders’ representative, arguing that the buyer had breached Section 5.4 of the merger agreement and violated the implied covenant of good faith and fair dealing by failing to take certain actions (such as signing of a reseller agreement) that the seller contended would have resulted in an earn-out payment.

Court of Chancery

Vice Chancellor Laster framed the case as follows: “Given the language of 5.4, to succeed on its contract claim Lazard had to prove at trial that buyer had the intent to reduce or limit the earn-out payment. Absent this bad intent, actions that diverted or deferred opportunities would not violate Section 5.4.” The court ruled in the buyer’s favor, finding that, while buyer’s actions may have adversely impacted the earn-out prospects and arguably represented intentional foot-dragging by buyer, the court could not determine on these facts that buyer acted with an intent to reduce or limit the earn-out payments.

The Court of Chancery also ruled that the covenant of good faith was inapplicable because there was no “gap to be filled” in the merger agreement, and that, even if there had been, it would be filled with an implied term that also turned on the buyer’s intent, not with an implied term that turned on some objective standard. A key driver of that decision was that, in terms of the negotiating history, seller had attempted to negotiate for a range of additional buyer affirmative post-closing obligations (including to act in good faith to maintain existing or greater levels of business, to preserve relationships of customers and cause the surviving corporation to have adequate amounts of capital required to achieve the earn-out payments, make reasonable commercial efforts to recruit and employ sufficient employees to achieve the earn-out payments, market and bid for new contracts consistent with past practice and not divert any contracts or business opportunities from the surviving corporation to any other entity). The buyer rejected all of these proposed affirmative obligations, and the seller settled for including only the post-closing obligation that buyer could not take action with the intent of reducing or undermining the earn-out payment. The court also noted that there was no best-efforts covenant or other efforts-related agreement that is sometimes included in such provisions. The court ruled that that there was insufficient basis to find that buyer had taken specific actions with intent to reduce the earn-out payment.

Delaware Supreme Court

On appeal, the Delaware Supreme Court affirmed the lower court's decision "that the merger agreement meant what it said, which is that in order for the buyer to breach Section 5.4, it had to have acted with the "intent of reducing or limiting the Earn-out Payment" [and] that the seller had not proven that any business decision of the buyer was motivated [at least in part] by a desire to avoid an earn-out payment...It thus found that the merger agreement's express terms were supplemented by an implied covenant. But as to whether conduct not prohibited under the contract was precluded because it might result in a reduced or no earn-out payment, the Court of Chancery held that, consistent with the language of Section 5.4, the buyer had a duty to refrain from that conduct only if it was taken with the intent to reduce or avoid an earn-out altogether."

The Delaware Supreme Court also rejected the seller's argument that it could rely on the implied covenant of good faith and fair dealing to avoid the burden to prove that the buyer intentionally violated Section 5.4. "Section 5.4 specifically addressed the requirements 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 did not act with the intent to reduce or limit the earn-out payment. And as the Court of Chancery found, "[the seller] attempted to negotiate for a range of additional affirmative post-closing obligations, but [the buyer] rejected all of them.... Instead of the various affirmative obligations, the agreement provided only that [the buyer] could not take action with the intent of reducing or undermining the earn-out payment.... Therefore, the Court of Chancery correctly concluded that the implied covenant did not inhibit the buyer's conduct unless the buyer acted with the intent to deprive the seller of an earn-out payment."

The Delaware Supreme Court's holding (and cited comment that the [interpretation of the] implied covenant of good faith and fair dealing involves a "cautious enterprise"), suggests that a target's reliance on the implied covenant of good faith and fair dealing to save it from "losses at the negotiating table" is a tenuous strategy, made even more so where, given the negotiating history, the merger agreement is both clear on its face and at least arguably addresses the range of actions buyer may not take that may adversely impact the earn-out.

Implications and Practice Considerations

- Buyers are well advised to seek to disclaim any implied duty of good faith and fair dealing, since that could impose an objective standard that could have altered the outcome here, and to reject any affirmative post-closing operational covenants.
- Alternatively, buyers can adopt the approach here—using a post-closing operational covenant governed by a subjective intent standard without a disclaimer of the implied duty of good faith and fair dealing, in the hope that either (i) any such implied duty will be deemed inapplicable absent a subjective "bad intent", (ii) any such implied duty will be deemed superseded by the express covenant or (iii) the seller will be unable to prove that the buyer's actions were motivated at least in part by a desire to impair the earn-out.
- Sellers are well advised to seek an express good faith obligation to maximize the earn-out, but most buyers will reject such a request.
- Sellers should assume that inclusion of an intent standard in a post-closing affirmative operations covenant may be interpreted as imposing a similar intent standard on any restriction that the implied covenant of good faith and fair dealing may impose.
- Sellers should consider the risk that inclusion of any earn-out-related covenant may, in light of the negotiating history, preclude application of the covenant of good faith and fair dealing and an objective standard, given the "absence of gaps" to fill.
- But sellers should also not rely solely on the implied covenant of good faith to expand the buyer's earn-out obligations beyond those expressly set out in the merger agreement.

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