Earnout Contract Considerations After NC Good Faith Ruling

By **Benjamin Hicks** (November 6, 2023)

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As merger and acquisition professionals are well aware, earnouts are a basic structuring tool in the M&A toolbox that are commonly used to bridge valuation gaps and to allocate post-closing performance risk between buyers and sellers.

Because earnouts typically include financial triggers that are affected by post-closing operation of the business, both sellers and buyers are incentivized to clarify in the contract the standards that will apply to the buyer's operation of the business post-closing.

When post-closing disputes arise related to earnouts, the express contractual standards that are usually included in the purchase agreement take center stage.

In addition to these express standards, sellers in earnout disputes will often appeal to the implied covenant of good faith and fair dealing in arguing that the buyer breached an obligation to the seller in the post-closing operation of the business. This piece will refer to the "implied covenant of good faith and fair dealing" simply as the "implied covenant."

The North Carolina Supreme Court in the Sept. 1 Value Health Solutions Inc. v. Pharmaceutical Research Associates Inc. decision considered the question of whether and to what extent the implied covenant of good faith and fair dealing applied in an earnout dispute related to an M&A transaction governed by Delaware law.[1]

Before examining this decision, the article will start first with the North Carolina Superior Court's general summary of the implied covenant and its application to establish a background understanding of the implied covenant:

> Under North Carolina law, every enforceable contract contains an underlying, implied covenant of good faith and fair dealing. A claim for breach of this implied covenant arises when one party "wrongfully deprives" the other of some benefit "to which they were entitled," or takes some other action for a "wrongful or unconscionable purpose." In addition to its express terms, a contract contains all terms that are necessarily implied "to effect the intention of the parties" and which are not in conflict with the express terms. Among these implied terms is the basic principle of contract law that a party who enters into an enforceable contract is required to act in good faith and to make reasonable efforts to perform his obligations under the agreement. All parties to a contract must act upon principles of good faith and fair dealing to accomplish the purpose of an agreement, and therefore each has a duty to adhere to the presuppositions of the contract for meeting this purpose.[2]

Upon reading this summary from the court's 2020 decision in Klos Construction Inc. v. Premier Homes and Properties LLC, one might assume that the implied covenant should always apply to post-closing earnout disputes where a seller argues that a buyer has wrongfully deprived it of an earnout payment.

Value Health Solutions v. Pharmaceutical Research Associates

In Value Health Solutions, the court considered an earnout dispute related to an asset sale transaction in which the seller argued that the buyer violated the implied covenant and that as a result the seller was entitled to certain milestone-based earnout payments.

Certain of these milestones were based on the buyer's post-closing completion of integration and certain improvements to software acquired from the seller as part of the asset sale, while other milestones were based on revenue from sales of that software by the buyer.

Interestingly, the court was split as to whether the implied covenant applied to the facts in the case, with the majority opinion holding that the buyer was not subject to an obligation to comply with the implied covenant with respect to either set of milestones.

The case involved a situation in which the parties to the transaction agreed upon specific milestones in the purchase agreement, but later realized that "completing the milestones would be very difficult if not impossible."

It appears from the opinion that the original milestones were drafted based on the buyer's determination that certain technical deficiencies in the software needed to be addressed and that certain integrations for the software were required.

It further appears that the buyer determined post-closing that the integrations contemplated by the milestone "no longer made sense" and that the improvements to the software contemplated by the milestone were no longer required and thus were not pursued by the buyer. As a result, no milestone payments were paid.

The seller argued to the court that the buyer had violated the implied covenant of good faith and fair dealing when it (1) allocated inadequate resources to complete the milestones and (2) determined that certain milestones had not been completed.

Notably, the purchase agreement provided that the buyer was to "reasonably determine" whether a milestone had been achieved. The seller argued that the buyer failed to act reasonably, and violated the implied covenant, in making the determination that no milestone had been achieved.

The majority opinion determined that the implied covenant did not apply to the buyer because the purchase agreement sufficiently addressed the milestone conditions such that there was no contractual gap giving rise to the implied covenant.

In the majority's view, there was no inherent issue as a matter of law with the milestone concepts in the purchase agreement — the milestones established that certain requirements to trigger a milestone payment obligation were unambiguous.

In specifying how the milestones were to be completed and which party was responsible for determining their completion, the contract did not leave a gap that could be filled by the implied covenant.

While acknowledging that performance of the milestone conditions was difficult to impossible, the majority cited Delaware case law standing for the proposition that the court would not invoke the implied covenant to "rewrite a contract that a plaintiff now believes to have been a bad deal" and that the covenant should not be applied to give the plaintiff protections that "they failed to secure for themselves at the bargaining table."

In the majority's view, the purchase agreement adequately addressed the milestone process and issues that eventually emerged with the milestones could and should have been anticipated and addressed in the contract itself.

In the majority's words, "[the seller] complains that [the buyer] allocated inadequate resources towards completion of the milestones — [the seller] could have and should have anticipated the need for adequate resources and contracted for such allocations."

By contrast, the minority opinion argued that under Delaware law the implied covenant did apply to the buyer's post-closing conduct as relates to the earnout.

The minority cited Delaware case law in support of the proposition that if the terms of a contract provide a party with discretion in determining whether a condition is met, then the implied covenant necessarily applies and requires that party to use good faith in making that determination.

In the minority's view, when the purchase agreement left the determination of whether a milestone was satisfied up to the buyer, that subjected the buyer to an obligation to exercise its discretion in accordance with the implied covenant.

The minority argued that the court needed to determine "which party is responsible for these milestones not being met," rather than simply looking to whether the milestone was met.

The minority concluded that the seller party had sufficiently pled facts creating an issue as to whether the buyer had changed the requirements necessary to meet the milestones, which in its view did not meet the definition of reasonably determining the completion of the milestones in good faith.

Conclusion

The ruling in this case demonstrates the critical importance of paying careful attention to milestone concepts in M&A transactions that utilize milestone-based earnout concepts.

If, as seems to have been the case here, the milestone concepts turn out to be impractical or impossible to comply with as a result of a buyer's post-closing operation of a business, sellers should not expect to be able to rely on the implied covenant as a catch-all to prevent a buyer from benefiting from arguably inequitable application of those milestone concepts.

It merits emphasis that this case involved the North Carolina Supreme Court applying Delaware law, and thus its utility for precedential purposes may be limited to cases brought in North Carolina state court that involve application of the implied covenant in contracts governed by Delaware law.

Despite this limited precedential value, this case provides a cautionary tale to M&A practitioners of how courts may unpredictably apply the implied covenant and how individual judges may disagree on that application.

To address this uncertainty, practitioners should take care to carefully consider and draft earnout concepts that allocate post-closing responsibilities and performance metrics so as to avoid the need to seek application of the implied covenant.

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[1] Value Health Sols., Inc. v. Pharm. Rsch. Assocs., 891 S.E.2d 100

[2] Klos Constr., Inc. v. Premier Homes & Properties, LLC, 2020 WL 4197138, at *10 — 11 (N.C. Super. July 21, 2020)