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# ARBITRATION IN M&A TRANSACTIONS: LAWS OF NEW YORK AND DELAWARE Part II

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***Part I of this Article, published in the September 2016 issue of Dispute Resolution Journal, covered Pre-Contractual Considerations and Purchase Price Adjustments. Part III, to be published in the next issue, will cover Closing Conditions, Fraud and Extra-Contractual Rights, Remedies for Breach and the use of Emergency Arbitration Proceedings.***

## IV. BREACH OF REPRESENTATION AND WARRANTIES

The crux of any agreement to acquire a business or its assets is the representations and warranties made about the conduct of the business. The buyer relies on these representations to be assured of what it is buying. Typically there tends to be a long and fairly standard list of representations made in acquisition agreements. It would be well beyond the scope of this article to look at all or even most of them. Those that are most likely to give rise to disputes tend to be the following.

- The main equipment and physical assets of the business (as well as real estate and intellectual property).
- The list of material customer contracts and/or purchase orders.
- The level of inventory.
- The accuracy of the financial statements presented.

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- The absence of any material adverse change in the business since the most recent financial statements.
- The tax status of the business and its compliance with tax filing obligations.
- The status of employee agreements and benefit plans.

Indemnification claims often arise in the course of the post-closing integration of the businesses, once the buyer takes over and has full access to the books and records of the business.[107] The key sources of these claims tend to be:

- Incorrect target accounting methods, which are revealed when the buyer prepares its first audited financial statements including the target's financial results.
- Former target employees, who are now effectively employees of the buyer, disclose actions taken at the direction of the sellers prior to closing, sometimes in an effort to curry favor with the buyer and absolve themselves of responsibility for those actions.
- Incorrect positions taken in prior target tax returns are revealed when the buyer prepares its first consolidated tax returns including the target.
- Disgruntled former target employees terminated in connection with the transaction try to enhance their position in wrongful termination claims by notifying the buyer of issues with the way that the target's business was conducted by the sellers pre-closing.
- After closing, regulators notify the buyer of violations of law by the target, which include actions taken by the target pre-closing.
- After closing, customers, suppliers and other contract counterparties of the target assert pre-closing breaches of their contracts with the target.
- The sellers engaged in intentional misrepresentation of the target during the time leading up to closing of the acquisition, which comes to light once the buyer controls the target and has access to its books and records.

[107] Adapted from "The Indemnification Claims Process in M&A Transactions" by John J. McDonald & Matthew J. Aaronson (Troutman Sanders LLP, December 2015)("McDonald & Aaronson").

The strength of the buyer's claim depends first of all on proving the underlying facts and then matching its claim to the particular representations and warranties in the agreement. As most professionally drafted acquisition and merger agreements tend to include a fairly standard array of seller representations and warranties, this aspect of the claim process is generally not an impediment to asserting the claim.[108]

## Example of an Arbitral Award Dealing with Breach of Representation Claim - In the Matter of the Arbitration between Controlotron Corporation, Claimant, and Siemens Energy & Automation, Inc., Respondent[109]

One AAA arbitral award presented for enforcement in New York involved a claim by Siemens Energy & Automation, Inc. of breach of a material contract representation (among other claims). Seimens had entered into an asset purchase agreement to acquire the business and assets of a company called Controlotron. A portion of the purchase price was placed into escrow to cover indemnification claims. Seimens asserted a breach of the contractual warranty that each material contract of the Seller (defined to be over $25,000) is in full force and effect and that to the Seller's knowledge, "no other party to any material contract was in breach thereof or default thereunder … ." A schedule to the contract listed open purchase orders including one from an oil refining company and six from British Petroleum. As a factual matter, the Seller conceded at the arbitration that British Petroleum had cancelled its orders prior to closing. As to the contract with the oil refining company, the Seller claimed that since the arrangement between it and the refining company was actually a letter of intent and not a binding agreement, it was not a breach of the representation.

In the award, of course the arbitrator found for Seimens as claimant regarding the cancelled purchase orders, awarding it damages based on a methodology proposed by Siemens that it was due the revenues it would have received from the orders less an amount calculated to cover the variable costs of production it did not have to incur. The damages sought by Siemens were ordered to be covered from the amount held in escrow.

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[108] See McDonald & Aaronson for a detailed description of how the indemnification claims process works.

[109] AAA Case #13-489-Y-01500-08, filed for enforcement in Supreme Court, County of New York, Case 1:09 cv-03112-GBD, April 1, 2009.

## A. Sandbagging

When a buyer makes a claim that the buyer breached a representation or warranty, the seller often responds that the lawyer knew of the situation and chose to close anyway. Thus, many disputes arise in both the litigation and arbitration contexts over claims of "sandbagging", which is generally understood to mean when a buyer closes on a transaction in spite of knowing that one or more of the representations or warranties of the seller are not true and sues for breach of them later.

### *1. Origin and Meaning of Term "Sandbagging"*

The origin of the term "sandbagging" is somewhat obscure. According to the Online Etymology Dictionary, a sandbagger was used in 1882 to describe a "bully or ruffian who uses a sandbag to knock his intended victim unconscious."[110] Why they needed something as large as a sandbag to do that is unexplained. The term apparently came to be in fairly wide use in the poker context as early as 1940 to describe the situation where one player is initially dealt a strong hand but does not bet or raise early on so as to lure the other players into staying into the hand longer and having the pot grow.[111] The following is related in a very serious law review article on sandbagging.

> Rick Climan, [then] an M&A partner at [the now defunct] Dewey & LeBoeuf, relates the following history: While in college, he and other students held regular late-night poker games. The term "sandbagging" described a "check-raise" gambit – in which a player (usually with a strong hand) would check early in a round of betting in order to lure another into making the opening bet, and then proceed to raise that bet. Years later, Rick began using the term "sandbagging" in internal law firm training sessions to describe a buyer who, knowing of a material breach of a seller's warranty, would wait for the transaction to close before suing the seller. The terminology caught on with colleagues on the ABA Mergers and Acquisitions Committee before becoming a common term of art.[112]

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[110] http://dictionary.reference.com/browse/sandbag (visited July 2 2015).

[111] *Id*.

[112] Charles K. Whitehead, "Sandbagging: Default Rules and Acquisition Agreements", DELAWARE JOURNAL OF CORPORATE LAW, 1081 (2011), at ft. 4 ("Whitehead").

### 2. *Delaware Tolerance of Sandbagging*

The law of sandbagging, so to speak, differs somewhat between Delaware and New York. In Delaware, absent an express provision in an acquisition agreement denying a buyer the right to sandbag, there is generally no restriction on a buyer's bringing a claim based on breach of warranty. In one case, a Chancery Court judge noted that:

> [R]epresentations like the ones made in the [purchase agreement] serve an important risk allocation function. By obtaining the representations it did, [buyer] placed the risk that [target's] financial statements were false and that [target] was operating in an illegal manger on [seller]. Its need then, as a practical business matter, to independently verify those things was lessened because it had the assurance of legal recourse against [seller] in the event the representations turned out to be false.[113]

Thus, in Delaware, knowledge acquired by the buyer through its own due diligence has no bearing on its rights to rely on the seller's warranties.[114]

### 3. *New York Law on Sandbagging Not Straightforward*

In New York, the law is not nearly so straightforward.

*Pro-Sandbagging: CBS v Ziff-Davis*

*CBS, Inc. v. Ziff-Davis Publishing Co. et al.*[115] from 1990 is probably the leading case on sandbagging from the highest New York State court, the Court of Appeals. That dispute arose from an agreement by CBS to buy the Ziff Davis Publishing Company from its owner. The agreement was entered into in November 1984 for a purchase price of $362.5 million with closing to occur later. The purchase agreement contained the typical seller warranty that the audited financials had been prepared in accordance with GAAP and that they presented fairly the items set forth. The sellers further committed to provide a stub report for 1984. Seller also provided a representation that all representations and warranties would be true and correct at the time of

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[113] *Cobalt Operating, LLC v James Crystal Enters., LLC*, 2007 WL 2142926 at *28, *aff'd without opinion*, 945 A.2d 594 (Del. 2008), as quoted in Whitehead at ft. 17.

[114] Brian M. Gingold & Chris Babock, "Del. v N.Y. Law in Determining Liability under Acquisition Agreements", DELAWARE BUSINESS COURT INSIDER (June 11, 2014).

[115] 75 N.Y.2d 496, 533 N.E. 2d 449, 1990 N.Y. LEXIS 714 (NY 1990).

closing and that they would survive the closing "notwithstanding any investigation made by or on behalf of the other party".[116] The agreement also gave CBS access to the books and records for purposes of making an investigation.

In January 1985, the seller delivered the stub report for 1984. CBS also performed its own due diligence and came to the conclusion, stated in a letter dated January 31, 1985 that there were material misrepresentations in the financial statements provided. The seller rejected that contention, saying that all conditions to the closing were satisfied and that the financial statements were properly prepared and fairly presented the financial condition of the business. The seller warned CBS that if it didn't proceed to closing, it would exercise all legal remedies. CBS proposed a letter that the seller accepted to the effect that a clear dispute existed between that parties but that CBS's proceeding to closing would not constitute a waiver of any rights that it might have. The closing occurred and CBS proceeded to sue the seller for breach of the warranty as to the profitability of the magazines constituting the business.

The seller moved to dismiss CBS's case, claiming that CBS itself did not believe that the relevant reps and warranties were true when it closed and that CBS did not satisfy the relevant New York law which requires that reliance be proven in a breach of warranty action. The trial court and the Appellate Division accepted that argument and CBS appealed.

The Court of Appeals explained that the reliance that the seller was pleading was essentially that required for a tort actions based on fraud or misrepresentation – "a belief in the trust of the representations made in the express warranty and a change in position in reliance on that belief."[117] CBS maintained that the decisive question was whether it purchased the express warranties as bargained for contractual terms, essentially a breach of contract theory, not a tort claim. The Court of Appeals agreed with CBS.

> The critical question is not whether the buyer believed in the truth of the warranted information, but whether [it] believed [it] was purchasing the [seller's] promise [as to its truth] …Once the express warranty is shown to have been relied on as part of

[116] *Ziff-Davis* at 500.

[117] *Ziff-Davis* at 502.

> the contract, the right to be indemnified in damages for its breach does not depend on proof that the buyer thereafter believed that the assurances of fact made in the warranty would be fulfilled. The right to indemnification depends only on establishing that the warranty was breached.[118]

The Court of Appeals reversed the lower courts' decision and allowed CBS's claim to proceed. One could argue that this case is unique in that the seller in fact denied that the representations were false on the eve of closing and pressed CBS to proceed. The Court of Appeals noted that, ironically, if the seller's position were adopted, it would have succeeded in pressing CBS to close despite CBS's misgivings and at the same time "would have succeeded in *defeating* CBS's breach of warranties action because CBS harbored these *identical misgivings*."[119]

In a more recent case, though, the Supreme Court, New York County, considered a claim by a buyer that a seller's representation concerning a key customer was incorrect.[120] An affiliate of the buyer, Project Gamma Acquisition Corp., entered into an agreement with the seller on September 12, 2007 to acquire an automotive glass and services business from the seller for $500 million. Closing was scheduled for November 15th of that year. In the acquisition agreement the seller made representations about its 20 largest customers, which included one that accounted for $58.5 million in sales in 2006. In the disclosure schedule there was a note that that particular customer had been acquired by another entity in 2007. The key customer representation in the argument provided that since the date of the target's last balance sheet (July 2007), none of the customers had cancelled, terminated or otherwise materially altered its relationship with the seller's businesses. All reps and warranties were made as of the date of the agreement and had to be true as well on the closing date for the deal to close. On November 2nd, the key customer sent an e-mail to the target's sales management detailing the volumes it could commit to, which were significantly lower than the projections. The reduced purchases were justified by the key customer by a price that was 30% higher than competitors – "[I] know that the volumes are below your expectations,

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[118] *Ziff-Davis* at 503, citations omitted.

[119] *Ziff-Davis* at 506, emphasis in original.

[120] *Project Gamma Acquisition Corporation v PPG Industries*, 34 Misc.3d 771, 934 N.Y.S.2d 671, 2011 N.Y. Misc. LEXIS 5596, 2011 NY Slip Op. 21415 (NY C'nty 2011).

but if you cannot offer prices at the volumes above, then you must prepare yourself for a significant loss in volume."[121] According to the court, the seller communicated the threat of November 2nd to the buyer. Near the end of November, the target sent a spreadsheet to the buyer showing that the loss of the key customer business would result in a more than $25 million loss in volume.

The buyer sought to back out of the deal and sued for a declaratory judgment that it did not have to close, asserting that the seller had breached the warranty concerning key customers. The seller argued that the buyer should have inferred that a reduction in volume would flow from the merger of the key customer and counter-claimed for the breakup fee that had been provided for in the agreement if the buyer wrongfully refused to close. The seller argued that since the buyer knew of the customer problem it could not sue for breach of warranty. The court cited the language of previous cases to the effect that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue as long as it believed it was purchasing the seller's promise regarding the truth of the warranted facts and found that even if the buyers knew that lower sales from the key customer would flow from the merger, they did not assume that risk.[122] Instead, the buyers "purchased an enforceable contractual warranty that protected them against the risk of [key customer] expressing an intention or threat in writing to lower materially its purchases …"[123] The court granted the buyer's request for a declaration that the warranty had been breached and denied the seller's motion to recover the breakup fee. Thus, this case is an example of a New York court finding a breach of warranty even though the seller informed the buyer that the warranty would not be accurate on closing.

### 4. *Anti-Sandbagging: Galli v. Metz*

There are frequently cited New York cases that go the other way. In *Galli v. Metz*[124] the Second Circuit Court of Appeals considered a disputed business acquisition and a claim by the buyers that the sellers breached a representation that they had no knowledge of any claim that might adversely affect the conduct of the business or the

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[121] *Project Gamma*, 34 Misc.3d at 776.

[122] *Merrill Lynch*, 500 F.3d 171 at 186.

[123] *Project Gamma*, 34 Misc.3d at 779.

[124] 973 F.2d 145 (2nd Cir. 1992).

condition of its properties when in fact one of the sellers had known of hazardous waste contamination of two sites for some twelve years prior to the closing. The trial court found as a factual matter that the problem with one of the sites was disclosed to one of the buyers prior to closing. The buyer did not dispute that factual finding, but, relying on *Ziff Davis*, argued on appeal that his knowledge was irrelevant, since reliance is not an element of a contractual breach of warranty claim.[125] The Second Circuit agreed with the legal argument but did not find for the buyer and distinguished *Ziff Davis*. The court noted that in *Ziff Davis* there was a dispute at the time of closing as to the accuracy of particular warranties and asserted that the logic of *Ziff-Davis* was less compelling when the parties are in agreement that at closing certain warranties were not accurate. It held:

> Where a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach. In that situation, unless the buyer expressly preserves his rights under the warranties (as CBS did in *Ziff-Davis*), we think the buyer has waived the breach.[126]

However, in the particular circumstances of the *Galli* case, the Second Circuit did not immediately rule in favor of the sellers because it wasn't clear from the trial court's determination whether the buyer learned of hazardous waste problem from one of the sellers or whether it was "common knowledge". If, in fact, the buyer learned of the problem from a third party, then the Second Circuit was of the view that the buyer had "purchased the seller's warranty as insurance against future claims" and that under *Ziff-Davis* it would have a strong argument to recover damages from the sellers.[127] The Second Circuit in a later case confirmed the reasoning that learning about the problem from a third party (but not the seller) strengthens the buyer's breach of warranty claim.[128]

In the *Galli* case, the Second Circuit also considered another breach claim based on a warranty given by the sellers that they had not

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[125] *Galli* at 150.

[126] *Galli* at 151.

[127] *Id.*

[128] *Rogath v. Siebenmann*, 129 F.3d 261 (2nd Cir. 1997).

mortgaged, pledged or subjected any of their properties or assets to any lien or security interest. One of the purchased businesses had, however, granted a security interest in a certain stream of payments to a lender prior to closing. It was contended at trial that the sellers' lawyer disclosed this to the buyer's lawyer prior to closing. The trial court found this to be the case and on that basis found that the buyer had waived any claim of breach of representation it might have based on the security interest. The Second Circuit affirmed this aspect of the trial court decision, finding that *Ziff-Davis* does not eliminate the possibility of a buyer waiver.[129] Thus, at least in this respect, the *Galli* decision is a fairly straightforward statement under New York law that a buyer who closes in full knowledge of an inaccurate warranty where that information is supplied by the seller itself cannot later sue for breach of warranty.

### B. Effect of Buyer's Own Due Diligence

One interesting question is the legal effect of what a buyer's own due diligence uncovers. The state of the law in New York appears to be that it is only the seller's active disclosure of a fact contradicting a representation or warranty that allows the seller to avoid the breach of warranty claim. If the buyer's own due diligence uncovers the situation, the New York courts tend to see the buyer as then purchasing the seller's warranty. In one case from 1998 (*Coastal Power Int'l, Ltd. v Transcon Capital Corp.*), the Southern District considered claims of a breach of warranty relating to a seller's accounting policies.[130] The court reiterated that the "law is clear" that in order to conclude that a buyer waives its right to assert a claim for breach of warranty, the court must find that, prior to closing, the seller itself actively disclosed to buyer facts that would have constituted a breach of warranty under the terms of the agreement. As to information developed by the buyer:

> [A]ny information about [seller's] accounting policies that [buyers] may have gained either through their own efforts, 'common knowledge' or third party communications is wholly irrelevant.[131]

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[129] *Galli* at 152.

[130] *Coastal Power Int'l, Ltd. v Transcon Capital Corp.*, 10 F. Supp2d 563 (S.D.N.Y. 1998).

[131] *Coastal Power* at 577.

In a case from 2003, the Southern District heard a dispute arising from the sale of a business and the land on which it operated where the seller had removed an underground storage tank about two years prior to the sale.[132] The seller had represented in the purchase agreement that any underground storage tank removed from the location was removed in accordance with applicable environmental law. After closing, the buyer found a contaminant (petroleum) under the surface of the property and had to incur costs in remediating it. During excavation, it found that a pipe leading to the removed tank had not been capped as required by New York environmental regulations. It sued the seller for breach of warranty. The seller claimed that any contamination discovered during the later excavation of the site was known by the buyer to have existed prior to the closing. It was true that in connection with the purchase, the buyer had hired an environmental consultant to perform both Phase 1 and Phase 2 environmental studies on the site and that the studies did indicate lows level of contamination in the soil where the removed tank had been. The court stated that it was a complicated question as to whether the buyer's knowledge of low concentrations of contaminants foreclosed its breach of warranty claim but it found that since the environmental consultant whose pre-closing report showed the low concentrations of contamination had been hired by the buyer, "the Sellers cannot argue that they disclosed the contamination to [buyer], and they cannot argue that [buyer] waived any breach of warranty".[133] The court cited favorably the language quoted from *Coastal Power* to the effect that information developed by the buyer itself during diligence or learned from third parties does not prevent it from making a breach of warranty claim.

## C. Effect of "Common Knowledge"

*Gusmao v. GMT Group*[134] involved the sale of a money transmitting business which had significant operations in Brazil. In that case a federal district judge considered a claim by the seller to have the escrow holdback released and the opposition on the part of the buyer based on alleged breaches of warranty concerning the Brazilian business. The warranty in question was that each of the acquired businesses was in full compliance with various U.S. and foreign laws. As it turns out, the

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[132] *Paraco Gas Corporation v. AGA Gas, Inc.*, 253 F.Supp.2d 563 (S.D.N.Y. 2003).

[133] *Paraco* at 577.

[134] 2008 WL 2980039 (S.D.N.Y.)(not reported in F. Supp.2d).

Brazilian business was using black market exchange rates and was not fully licensed under Brazilian law. This was a common practice in Brazil and the seller argued that it informed the buyer in advance of closing that the business operated exclusively through an unlicensed correspondent in Brazil. Further, the member of the buyer's management team who conducted due diligence on the international side of the seller's operations admitted that he knew it. The Court's opinion *in Gusmao* contains a useful summary of the state of the law of sandbagging in New York.[135]

> Under New York law, a breach of warranty claim sounds 'essentially in contract.'[136] To prevail, a party must establish the existence of a contract containing a bargained-for express warranty with respect to a material fact, reliance on that warranty, a breach of that warranty, and damages suffered as a result of the breach.[137] Reliance is required but '[i]n contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue.'[138] What matters is that 'the express warranty was part of the bargained-for agreement.'[139] The 'critical question is not whether the buyer believes in the truth of the warranted information, as [the seller] would have it, but whether it believe it was purchasing the seller's promise as to the truth.'[140]
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> This particular conception of reliance mandates 'fine factual distinctions in [New York's] law of warranties: a court must evaluate both the extent and the source of the buyer's knowledge about the truth of what the seller is warranting.'[141] An injured party 'must show that it believed that it was purchasing seller's promise regarding the truth of the warranted facts'.[142] Therefore, where a buyer 'closes on a contract in the full knowledge and acceptance of facts disclosed by the seller

[135] 2008 WL 2980039 *4-*5.

[136] Citing *Ziff-Davis*.

[137] Citations omitted.

[138] Citing *Merrill Lynch*.

[139] Citations omitted.

[140] Citing *Ziff Davis*.

[141] Citation omitted.

[142] Citing *Merrill Lynch*.

> which would constitute a breach of warranty under the terms of the contact, the buyer should be foreclosed from later asserting the breach … unless the buyer expressly reserves his rights under the warranties.'[143] However, where 'the seller is not the source of the buyer's knowledge, e.g. if it is merely common knowledge that the facts warranted are false, or the buyer has been informed of the falsity of the facts by some third party, the buyer may prevail in his claim for breach of warranty.[144] In such a situation, it is not unrealistic to assume that the buyer purchased the seller's warranty as insurance against any future claims, and that is why he insisted on the inclusion of the warranties in the bill of sale. Therefore, what the buyer knew and … whether he got that knowledge from the seller are critical questions.'[145]

In the *Gusmao* case, the court considered the evidence of the buyer's knowledge and could not rule on a summary judgment motion that it was conclusive.

## D. Directness of Disclosures

In *Gusmao*, the day before signing of the purchase agreement the buyer called to the seller's attention that about 33% of volume had been lost in Brazil, mostly due to Western Union's being cheaper. An officer of the seller responded as follows:

> Lost volume in Brazil has to do with the exchange rate [where] only for the second time as far as I can remember the official has been higher than the black market …our losses [have] been a gain only by W. Union, as you probably know we and other money transmitters have lost agents to them, but as soon as the situation changes those agents will return to us.[146]

The court did not find this "somewhat opaque" response a clear disclosure that the Brazilian business was operating on the black market and found that the question needed to be decided at trial.

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[143] Citing *Galli* and *Merrill Lynch*.

[144] Citations omitted.

[145] Citing *Rogath v. Siebenmann*, 129 F.2d at 265.

[146] 2008 WL 2980039 *11.

Thus, if the source of the disclosure of unfavorable facts is the seller, New York courts tend to require that the seller's disclosure be direct and specific for the seller to avoid having breach of warranty claims succeed. The disclosure cannot be indirect or "opaque" or require the buyer to infer the unfavorable fact.

### E. Effect of the Buyer's Duty to Conduct Due Diligence

Another frequently cited case on the question of whether under New York law a buyer can enforce the representations and warranties it has bargained for in spite of being aware that they may not be true is *Merrill Lynch & Co., Inc. et al. v. Allegheny Energy, Inc.*, (*Merrill Lynch*)[147], a decision of the U.S. Second Circuit Court of Appeals from 2007 applying New York law. That case involved a claim by a purchaser of a business that financial reports provided by the seller were false and a defense by the seller that the purchaser knew the reports were inflated and chose to close on the sale anyhow.

As noted above, under New York law it is possible for an aggrieved party in the acquisition of a business to sue the Seller under both fraud and contract theories and that the analysis of the New York courts differs slightly depending on whether the claim sounds in fraud or contract. First, as to the contract theories, concerning the applicable legal standard under New York law relating to claims of buyer knowledge of the inaccuracy of warranties, the Second Circuit points out in *Merrill Lynch* that, in contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may "enforce an express warranty even if it had reason to know that the warranted facts were untrue."[148] The rule is subject to a condition, however, which is that the buyer must show that it believed it was purchasing seller's promise regarding the truth of the warranted facts. The Second Circuit goes on to state that:

> We have held that where the seller has disclosed at the outset facts that would constitute a breach of warranty, that is to say, the inaccuracy of certain warranties, and the buyer closes with *full knowledge and acceptance* of those inaccuracies, the

[147] 500 F.3d 171 (2d Cir. 2007).

[148] *Merrill Lynch* at 186, citing *Rogath v. Siebenmann,* 129 F.3d 261, 265 (2nd Cir. 1997).

> buyer cannot later be said to believe he was purchasing the seller's promise respecting the truth of the warranties.[149]

The Second Circuit remanded the case to the District Court and gave instructions to the Court that if it found as a factual matter that the seller "candidly disclosed" that the financials were inflated and therefore inaccurate, the purchaser could not prevail on a claim that the seller breached its warranty.[150] The key here appears to be how clear and explicit the seller's disclosure is.

Further, with respect to breach of contract claims, the Second Circuit opinion in the *Merrill Lynch* case contains a reference to an argument on the part of seller there that it should be relieved of its warranties since it did not deny access to financial books and records during the due diligence period. While the District Court accepted that argument, the Second Circuit did not, finding that granting access was not tantamount to finding that the seller met its contractual obligation to provide information, which was a "catch-all" warranty that the information it provided to buyer in the aggregate included all information known to the seller which, in its reasonable judgment, exercised in good faith, is appropriate for the buyer to evaluate the sold business's trading positions and trading operations.

As to the fraud prong of the analysis, in the M&A context, New York courts are generally skeptical of claims of reliance asserted by sophisticated business people engaged in major transactions who enjoy access to critical information but fail to take advantage of that access.[151] In the *Merrill Lynch* case, the trial court found that that the buyer could have discovered the truth that the Seller was attempting to hide if the buyer had conducted its due diligence more vigorously and therefore it did not satisfy the "justifiable reliance" test for making out a fraud claim.[152]

The Second Circuit in *Merrill Lynch* did not accept the approach adopted by the District Court to the effect that the buyer did not conduct its due diligence with enough vigor. Instead, on the fraud theory as well, it remanded the case to the District Court for further review,

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[149] *Merrill Lynch* at 186 (emphasis added).

[150] *Merrill Lynch* at 186.

[151] *Merrill Lynch* at 181, citing *Grumman Allied Indus., Inc. v Rohr Indust., Inc.*, 748 F.2d 729 (2d Cir. 1984).

[152] *Id.*

stating that the warranties contained in the Parties' agreement imposed a duty on the seller to provide "accurate and adequate facts", which entitled the buyer to rely on them without further investigation.[153] The Second Circuit further cited one of the leading early cases in this area, *Metropolitan Coal Co. v. Howard*,[154] where Judge Learned Hand held that a warranty "is intended precisely to relieve the promissee of any duty to ascertain the fact for himself."[155] There is also a second prong to the test of reliance, namely whether the misrepresentations relate to a matters peculiarly within the other party's knowledge. If so, the wronged party may rely on them without further investigation.[156]

That being said, in spite of its discussion of the ability of aggrieved buyers to rely on the seller's warranties without further investigation, the Second Circuit in *Merrill Lynch* stated that the buyer cannot satisfy its burden of reliance in a fraud claim if it relies on representations it knew were false.[157] As a result, the Second Circuit ordered that on remand the buyer must offer proof that it was "not so utterly unreasonable, foolish, or knowingly blind as to compel the conclusions that whatever injury it suffered was its own responsibility".[158]

### F. Summary of the Law of Sandbagging in New York

An outsider observer could be forgiven for thinking that the law in New York on sandbagging claims is all over the lot. What sense are we to make of the *Merrill Lynch* decision and the other case law with its fine distinctions and apparently contradictory outcomes? One can draw a few relatively firm conclusions, though. The extent to which a buyer can sue on a contract theory for breach of a representation or a warranty concerning a fact or circumstance the buyer knows is untrue depends first of all on how the buyer got the knowledge. If it comes from anyone other than the seller or as a result of buyer's own due diligence, the buyer can still sue for breach of warranty. If it comes from the seller, the explicitness of the disclosure is important. If the disclosure is oblique or not obvious, then buyer can nonetheless

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[153] *Id.*

[154] 155 F.2d 780, 784 (2nd Cir. 1946).

[155] *Merrill Lynch* at 181.

[156] *Id.*, citing *Mallis v. Bankers Trust Co.,* 615 F.2d 68, 80-81 (2nd Cir. 1980).

[157] *Id.* at 182, citing *Banque Franco–Hellenique de Commerce v. Christophides,* 106 F.3d 22, 27 (2nd Cir. 1997).

[158] *Id*.

enforce its warranty under New York law. However, there are cases where if the seller tells the buyer directly and explicitly that a warranty is not true and the seller nonetheless closes, the court will most likely not allow a suit on a breach of contract theory. On a tort-based fraud theory, the buyer cannot prove a fraudulent inducement claim if it relies on representations it knows are false.

In the end, it is interesting to consider the Second Circuit's language in the *Merrill Lynch*, which seems to bring the analysis somehow beyond mere knowledge, when it ordered that on remand the buyer had to provide proof that it was not so inept or blind so as to be held responsible for its own loss. In more prosaic terms, if you are about to close on a purchase and the seller tells you something bad about the business that would make closing really dumb, the courts are not going to bail you out. Otherwise, you are most likely ok to sue after closing.

## V. EARNOUTS

There are many reasons business people desire to employ a mechanism to tie a part of the purchase price paid for the business to the post-transaction performance of the business. When a portion of the purchase price is deferred in this way and only released when the acquired business achieves certain defined performance thresholds (over agreed periods of time), this is known as an "earnout."

### A. Reasons for Earnouts

Usually the main reason to employ such a technique is that the buyer is skeptical of the seller's optimistic projections about how the business will perform or grow post-closing. An earnout is in essence the buyer's way of saying that the seller has to put its money where its mouth is. There are also potential benefits in terms of facilitating the buyer's financing of the transaction. The buyer may not be able to finance the entire purchase price and can defer payment over time. Indeed, it is possible to imagine that the buyer may be able to pay for all or part of the acquisition with the future profits of the acquired business.[159] Finally, earnouts can be a useful technique when acquiring a start-up enterprise or a business without a long track record – one that has promise that needs to be proven out over time.

[159] See "Earnouts in M&A Transactions: Key Structures and Recent Developments" P. Crimmins, B. Gray, and J. Waller. Mayer Brown. June 22, 2011.

### B. Susceptibility of Earnouts to Disputes

While earnouts thus are often very attractive to business people responsible for justifying the cost of an acquisition, they are very tricky to draft and implement. The parameters against which the performance of the business post-closing is to be measured need to be very carefully and precisely defined so that each party's expectations are met. Some of these metrics are widely understood especially when they are generally accepted accounting concepts but even some commonly used financial terms, such as EBITDA do not have a universal meaning and are subject to varying interpretations. Perhaps more importantly, there is also a human element that is difficult to define concretely in words and difficult to measure, namely what level of efforts will be required of seller's former management that stays on with the new owner – or what level of support or investment the new owner must apply to the acquired business to make it perform well. As a result, earnouts are frequently subject to dispute afterwards, so much so that earnouts have been described as "a dispute postponed", prompting one Delaware Chancery judge to observe that an earnout "often converts today's disagreement over price into tomorrow's litigation over outcome."[160] Another commentator has noted that "because of the challenges in negotiating and drafting earnout provisions that encompass all possible variables and earnouts' inherent vulnerability to manipulation by the buyer or the seller, the calculation and payout of earnouts commonly result in post-acquisition disputes."[161]

### C. Most Commonly Disputed Issues

The most commonly disputed issues related to earnouts fall into either the category of performance metrics or legal questions. On the performance metrics, the participation of accounting and other experts usually is crucial. In this regard, all of the considerations that were discussed in the section above of Post-Closing Adjustments come into play. How is the expert or experts to be chosen? Will they be acting only as experts or will they in fact be arbitrators? Will their decision stand or will it be subject to challenge under the criteria discussed above (palpable error, bad faith, failure to follow accepted procedures)?

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[160] Vice Chancellor Laster in the *Airborne Health* decision.

[161] "Earnout: Short-Term Fix or Long-Term Problem?" J. Mordaunt, K. Pierce. Fall 2011. http://www.srr.com/article/earnout-short-term-fix-or-long-term-problem.

Will each side have its own expert and leave it to the finder of fact as to which one to follow?

As to legal issues, a key consideration is whether the agreement requires the buyer to exercise some defined level of efforts to promote the acquired business If it does, as is sometimes the case, the issue becomes whether the buyer exercised the right level of efforts. If there is no explicit level of efforts defined, the issue becomes whether the agreement contains an implied covenant of good faith or implied levels of efforts that must be exercised. When the performance target is not achieved, did the buyer violate an implied covenant of good faith and fair dealing by not supporting or even preventing the achievement of the performance target (so as not to be obligated to pay the extra consideration)?[162] A related issue is the level of access that buyers have to provide to sellers post-closing so that the sellers can prove or disprove claims relating to the performance targets. Another legal issue is whether the business judgment rule applies. Can the buyer defend against claims by a seller that the decisions it made with respect to running the business post-closing were within its business judgment and thus not subject to challenge or second-guessing?

## D. Earnout Case Law

The leading case in New York law on the level of efforts that need be applied by an acquirer of a business where the consideration for the sale of the business includes payments based on performance after closing is *Bloor v. Falstaff Brewing Corp*., first an opinion by Judge Brieant of the Southern District in 1978 and then a decision of the Second Circuit in 1979 affirming Judge Brieant's findings.[163] This dispute arose over the purchase by Falstaff Brewing Corporation in 1972 of all of the assets (other than the brewery itself) of the P. Ballantine & Sons, a longstanding brewer of beer based in Newark, New Jersey. The price for the assets was $4 million plus a royalty of fifty cents on each barrel of the Ballantine brands sold in the six years following the sale of the assets. The buyer covenanted to "use its best efforts to promote and maintain a high volume of sales" based on the

[162] See "Top Six Legal Issues in Earnout Lawsuits" R. Miller. Venable. 2013. https://www.venable.com/files/Publication/1f65b164-4d03-458e-b42d-7cc5a779dfcc/Preview/PublicationAttachment/8fb640d8-610d-4574-9210-81216921d3be/Top_Six_Legal_Issues_in_Earnout_Lawsuits.pdf.

[163] 454 F. Supp. 258 (S.D.N.Y. 1978) and 601 F.2d 609 (2nd Cir. 1979).

rights acquired. The royalty clause also had a liquidated damages provision where if Falstaff "substantially discontinued" the distribution of beer under the brand name Ballantine, it would pay the seller a sum equal to the years remaining in the royalty period times $1.1 million.

Of importance to the dispute that arose over the level of efforts applied by Falstaff post-acquisition was the fact that three years prior to the sale a substantial investment in Ballantine had been made by a financial investor. That investor noticeably increased advertising spending, up to $1 million in 1971. This and other promotional activities had increased Ballantine's sales but the brewer was still not turning a profit, thus leading to the acquisition by Falstaff in 1972.[164] After acquisition, Falstaff moved brewing from Newark to a facility it owned in Rhode Island but continued the $1 million/year advertising budget and the distribution system used by Ballantine, which consisted of using its own warehouses and trucks to sell to smaller, individual customers in addition to selling to independent distributors. Nonetheless, sales declined and Falstaff claimed to have incurred significant losses between 1972 and 1975 on Ballantine products, even if its own products were holding their own. In 1975, a businessman with extensive experience in the brewing industry named Paul Klaminovitz took over Falstaff and immediately started to cut costs, including by reducing the annual advertising budget for Ballantine products down to $115,000 and discontinuing Ballantine's distribution practices such that two distributors servicing substantially fewer accounts took over. Sales of Ballantine products declined precipitously. While sales of Falstaff products also declined somewhat due to competition from national brands, Falstaff's financial situation improved noticeably. The new owner articulated a financial strategy of emphasizing profits over volume.

The trustee for Ballantine sued Falstaff alleging that it was not living up to its best efforts obligation "to promote and maintain a high volume of sales" and demanded payment of the liquidated damages for the unpaid per barrel royalties. Judge Brieant of the Southern District stated that the term "best efforts" takes it meaning from the surrounding circumstances and the obligor's own abilities. In this case, the "best efforts" commitment required Falstaff to merchandise the Ballantine

[164] On a personal note, I remember these events well. I grew up nearby and my father was employed by the Ballantine Brewing Company at the time as an accountant. He was then retained by the liquidating trustee to wind up the business that Falstaff did not acquire. The closing of the brewery in Newark was very traumatic as it had been part of the community for many years.

product "in good faith and to the extent of its own total capabilities."[165] He held in favor of Ballantine, finding that a number of Falstaff's actions or failures to act resulted in the decline of Ballantine sales, in particular the change in distribution method and its decision to make the distributor for the New York metropolitan area market, which had been Ballantine's strongest, one that was the owner of a competing brand. Mr. Kalmanovitz's philosophy of beer sales, articulated as – "We sell beer F.O.B the brewery. You come and get it." – did not jibe with the contractual obligation to promote Ballantine's products.

An interesting legal question highlighted by this case was whether a contracting party who had undertaken a best efforts obligation would have to endanger the financial health of its own business in order to fulfill it. Falstaff argued that Judge Brieant was indifferent to the distressed financial situation of Falstaff when the new owner acquired it in 1975 and that it was contrary to New York law to require a party to continue to use lawful methods to sell a product no matter what losses they would cause. Judge Brieant had found that even if Falstaff's financial situation was worse than it actually was in 1975 and even if that situation had continued, New York law was such that "where impossibility or difficulty or performance is occasioned only by financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy, performance of a contract is not excused."[166] The Second Circuit did not object to this finding, but emphasized the similarity of the Ballantine/Falstaff situation to the facts underlying another Court of Appeals decision where a contracting party agreed to sell all the bread crumbs it produced at a certain factory to a purchaser.[167] Either party could cancel the contract on six months notice. The bread crumbs operation was one of several lines of business the seller had. During the contract term, the seller ceased producing bread crumbs because it became uneconomic. The purchaser sued. The relevant law was a provision of the New York Uniform Commercial Code applicable to output and requirements contracts that impose (unless otherwise agreed) an obligation by the seller to use best efforts to supply the goods and by

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[165] 454 F.Supp. at 267.

[166] 454 F.Supp. at 267 n. 7, citing *407 E. 61st St. Garage, Inc. v Savoy Corp.*, 23 N.Y.2d 275, 281, 296 N.Y.S.2d 338, 334,, 244 N.E.2d 37, 41 (1968).

[167] *Feld v. Henry S. Levy & Sons, Inc.*, 37 N.Y.2 466, 373 N.Y.S.2d 102, 335 N.E.2dd 320 (1975).

the buyer to use best efforts to promote their sale.[168] In that case, the New York Court of Appeals held that, absent a cancellation within the required time frame, the seller was expected to continue to perform in good faith and could cease production of the bread crumbs, which was a single facet of its operations, only in good faith. Obviously, the court held, a bankruptcy "or genuine imperiling of the very existence of its entire business" caused by the production of the bread crumbs "would warrant cessation of production of that item," but the yield of less profit from the sale than expected would not.[169] Important to the Court of Appeals' reasoning was that bread crumbs were only part of the seller's enterprise and since there was a contractual right of cancellation, good faith required production until cancellation, even if there was no profit. The Court found that in these circumstances, the seller would be justified in good faith in ceasing production of the item prior to cancellation only if its losses from continuing were "more than trivial", a question of fact.[170]

Applying this precedent to the Ballantine case, Falstaff argued that it was not bound to do anything to market Ballantine products that would cause "more than trivial" losses. The Second Circuit did not believe that in finding for Ballantine Judge Brieant had proceeded on the basis that the best efforts clause required Falstaff to bankrupt itself in promoting Ballantine products or even to sell those products at a substantial loss, but that Falstaff's attitude towards distribution was not conducive to fulfilling its best efforts obligation and that once the prospect of Falstaff's bankruptcy had been adverted, Falstaff was required to explore steps not involving substantial losses that would have lessened the decline of Ballantine sales. The Second Circuit agreed that the best efforts clause did not require Falstaff to spend itself into bankruptcy to promote the sales of Ballantine products, but it did prevent the application of Falstaff's philosophy of emphasizing profits above all without fair consideration of the effect on Ballantine volume. Ballantine was not required to show what steps Falstaff could reasonably have taken to maintain a high volume for Ballantine products, just that Falstaff didn't care about Ballantine's volume. The burden was on Falstaff to show that there was nothing significant it

[168] N.Y. UCC § 2-306 (2).
[169] 37 N.Y.2d at 471-472.
[170] *Id*.

could have done to promote Ballantine sales that "would not have been financially disastrous."[171]

The contract between Ballantine and Falstaff had an explicit best efforts clause. The opinion of the Second Circuit is also significant in that it took the position that even without the best efforts clause, Falstaff would have been bound to make a good faith effort to see that substantial sales of Ballantine products were made, especially since the royalty per barrel of sales was an essential part of the purchase price.[172]

*Bloor v. Falstaff Brewing Corp.* is a significant case for disputes over earnouts under New York law because the situation is analogous to many situations where the acquired business becomes part of a larger one and the dispute becomes to what extent the acquirer has to promote the acquired business subject to an earnout in the larger context of its overall operations. Group-wide business decisions that would be perfectly rational in a normal context are seen by the courts in a different light if a part of that business is subject to an earnout. Even if there is not an explicit efforts clause, there is an implicit obligation of the buyer at the least not to undermine the acquired business and most likely to take measures to help promote it so as to fulfill the earnout obligations.

Another reason why lawyers still look to *Bloor v. Falstaff Brewing Corp.* is its implications as to what the "best efforts" obligation means under New York law. Based on the reasoning of Judge Brieant and then of the Second Circuit, a "best efforts" obligation under New York law clearly means something more than an obligation to use "reasonable commercial efforts" or something similar, even if both make reference to the surrounding circumstances and what other similarly situated parties would do. Best efforts were held to mean that Falstaff had to act "to the extent of its total capabilities." Subsequent New York cases in other contexts have suggested, however, that a best efforts standard is not as stringent as *Bloor v. Falstaff* implies, making reference to good faith obligations in light of the circumstances,[173] such that the analysis remains very fact specific.[174]

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[171] 601 F.2d at 615.

[172] 601 F.2d at 614.

[173] See e.g. *Cruz v. FXDirectDealer LLC*, 720 F.3d 115 (2d Cir. 2013).

[174] See *Harbinger F&G v. OM Group (UK) Ltd.*, No. 12 Civ. 05315, 2015 U.S. Dist. LEXIS 33689 (S.D.N.Y. Mar. 18, 2015).

For a case where the court did not find that a buyer breached its earnout obligations, a federal district court in Massachusetts applying New York law addressed the question of whether the buyer breached an implied covenant of good faith in the way it ran the business post-closing. [175] In that case, the sellers sold their business for a specified sum plus the possibility of additional earnout payment over five years, and when the acquired business did not meet the maximum earnout targets, sellers alleged buyer breached the implied covenant by rebranding the product, removing and marginalizing key talent from the business and refusing to use its sales force to promote the product.

Applying New York law, the court held that "the merit of [seller's] claim depends on whether [buyer] intentionally or recklessly caused the acquired business to lose money." The court found that the buyer's actions were legitimate business decisions, and that plaintiff's allegations amounted to nothing more than "disputes concerning strategy…" As a result, the court held that there was no dispute of material fact as to whether defendant buyer breached the implied covenant of good faith, and granted buyer's motion for summary judgment.

Courts applying Delaware law have found that there is an implied duty of good faith on the part of the buyer to promote the business. In *O'Tool v. Genmar Holdings, Inc.*, the 10th Circuit, applying Delaware law, upheld a jury verdict in favor of sellers of a boat manufacturing business.[176] The opinion was significant in that it was not based on a breach of express provisions in the purchase agreement, but on the implied duty of good faith and fair dealing. The court found that the implied covenant of good faith and fair dealing inheres in every contract. The implied covenant protects the spirit of an agreement when, without violating the express terms of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain. The implied covenant, however, cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract.

The court reasoned that despite the lack of express provisions restricting the buyer's actions, the obvious spirit of the contract was to give the sellers "a fair opportunity to operate the [acquired business]

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[175] *Fireman v. News America Marketing In-Store, Inc.,* U.S. District Court 2009 U.S. Dist LEXIS 91236 (D. Mass. 2009).

[176] 387 F.3d 1188 (10th Cir. 2004).

in such a fashion as to maximize the earn-out." A significant factor in this decision was the fact that the court strongly suggested the buyer had an ulterior motive and his strategy was not to grow the business but to eliminate a competitor and gain a production facility for its other brands.

Another case where the Delaware Chancery Court found that the implied covenant of good faith and fair dealing was breached in an earnout situation was *American Capital Acquisition Partners, LLC v. LPL Holdings, Inc.*[177] That case involved an acquisition of a company that provided technology to trust departments of financial institutions. The acquirer provided a proprietary platform of technology and investment advisory services to some 12,000 financial advisors, both independent and at financial institutions. The parties expected great synergies after the acquisition, in particular after applying the buyer's technological solutions to the Seller's custody-based services. The revenue from the growth of the custody business after acquisition as a result of the synergies was projected to be $1 million in 2011, $4.3 million in 2012, $9.3 million in 2013, $14.8 million in 2014 and $20.4 million in 2015. The Stock Purchase Agreement had a significant contingent payment component based on the "gross margin" of the combined business. Three key employees also were retained with significant incentive payments in their employment agreements based on revenue targets.

The sellers and key employees in their complaint asserted that the buyer's technology had limitations of which the management of the buyer was aware and that the buyer did not disclose that the buyer's computer systems could not easily be adapted for the integration of the two businesses and the growth of the custody business. In any case, the sellers alleged that the buyer was unwilling to attempt to make the necessary changes to its system, in no small part because it wanted to avoid having to make the earnout payments. The sellers further alleged that the buyer began to "pivot" sales from the combined business to another subsidiary of the buyer, also with the motivation of avoiding the earnout payment. The sellers' complaint included both breach of contract claims (relating to the alleged misrepresentation of the technology) and a claim that the buyer breached the implied covenant of good faith and fair dealing. In addition to making the expected argument that the buyer's shifting of

[177] 2014 Del. Ch. LEXIS 12; 2014 WL 354496 (Del. Ch. 2014).

customers to its affiliate was a breach of the implied covenant of good faith and fair dealing, the sellers went so far as to argue that the implied covenant of good faith and fair dealing imposed upon the buyer an affirmative obligation to make the technological adaptations necessary for the acquired company to provide custody services to the pre-acquisition customers.

Vice-Chancellor Glasscock considered the sellers' claims in ruling on the buyer's motion to dismiss them. He was not persuaded by the argument that the implied covenant of good faith and fair dealing imposed an affirmative obligation to make the system changes. He noted the Delaware law that the implied covenant has a gap-filling function by creating obligations only where the parties to the contract did not anticipate some contingency and "had they thought of it, the parties would have agreed at the time of contracting to create that obligation."[178] He also noted that the parties did not put in the agreement any best efforts or other provision requiring the buyer to make the adaptations. He agreed with the buyer that the sellers could not in their lawsuit write into the agreement an additional term for which they did not bargain and so dismissed that part of the claim.

However, he was receptive to a claim that the implied covenant was breached with regard to the alleged shifting of business to buyer's affiliate. Reading the contingent purchase price provision of the SPA and the compensation targets in the employment agreements together, he found that "had the parties contemplated that the [buyer] might affirmatively act to gut [the acquired company] to minimize the payments under the SPA and the employment agreements, the parties would have contracted to prevent [buyer] from shirting revenue from [the acquired company] to [the affiliate]." In this way, and by allowing the sellers to proceed with this claim, he affirmed the odd and somewhat counter-intuitive state of the Delaware law that the implied covenant will apply to situations where the parties theoretically would have provided for the obligation in the agreement had they thought of it during contracting.

In addition to the implied covenant of good faith, is there an implied obligation on the part of the buyer to use reasonable efforts? Delaware courts have suggested there is no such implied obligation. One example of this is the decision in *Lazard Technology Partners v. QinetiQ North*

[178] Citing *Winshall v Viacom Int'l, Inc.*, 55 A.3d 629, 637 (Del Ch. 2011).

*America Operations LLC*, a bench ruling from the Court of Chancery that was affirmed by the Delaware Supreme Court.[179] The Supreme Court agreed with the Chancery Court's conclusion that the implied covenant did not require the buyer to affirmative take actions that would have resulted in sufficient revenue to meet earnout targets. The First Circuit Court of Appeals appears to be the only circuit to hold that there is in fact an implied obligation to use reasonable efforts to develop and promote the subject of the sale.[180]

The more recent decisions of the Delaware Chancery Court tend to focus on interpreting and enforcing the express terms of agreements delineating the level of efforts to be applied in achieving earnout targets rather than allowing implied covenant claims In *Fortis Advisors v. Dialog Semiconductor PLC*,[181] the merger agreement required that the buyer use "commercially reasonable best efforts" in successfully managing the acquired business to achieve the earnout targets and make the earnout payments in full. In a dispute arising from the lack of earnout payments, the sellers asserted breach of contract but also pleaded the implied covenant of good faith and fair dealing as an alternative theory. [182] The Chancery Court acknowledged that under Delaware law the implied covenant of good faith and fair dealing requires each contracting party to refrain from arbitrary or unreasonable conduct in an effort to prevent the other party from receiving the fruits of the bargain, especially when an agreement lacks specific provisions. Since the merger agreement in question had a contractually defined level of efforts the buyer had to employ, as well as several specific obligations and prohibitions on buyer's operation of the business during the earnout period, the court rejected the use of the implied covenant as an alternative theory.

In *Haney v. Blackhawk Network Holdings*,[183] the acquisition agreement provided that key personnel were required to "dedicate a commercially reasonable" amount of time and resources to the generation of net revenues for the acquired business so as to reach the

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[179] 114 A.3rd 193 (Del. 2015).

[180] See "Earnouts in M&A Transactions: Key Structures and Recent Developments" P. Crimmins, B. Gray, and J. Waller. Mayer Brown. June 22, 2011.

[181] No. 9522-CB (Del. Ch. Jan. 30, 2015).

[182] Summary of the case provided in Lisa A. Fontenot, "Lessons from Delaware on Good Faith, Fair Dealing in Earnouts", Law 360 (Aug. 18, 2016).

[183] 2016 WL 769595 (Del. Ch. Feb. 26, 2016).

earnout targets. The selling shareholders sued asserting that the buyer deliberately prevented the business from achieving the earnout by failing to devote the required resources to the business. They advanced an implied covenant claim on the theory that the contractual obligation to dedicate a commercially reasonable amount of time was not a specific enough standard. The Chancery Court did not agree, saying that the implied covenant "only applies where a contract lacks specific language governing an issue and the obligation the court is asked to imply advances, and does not contradict, the purposes reflected in the express language of the contract."[184]

## Example of an Arbitral Award in an Earnout Dispute – Daum Global Holdings Corp. (Claimant) and Ybrant Media Acquisition Inc., Ybrant Digital Limited and LGS Global Limited (Respondents) ICC Case No. 18445/CYK[185]

This award, which was delivered in September 2014 by an ICC tribunal sitting in Singapore applying New York law, addresses many of the issues and claims arising in earnout disputes, including that the seller's management manipulated the business during the pre-closing period and afterwards to artificially inflate EBITDA of the acquired business and thus increase the earnout payment. Daum Global Holdings Corp. as Seller, a South Korean company, owned Lycos, the well-known search engine and web portal. Ybrant Media Acquisition Inc. was a Delaware acquisition vehicle owned by Ybrant Digital Limited, an Indian company. Daum as Seller and Ybrant as Buyer entered into a Stock Purchase Agreement on August 15, 2010 for the sale of all of the capital stock in Lycos. The acquisition closed on December 15, 2010. Ybrant Digital delivered a guarantee of the Ybrant Media Acquisition's obligations.

The Buyer paid $20 million (minus a closing balance sheet adjustment amount) on closing. The overall purchase price for the acquisition was defined to be an earnout payment equal to be six times EBTIDA for the fiscal year ending December 31, 2010, which ended only two weeks after the closing, less the $20 million paid on closing

[184] *Id*., at *8.

[185] U.S. enforcement action reported at *Daum Global Holdings Corp. v. Ybrant Digital Ltd.*, 2015 U.S. Dist. Lexis 136835, 2015 WL 5853783 (Oct. 6, 2015, S.D.N.Y). Award is Document 46-1 in Case 1:13-cv-03135-AJN, filed June 25, 2015.

and other deductions related to senior employees' bonuses and employer paid payroll taxes. EDITDA was defined in the usual way - earnings before interest, taxes, depreciation and amortization - to be calculated consistent with the past practices of Lycos, as were laid out in an exhibit to the SPA.[186] Interestingly, given the point made above with respect to purchase price adjustments that EBITDA is not a defined accounting term under U.S. GAAP and that the parties should take care in drafting in how it might be calculated, the exhibit made several references as to how specific items in Lycos' financial statements should be treated in calculating EBITDA.[187] The exhibit also made reference to an Operating Plan for Lycos that had been agreed between Buyer and Seller. The target earnout amount was $6 million[188], such that the parties' expectation was that the Seller would be entitled to approximately $16 million in additional consideration after the earnout payments were calculated and made. On closing, the Seller delivered 56% of the shares of Lycos to Buyer and, as security, delivered certificates representing 44% of the Lycos shares to an escrow agent to be held in escrow to satisfy indemnity claims.[189]

The SPA laid out a detailed procedure for calculating the earnout payment.[190] After the end of 2010, the Buyer was obligated to hire KPMG to audit Lycos' 2010 financial statements with a target completion date of March 31, 2011 (latest May 30, 2011). Within fifteen days after the completion of the audit, the Buyer had to deliver an earnout notice using the amount of EBITDA in those audited financial statements. If the Seller agreed or did not dispute within fifteen days, Buyer was obligated to make the earnout payment within a further fifteen days. If the Seller wished to dispute the amount of the earnout payment in the notice, it had 30 days to do so. However, in this case, the Buyer nonetheless had to pay any undisputed portion within fifteen days of its receipt of Seller's dispute notice. If the parties could not agree on the disputed portion, that would be referred

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[186] SPA §1, Award ¶86.

[187] For instance, accelerated recognition of certain deferred licensing revenues and an expected litigation settlement were to be included, while non-cash, stock-based compensation to executives, amounts payable under change of control agreements before Dec. 31, 2010 and certain other items were not. Exhibit B SPA, ¶87 Award.

[188] SPA §2.3(i)(iii), Award ¶85.

[189] SPA, §2.1, Award ¶85.

[190] SPA, §2.3, Award ¶85.

to an independent accounting firm acting as an expert, with its decision to be final and binding on the parties.

The Buyer paid the sum of $20 million on closing as provided and had KPMG carry out the audit of Lycos' financial statements. On August 15, 2011, it delivered the earnout notice required which stated that Lycos' EBITDA for 2010 was $6.2 million, such that the total purchase price was six times that, or $37.2 million. After deduction of the $20 million already paid on closing, the earnout payment was stated to be $17.194, after taking into account some expenses.[191]

The Seller disputed the Buyer's earnout calculation, asserting that Lycos' EBITDA for 2010 was in fact $9.175 million, such that the earnout payment amount should be much larger, almost twice the amount proposed by the Buyer. Following the terms of the SPA, the Seller demanded payment of the $17.194 as the undisputed portion, however.[192] The Buyer did not make payment as demanded and on September 14, 2011, the Seller made demand under the guarantee delivered by Ybrant Digital. That payment was not made either.[193]

According to court records in Andhra Pradesh in Hyderabad India, Ybrant Digital merged into another entity, LGS Global, following a shareholder vote on December 24, 2011. The Seller asserted that it learned that just after the KPMG audit Lycos lent $1 million to an Ybrant affiliate in India and soon thereafter learned that Lycos transferred $7 million in cash to Ybrant in India. It proceeded to obtain an injunction in New York in November 2011 to restrain Ybrant from further diminishing Lycos' assets.[194] It filed its request for arbitration with the ICC on January 3, 2012.

The Buyer's main argument, after disputing some aspects of KPMG's audit report, was that the management of Seller manipulated for short-term profitability the management of one of Lycos' major contracts, a two-year agreement dated May 1, 2010 with Yellow Book USA for web traffic management, which caused a deterioration in the

[191] Award ¶80.

[192] Award ¶81.

[193] Award ¶82.

[194] Award ¶84. The SPA's arbitration clause provided that "the parties hereto hereby submit to the exclusive jurisdiction of the New York Courts for the purpose of an order to compel arbitration, for preliminary relief in aid of arbitration or for a preliminary injunction to maintain the status quo or prevent irreparable harm prior to the appointment of the arbitrators…."

service provided and formed the basis for Yellow Book's not renewing the contract. They submitted that Lycos adopted a fundamental change of business plan that produced short-term cost savings at the expense of long-term damage to Lycos. The Buyer also emphasized the typical covenants in an acquisition agreement that require the Seller to conduct the business until closing in the ordinary course and consistent with past practice, claiming that the increased profitability of the Yellow Book contract was achieved by the CEO's giving employees incentives to drive up the value of EBITDA in order to maximize the sales price for the Seller.[195] The Buyer claimed that in fact no value was created by the Yellow Book contract. As a result, any earnings during the 2010 fiscal year from the Yellow Book contract should be removed from the EBITDA calculation, such that the correct earnout payment amount was zero.

In its award, the tribunal focused on a provision of the operating plan for the period of 2010 remaining after the SPA was signed which stated that "[i]n accordance with the parties' agreement and intention, Lycos will exert its commercially reasonable efforts to maximize EBITA for this year and thus the Plan is geared toward such a goal."[196] There was also a specific provision relating to the Yellow Book contract, which stated that it "will be managed pursuant to a separate sub-operating plan in order to monitor and optimize the margin in connection with Yellowbook."[197] Finally, there was a general statement that the operating plan was a "guideline and handbook" for the CEO of Lycos, who was being retained and that "any reasonable deviation or modification" will be permissible if the CEO "believes such deviation is in the best interest of the shareholders and the public."[198]

In interpreting the SPA, the tribunal did not find that the Seller breached the provision of the Operating Plan to the effect that Lycos was bound to exert its commercially reasonable efforts to maximize EBITDA. On the contrary, they found that this term *required* EBITDA to be maximized and that there was no term of the SPA that would have required EBITDA to be maximized without any reduction in expenses.[199] On the crucial question of what level of efforts must be

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[195] Award, ¶131.

[196] Exhibit F SPA, ¶88 Award.

[197] *Id*.

[198] *Id*.

[199] Award, ¶135. Emphasis in original.

exercised in earnout situations, in effect they didn't accept the thrust of Buyer's argument that the management of Lycos tried too hard to maximize EBITDA. Further, they accepted the explanations of Lycos' CEO as to the source of the increase in EBITDA related to the Yellow Book contract.

> The Yellowbook contract created an enormous value to Lycos with $1 million in monthly revenues for the full 24 months, yielding $24 million to Lycos (and ultimately to [Buyer])….The Yellowbook contract was a 'web-based arbitrage' or 'search arbitrage' in which Lycos acquired a certain monthly quantity of web-traffic from third parties for a fee and then delivered it to Yellowbook for a fee equal to some $1 million per month …Around September 2010 Lycos found less costly sources of web-traffic and accordingly between September and December of 2010 the expenses of fulfilling the Yellowbook contract were lower than projection in the Operating Plant.

The tribunal also noted than a significant portion of the increase in EBITDA occurred after the Buyer obtained control of Lycos in October 2010. Of importance to the tribunal was that after closing the CEO of Lycos reported directly to the management of the Buyer and produced a weekly EBITDA report. According to the testimony of Lycos' CEO at the arbitration hearings, the Buyer was unconcerned about the upward trend in EBITDA after the Closing and that, on the contrary, was keen to show better results to investors in a potential IPO of the Buyer in India.[200] The tribunal found that the evidence of Buyer's representatives tended to confirm these observations.

In finding for the Seller, the tribunal stated that it was "unable to accept that no value was created by the Yellowbook contract."[201] It also found as a factual matter that there was no deterioration in the quality of the service provided by Lycos and thus no causal link between the quality of service provided by Lycos and the termination of the Yellow Book contract.[202]

In terms of the mechanics of how acquisition agreements work, the tribunal noted that the Buyer's claims that the business was not managed in the ordinary course after signing and closing were breaches

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[200] Award, ¶102.

[201] Award, ¶160.

[202] Award, ¶163.

of covenants that should have been raised by the Buyer under the indemnification provisions of the SPA within the time periods provided, something they did not do; instead, these claims were raised after a dispute over the proper amount of the earnout payment arose, a process subject to the specific earnout provisions of the agreement. As a result, the Buyer had no basis at all to claim that it was not liable to Seller at least for the $17.2 million earnout payment that the Buyer itself submitted in its first earnout statement before the Seller disputed the amount. In terms of the dispute of the earnout amount itself, the tribunal accepted the Seller's claim for the earnout amount with some minor adjustments based on an expert report presented at trial, finding that the Buyer was liable to pay some $33.5 million in additional earnout consideration.

The tribunal ordered that the Buyer to pay that sum (plus pre-judgment interest) within fifteen days after the delivery of the award, failing which the Seller would be entitled to claim that amount from the guarantor to be paid by the guarantor within 20 days of demand. If neither the Buyer nor the guarantor paid by October 9, 2014, the tribunal ordered that the Seller would be entitled to have the 44% of the Seller's shares held back in escrow released to it and authorized the escrow agent to disburse the escrowed shares accordingly.[203] The escrow agent complied with the order, but since the value of the escrowed shares (estimated $6.4 million) was less than the amount of the award, the Seller sought to enforce the award in the Southern District, specifically asking that the guarantor and various affiliates turn over their stock certificates in a variety of wholly-owned subsidiaries (including Lycos itself) to satisfy the award. The guarantor resisted this enforcement proceeding, claiming that the terms of the Award were such that the release of the escrowed shares was the Seller's sole remedy and that in the case of any ambiguity under the award, the matter should be returned to the arbitral tribunal for clarification. The Seller argued that remedies were cumulative under the SPA and that the Seller was entitled to judgment for difference in value between the escrowed shares and the total amount of the award. Judge Nathan of the Southern District did not find that the language of the award was ambiguous, noting that nowhere does the award indicate that taking possession of the escrowed shares is in lieu of full payment. Since the Buyer failed to make the payments

[203] Award, *Dispositif*, ¶213.

required by the award, the Seller was entitled to retain possession of the escrowed shares and execute on the remaining value of the judgment. She granted Seller's request for the turnover order.[204]

### E. Damages in Earnout Disputes

In earnouts, damages can be hard to prove. In *LaPoint v. AmerisourceBergen Corp.*,[205] the Delaware Chancery Court held that the buyer breached a covenant requiring it to exclusively and actively promote the acquired business's products, but it did not find that seller satisfied its burden in proving damages, awarding only nominal damages on that count. If the parties wish to avoid this type of outcome, they can specify remedies for breaches of the agreement (e.g. liquidated damages). It is difficult to prove, however, that specific benchmarks would have been achieved but for breaches by buyer. In a case from 2011, *Airborne Health, Inc. v. Squid Soap LP,*[206] the Delaware Chancery Court followed the theory surrounding the implied covenant of good faith but reached a result favoring the buyer on the particular facts there. In addition to an earnout provision, the buyer had agreed to return the sold assets if certain business targets, such as advertising spending and sales were not achieved. When buyer suffered from crippling litigation and negative publicity, the earnout targets were not achieved.

Although there was no express breach of contract, the court agreed with the seller's assertion that the buyer could not arbitrarily or in bad faith refuse to expend resources, and thereby deprive seller of the earnout. The court recognized, however, that the buyer had "suffered a corporate crisis" and "was undoubtedly restrained by the legal and financial burdens of the settlement and systemic market damage". As a result, the buyer's motion for summary judgment to dismiss the seller's claim was granted, essentially on the theory that the earnout targets would never have been achieved anyhow owing to unrelated adverse events negatively affecting the business.

This is essentially what the arbitrator found in the arbitral award described below – even though the buyer breached all of its obligations

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[204] *Daum Global Holdings Corp. v Ybrant Digital Ltd.*, 2015 U.S. Dist. Lexis 136835, 2015 WL 5853783 (Oct. 6, 2015, S.D.N.Y).

[205] 2007 Del. Ch. LEXIS 131 (Del. Ch. 2007).

[206] 984 A.2d 126 (Del. Ch. 2009).

to the seller regarding the earnout, no damages were awarded because economic circumstances facing the business at the time were such that the earnout targets could not have been achieved in any case.

### Example of an Arbitral Award in an Earnout Dispute - John Purtell, as Stockholder Representative on behalf of Stockholders of Vocada, Inc. and Nuance Communications, Inc.

One arbitral award presented for enforcement in New York highlights many of the difficulties and issues related to earnout provisions and the extent to which they can be enforced by the sellers who stand to benefit from the incentive payments.[207] The AAA award was delivered in October 2012 by a panel of three arbitrators. The dispute was between the selling shareholders of a Texas-based company called Vocada, Inc. that had developed a software product known as Veriphy which was designed to facilitate the communication of clinical medical test results to referring physicians, and Nuance, Inc., as buyer, a publicly traded computer software company based in Burlington, Massachusetts that had significant sales from a voice-recognition software used by doctors dictating notes. The buyer's product was called PowerScribe. The target's product, Veriphy, allowed verbal and numerical "critical test results" to be sent using speech recognition, which would then be delivered to referring physicians' pagers, smart phones and other real time devices. The target started its sales in 2004 and steadily grew its business, reaching $2 million in sales in 2006 and was projecting $4 million in 2007.[208]

Since the target's product apparently worked well together with the buyer's product, the parties made an agreement to integrate their products near the end of 2006, thus creating "a simplified user interface for radiologists and pathologists to communicate critical patient findings and report test results", and undertook a joint marketing effort.[209] The joint marketing effort was unsuccessful, but the buyer nonetheless determined it would like to acquire the target. The parties were quite optimistic about the results that could be achieved for the target's product given that the buyer had an installed base of 1000

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[207] AAA Case No. 13 117 Y 03005 10. See *Nuance Communs., Inc. v Purtell*, U.S,Dist.LEXIS 123943 (S.D.N.Y. Aug. 28, 2013).

[208] Award, p. 11.

[209] *Id.*

PowerScribe customers.[210] One of the target's selling shareholders constructed a financial model based on the number of sales representatives the buyer had, the number of products they could each sell and the selling price to come up with projected annual revenues of $32 million from sales of Veriphy by December 2009.

The parties negotiated a letter of intent that included an earnout element. The purchase price agreed upon for the seller's business was $42 million but half of that would be subject to an earnout. There were three tranches of additional consideration on top of the $21 million base amount based on sales of the seller's product post closing.[211]

| | |
|---|---|
| $8-12 million in sales | $7 million additional consideration |
| $18-22 million in sales | $7 million additional consideration |
| $22-$32 million in sales | $7 million additional consideration |

The parties entered into a merger agreement in October 2007 and the merger closed in early November 2007. The purchase price reflected the earnout structure from the letter of intent. There were also certain other key terms of the merger agreement related to the earnout. The sellers wanted to make sure that the buyer's sales team would actually make a serious effort to promote the target's product, so the parties negotiated language which obligated the buyer "to set specific sales targets for Verify-related products within its healthcare sales force in an effort to achieve the milestones specified …, subject to reasonable business judgment."[212] The sellers had tried to add language to the merger agreement that would have required the buyer to "maximize" sellers' earnout payments, but the buyer refused that language.[213] The sellers also tried to put specific obligations regarding the target's products in the agreement, such as requiring the hiring of additional sales and implementation personnel for the target's product and pursuit of the buyer's PowerScribe client base, but the buyer also resisted that language. As a result, the parties decided to enter into a "side letter" regarding the "guiding principles" and "spirit" of how the buyer would run the business post-closing.[214]

[210] Award at p. 12.

[211] Award at p. 13.

[212] Award at p. 6.

[213] *Id.*

[214] *Id.* at 15.

It is worth considering the terms of this somewhat unusual and purportedly non-binding side letter in some detail, particularly as it weighed heavily in the arbitrators' award. The letter began with a statement that although the buyer would not be able contractually to "restrict the company's ability to react to changing market dynamics and act in the shareholders' best interests", the buyer was willing to outline its "current intentions regarding the operation of the [sellers'] business". Accordingly, the letter set out a "number of principles" regarding the buyer's "current intent in running the [sellers'] business following the closing of the transaction". The principles are quoted in full as follows:[215]

- [Buyer] intends to fully pursue the Veriphy business and considers the achievement of the earnout targets very important to the realization of the benefits of the transaction for [Sellers].
- [Buyer's] annual operation plan ….will include targets for Veriphy revenue.
- [Buyer] will create and deploy sales training tools and share successful sales practices to facilitate widespread understanding of the Veriphy products by the [Buyer] salesforce.
- The [Buyer] salesforce will receive full credit for all revenue attributable to the sales of Veriphy products when determining compensation.
- The Veriphy products will be managed similarly to other core [Buyer] products, with management reviews, marketing attention, and product and feature evolution appropriate to the market conditions.

After the elaboration of the principles, there follows a statement on the legal nature of the letter – that the principles reflect the buyer's current intention regarding the operation of the target's business following the closing. However there is a strong statement that notwithstanding the buyer's current intention, "in no event are these principles binding contractual commitments of [buyer]" and that "[buyer] must retain all operational flexibility to respond to changing market dynamics and act in the best interests of its shareholders." The letter ends with what seems like an innocuous enough closing.

[215] *Id.* at p.2.

> We look forward to completing this transaction, welcoming the [sellers'] team to [buyer] and significantly exceeding the earnout performance targets.

According to the arbitrators' findings of fact, the buyer would have needed $45 million in sales of the Veriphy product during the first earnout period to trigger the maximum earnout payment under the Merger Agreement. For the first full year after the merger (2008), the buyer's sales managers, apparently unaware of the buyer's obligation to meet the earnout targets, set a sales target of $15 million.[216] They simply used the same projected sales number that had been used in 2007 when the buyer was a reseller of the target's software. As it turned out, sales of the Veriphy product were $9.4 million in 2008 in spite of what the arbitrators found was a considerable effort made by buyer to promote the product. It was also noted that the some of the sellers participated in the setting of the post-closing sales quotas and even expressed some concern themselves that they were too high.

Also, literally the day after the agreement closed, the buyer informed the sellers that it was not going to hire a new western regional sales manager to promote the Veriphy product until the revenue model proved out a little more and the Buyer further refused to hire additional sales personnel. It should be noted that these decisions were being made about the same time the U.S. economy starting going into recession and the arbitrators found that reluctance on the part of customers to spend had a significant impact on the weak sales figures.

After a couple of more years of disappointing sales, the sellers brought a series of claims against the buyer, the first being a fraudulent inducement claim under a Texas statute relating to the terms of the side letter, and the others being breach of contract and breach of the duty of good faith in performing contracts, both under New York law, which had governed the parties' agreement.

Concerning the fraudulent inducement claim, the arbitrators considered whether the elements of the Texas statute were met, the most important of which were that the buyer made a false representation of a past or existing fact, that buyer made the representation for purpose of inducing the sellers to enter into the Merger Agreement, that the sellers relied on the representation and reliance on the misrepresentation caused

[216] *Id.* at p. 17.

the damage complained of.[217] The argument naturally was raised that the side letter was not part of the Merger Agreement, that by its own terms it explicitly stated that it was non-binding, and that the Merger Agreement had a typical integration clause saying that it was the entire agreement between the parties.

The arbitrators found that under Texas law, an integration clause does not totally preclude a claim for fraudulent inducement under the right circumstances, so they actually considered the principles set out in the side letter (quoted above). Nor were they troubled by the terms of the side letter that it was non-binding. They responded to the buyer's arguments in this manner.

> [Buyer] invites the Panel to conflate "non-binding" with "meaningless", and that we cannot do. It is true that the side letter was not binding and therefore could not serve as the basis for a breach of contract action. But it is not without meaning, and the [target's] board had a right to rely on it as a representation of what [buyer] at that time intended to do …."[218]

In its conclusions of law, the Panel found that when the main negotiator for the buyer made the statements of principle in the side letter, he lacked a reasonable basis for stating that the buyer intended to fully pursue the Veriphy business and pay the buyer's sales force on revenue relating to the Veriphy business (and not on booked sales of the buyer's sales force for its pre-merger products was paid). The Panel found that these statements were not true when made and that post closing the buyer refused to hire sales representatives, an account management team and implementation engineers. It also found that the buyer did not intend to fulfill the contractual promise to set sales targets at levels to enable the sellers to achieve the earnout thresholds, at the time the contractual promise was made. Finally the Panel found that the last sentence of the said letter (quoted above) to the effect that "[w]e look forward to … significantly exceeding the earnout performance targets" was intended to assure the Seller that a full earnout of the performance targets was a realistic expectation.[219]

In short, the Panel found in favor of the sellers on the fraudulent inducement claim. However, the sellers were not entitled to any

[217] *Id.* at p. 26, citing Tex. Bus & Com. Code §27.01(a)(1).

[218] *Id.* at p. 4.

[219] *Id.* at p. 27.

damages as a result, basically because even if the buyer had complied with its representations regarding its current intentions, and its contractual promise to include revenue goals "it is reasonably certain that Veriphy would, nonetheless, not have achieved any of the three earnout thresholds identified in the Merger Agreement".[220] As a result, the panel concluded that sellers were "not entitled to any portion of the $21 million Earnout Consideration on account of its statutory fraud claim."[221]

On the breach of contract claim, the Panel similarly found that the buyer failed to set specific sales targets for the Veriphy product and thus had breached the provision of the Merger Agreement (§8.4) where it expressly agreed, subject to reasonable business judgment, that it would set specific sales targets for Veriphy-related products within its healthcare sales force in an effort to achieve the earnout thresholds.[222] However, the Panel found that the breach was not material because, "the preponderance of the evidence showed that even if Nuance had set higher sales targets, the earnout thresholds still would not have been achieved." As a result, the sellers were not entitled to any damages, "as there is no proof that setting the sales targets higher would have actually increased sales".[223] The Panel concluded that Veriphy sales "would not have reached the revenue targets within the negotiated time frames even if [Buyer] had complied with the letter of the Merger Agreement and the Earnout Side Letter."[224]

On the sellers' claim that the buyer breached the duty of good faith and fair dealing that it asserted should be implied in every contract governed by New York law, the Panel concluded that the buyer did not breach the implied covenant of good faith and fair dealing "because it considered and rejected the very obligations [sellers] seek to impose by implication", citing its interpretation of New York law that an obligation can only be implied "if the parties themselves would have imposed such an obligation had their attention been drawn to it during contract negotiations."[225] The Panel further concluded that the buyer

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[220] *Id.* at 28.

[221] *Id.*

[222] *Id.* at p. 29.

[223] *Id.*

[224] *Id.*

[225] *Id.*, citing *Reiss v. FIN Performance Corp.*, 97 N.Y.2d 195, 199 (N.Y. 2001).

did not breach the implied covenant because there was no evidence that the buyer intended to prevent the earn-out from occurring.[226]

In sum, interestingly, the Panel found for the sellers in all of their earnout related legal arguments, but essentially found that even if the buyer did breach its obligations, market conditions were such that the target's' software product would not have sold enough in any event to reach even the first earnout threshold, and that the sellers "shall take nothing on [their] claims."[227]

The sellers objected very much to the panel's conclusion that the contract had been breached but that no damages were owing, filing an application in a state court in Dallas County, Texas to vacate and remand the award to the panel. The action was then removed to the federal district court for the Northern District of Texas. Judge Solis of the Northern District of Texas actually agreed that the award did not provide sufficient findings of fact and conclusions of law on the issue of damages, and remanded it to the panel for further proceedings, but he denied the application to vacate the award.[228] In other words, even though the panel's analysis was considered insufficient by that court, the award of no damages stood. An appeal of this ruling was denied by the Fifth Circuit Court of Appeals.[229] It is not clear from the public record whether the panel ever made further findings on the damages issue or reconsidered its decision that no damages were owed.

## VI. TAX CLAIMS

The seller's representations concerning its due payment of all taxes owing prior to the transfer of the business are a very important part of an acquisition agreement. Typically, the seller agrees to indemnify the buyer for any taxes that are discovered to be owed. This obligation to indemnify usually is not subject to the deductible or threshold amounts defined for more general indemnification claims or any liability cap. Buyers prefer that the indemnification be "dollar one" and that it be unlimited in amount. Also, the period to make indemnification claims generally is not limited to the negotiated one or two-year cut-off for

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[226] *Id*. at p. 30, citations omitted.

[227] *Id* at p. 30.

[228] *Murchinson Capital Partners, L.P. v Nuance Communs., Inc.*, 2013 U.S. Dist. LEXIS 124935 (N.D. Tex. July 30, 2013).

[229] *Murchinson Capital Partners, L.P. v Nuance Communs., Inc.*, 760 F.3d 418, 2014 U.S. App. LEXIS 14237 (5th Cir. Tex 2014).

general claims. In almost all acquisition agreements, claims to be indemnified for pre-closing tax liabilities can be made up until the time the relevant audit period and tax statute of limitations expires for those pre-closing liabilities. The arbitral award described below resulted from just this type of dispute where a buyer purchased a company with a number of subsidiaries, including one in Peru. After closing, the Peruvian tax authorities made a claim that a large amount of VAT taxes were not paid in a five year period before closing and the buyer sought indemnification, which triggered the dispute.

## Example of an Arbitral Award dealing with Tax Claims - Offshore Exploration and Production, LLC, Claimant against Korea National Oil Corporation and Ecopetrol S.A.[230]

The claimant in this case, Offshore Exploration and Production, ("Offshore" or "seller") was a private investment holding company based in Houston, organized as a Delaware corporation. On December 29, 2008, Offshore entered into a Stock Purchase Agreement as seller with Korea National Oil Corporation and Ecopetrol S.A. as purchasers (the "Purchasers"), companies from Korea and Colombia, respectively. Under the Stock Purchase Agreement, Offshore sold to the Purchasers all of the issued and outstanding common stock of its subsidiary, Offshore International Group, Inc. and each of Offshore International Group's subsidiaries for total consideration of $1.2 billion, with $150 million of the purchase price being held back in escrow to satisfy indemnification claims. One of the subsidiaries was a Peruvian company called Savia Peru, S.A. Section 7.4(a) of the Stock Purchase Agreement required the seller to indemnify the Purchasers and their affiliates, defined to include subsidiaries such as Savia Peru, for all tax liabilities in the tax period prior to the closing. Section 7.4(d) contained the following terms on how and when the tax indemnification payment should be made:

> Any indemnity payment required to be made pursuant to this Section 7.4 will be paid within thirty (30) days after an Indemnified Party makes written demand upon an Indemnifying

[230] ICDR Case No. 50 198 T 00825 11. Decision of the Southern District in the action to confirm the award found at *Offshore Exploration & Prod. LLC v. Morgan Stanley Private Bank, N.A.*, 996 F.Supp. 2d 308, 2013 U.S. Dist. Lexis 16978 (S.D.N.Y. 2013); *Ecopetrol S.A v Offshore Exploration & Prod. LLC*, 46 F.Supp.3d 327 (S.D.N.Y. 2014); *Offshore Exploration & Production LLC v Morgan Stanley Private Bank, N.A., Ecopetrol S.A. and Korea National Oil Corporation*, 2015 WL 5568406 (2d Cir. 2015).

> Party …If the Taxes that are contested must be paid under applicable Law prior to or upon commencement of a contest proceeding, Seller shall pay such Taxes to the applicable Governmental Authority prior to or upon commencement of such proceeding.

After closing in 2009, Savia Peru was forced to pay to the Peruvian authorities $75.3 million in Value Added Taxes and penalties relating to period from 2002-2007. The Purchasers also submitted to Morgan Stanley, the escrow agent holding the $150 million in escrow, a claim under the applicable escrow agreement for release of the amount paid to the Peruvian tax authorities. Under the provisions of the escrow agreement, Morgan Stanley contacted the seller to determine if it objected to the disbursement. The seller did object and also contended that the indemnification claim was invalid due to the Purchasers' alleged failure to comply with the Stock Purchase Agreement's requirements to keep the seller informed of the Peruvian tax proceedings and to allow seller to control those tax proceedings.

The Purchasers then invoked the dispute resolution clause of the Stock Purchase Agreement, which provided for arbitration in New York under the AAA's international rules, to bring a claim against the seller. The Purchasers demanded reimbursement of the amounts that Savia Peru had to pay to the Peruvian authorities. A panel of three arbitrators was constituted and heard the claim in New York, applying ICDR rules.

The seller opposed the claim, it argued that an order by the panel along the lines being sought by the Purchasers would amount to a preliminary injunction and that the New York law requirements for issuing a preliminary injunction, which included a finding of irreparable harm and likelihood of success on the merits, were not met. The Stock Purchase Agreement had a provision, however, which allowed a party the right to seek specific performance of the agreement "without the necessity of proving the inadequacy of money damages as a remedy". As a result, the panel was not persuaded. It found that the parties had bargained for the specific performance provision and were entitled to its enforcement. Also, it cited the New York case law, discussed in the section of this article on specific performance, to the effect that arbitrators are not bound to the strict standards for interim

relief that New York courts must apply and may, in appropriate situations, grant relief that would not be available in a court of law.[231]

The panel did not reach the seller's claim that the Purchasers had breached the Stock Purchase Agreement's requirement to keep them informed of the Peruvian tax proceedings and to allow the seller to take control of it. Instead they found that the Purchasers were entitled to an order enforcing Section 7.4(d) quoted above as written, thus requiring Seller to reimburse Savia Peru for the VAT taxes assessed and paid regarding the years in question. This determination was based solely on what the panel viewed as the "unambiguous language of the [Stock Purchase Agreement] regarding the payment of funds in advance of the dispute resolution procedure called for in the parties' agreement." The panel ordered the seller to pay over $75 million to the Purchasers within thirty (30) days of the award.

The panel went on to emphasize that it was making no determination regarding the underlying merits of the dispute, including the question of whether the Purchasers breached the Stock Purchase Agreement by failing in a timely manner to cede control of the tax contests to the seller.

The seller then instructed the escrow agent to pay the amount of the arbitral award out of the escrowed funds, thus dropping its initial objection. It was then the Purchasers who objected to the disbursement, arguing that the money remaining in escrow ($125 million at the time of the Interim Award) should stay there to satisfy other indemnification claims. Since Morgan Stanley did not have joint instructions from the parties to the escrow agreement (as required by the agreement), it did not release the funds. The seller then sought a declaratory judgment in the Southern District that the escrow agent was required to release the funds to satisfy the tax claim. Shortly thereafter the Purchasers started a supplemental proceeding before the arbitral panel to declare ineffective the seller's attempt to satisfy the arbitral award with escrowed funds. The Purchasers also sought a stay of the declaratory judgment proceeding before Judge Koeltl to allow the arbitral panel to make a determination. Judge Koeltl granted the stay and the supplemental arbitral proceeding went forward.

[231] Citing *Sperry International Trade v. Government of Israel*, 432 F.Supp. 901 (S.D.N.Y), *aff'd*, 689 F.2d 301 (2nd Cir. 1982).

On December 1, 2013, the arbitral panel issued a "Supplemental Interim Award" finding that it had jurisdiction to decide whether the seller was permitted to satisfy the interim award from the escrow amount since the claim arose under the terms of the Stock Purchase Agreement and not the escrow agreement.

The panel quoted the terms of Section 8.6 of the Stock Purchase Agreement, which gave the Purchaser a right to assert an indemnification claim and be paid out of the Escrow Amount, but did not give the seller a unilateral right to force the payment of an indemnification claim from the escrowed amount. The Purchaser's rights were found by the tribunal to be permissive, not mandatory. The panel found that the Purchasers' decision to decline to have its award paid out of the escrowed funds due to the possibility that other claims for indemnification would have to be paid out of the escrowed funds was rational and consistent with the terms of both the Stock Purchase Agreement and the Escrow Agreement.

The panel also placed some importance that its original order was fashioned as an interim order. In its supplemental award, the panel concluded that the question of whether the escrowed funds could be sued to satisfy a final award over the objection of the Purchaser was still an open one. However, the panel did not alter its original decision that the seller was required to pay the Purchaser $75 million without use of the escrowed funds.

According to the federal court's description of the background of the dispute, the arbitral panel then held hearings on the merits of the dispute on seller's claim that the Purchasers did not allow the seller to participate in the tax contest. It is unclear from the public record whether that question was ever resolved.

In the meanwhile, both Judge Koeltl of the Southern District and the Second Circuit Court of Appeals rejected the seller's attempt to set aside the panel's two awards.[232]

## VII. MATERIAL ADVERSE EFFECTS AND CHANGES

An agreement to acquire a business can either take effect immediately upon signing or the closing can be put off until a future date after certain conditions to closing are met. In M&A parlance, there is either a simultaneous or "staggered" signing and closing. The

[232] *Id.*

main reason for staggering the closing is that the sale of the business is subject to regulatory approvals or antitrust clearance, but there can be more business-specific conditions to be met. For instance, in agreements to acquire renewable energy projects, the buyer usually insists that all the conditions to acquire title insurance are met since real estate rights are such an important part of a wind or solar project.

### A. Material Adverse Effect Clauses and Claims

It is typical to include in agreements providing for a staggered signing and closing that the buyer is not obligated to close if there has been a material adverse change in the seller's business. The term "material adverse change" (or "effect") is usually defined in the acquisition agreement and is with reference to a certain point in time or other reference point, such as the date of the most recently published financial statements of the business being sold. The standard definitions of material adverse change tend to be somewhat unsatisfactory and tautological (e.g. a material adverse change is a change that materially and adversely affects the seller's business), such that what actually constitutes a material adverse change is fact specific and easily subject to dispute.

That said, it is difficult for buyers to prevail under New York and Delaware law when making claims that the target business has undergone a material adverse change such that they have the right to back out of the transaction after signing but before closing. Significantly, no Delaware court has ever found a material adverse effect ("MAE") in an acquisition context.[233] MAE clause interpretation involves a fact-specific determination of materiality, and the party claiming the occurrence of a MAE bears a heavy burden of proof. The following is a discussion of some cases that shape New York and Delaware MAE clause interpretation in an acquisition context.

### B. Case Law

The seminal case on modern MAE clause interpretation is *IBP v. Tyson*, a decision from 2001 then Vice Chancellor Strine of the Delaware Chancery Court applying New York law. In that case, Tyson Foods, Inc. ("Tyson") sought to terminate an agreement for the

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[233] Arthur Fleischer, Jr. & Alexander R. Sussman, Takeover Defense: Mergers and Acquisitions § 14.07[B], at 14-438 (Supp. 2015); Alan Schwartz & Ronald Gilson, Understanding MACs: Moral Hazard in Acquisitions, 21 J.L. Econ. & Org. 330, 333-34 (2005).

acquisition of IBP, Inc. ("IBP"),[234] the largest beef producer in the United States at the time and second-largest pork producer.[235] The IBP-Tyson merger resulted from an auction that began in November 2000.[236] During the bidding process, Tyson received information that raised serious concerns about IBP's financial health.[237] Specifically, (a) there were indications that IBP's beef business was heading into a cyclical trough; (b) IBP was projected to fall short of its projections for the fiscal year 2000; and (c) accounting fraud at one of IBP's subsidiaries resulted in a charge of $30 million to earnings.[238] Despite these serious issues, Tyson entered into a definitive merger agreement with IBP on January 1, 2001.[239]

In the coming months, IBP's 2001 first quarter earnings from operations were off by 64 percent from the previous year.[240] Additionally, following a Securities and Exchange Commission ("SEC") investigation, IBP announced it would have to restate its financial statements to take an additional earnings charge.[241] Shortly thereafter, Don Tyson, Tyson's former CEO and controlling shareholder, and other former Tyson executives determined that Tyson should back out of the merger.[242] Tyson's legal team immediately drafted a letter to IBP regarding its withdrawal, citing the financial restatements and failure to disclose the SEC investigation.[243] IBP sued to compel Tyson to complete the merger. Tyson argued that the decline in IBP's performance in the last quarter of 2000 and the first quarter of 2001 constituted the existence of a MAE.

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[234] In re IBP, Inc. Shareholders Litigation, 2001 Del. Ch. LEXIS 81 (June 15, 2001).

[235] Dorsey & Whitney LLP, IBP v. Tyson Foods: Where's the Beef in Big Mac? 2 (June 30, 2001), available at http://www.dorsey.com/files/tbl_s21Publications%5CPDFUpload141%5C118%5C96.IBP%20v%20Tyson%20010630.pdf.

[236] IBP, 789 A.2d at 28.

[237] *Id.* at 38–39.

[238] *Id.* at 45.

[239] *Id.* at 22, 45 ("Tyson trumpeted the value of the merger to its stockholders and the financial community, and indicated that it was fully aware of the risks that attended the cyclical nature of IBP's business.").

[240] Simpson Thatcher & Bartlett LLP, "Delaware Chancery Court Orders Specific Performance of Merger Agreement. An analysis of the IBP-Tyson Litigation 3" (Aug. 2, 2001), available at http://www.stblaw.com/content/publications/pub320.pdf.

[241] IBP, 789 A.2d at 45–47.

[242] *Id.* at 50.

[243] *Id.* at 50–51.

Vice Chancellor Strine ultimately concluded that there existed no legal grounds for Tyson to terminate the agreement. In his view, Tyson was simply experiencing a case of buyer's remorse, especially in light of the fact that Tyson's publicized reasons for termination did not include a possible MAE. In reaching this conclusion, the court made several holdings that limited the scope and use of broadly defined MAE clauses. First, the court held that a general economic or industry decline alone could not constitute a MAE.[244] Instead, the purchaser must show that the event had the "required materiality of effect" on the target.[245] Second, the court held that interpretation of MAE clauses must take into account the "negotiating realities" and context in which the parties were contracting, distinguishing between strategic and financial purchasers.[246] Illustrating this concept, Vice Chancellor Strine noted that "[i]t is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause."[247] By entering into a merger agreement with IBP, Tyson, the nation's largest chicken producer, hoped to create "the world's preeminent meat products company."[248] Plainly, Tyson was purchasing IBP for strategic reasons.[249] As discussed below in the remedies section under specific performance, Vice Chancellor Stine ordered Tyson to complete the merger.

Another significant case under New York law came in 2003, not long after the *Tyson* case. That case involved a merger agreement between the holding company owning the electric utility company serving New York City, Consolidated Edison, Inc. ("Con Edison") and Northeast Utilities ("NU"), a holding company owing several regulated distribution utilities in New England, including Connecticut Light & Power ("CL&P"), and certain unregulated energy trading companies including one called Select Energy, Inc. ("Select").[250] The merger agreement was signed on October 13, 1999 with the closing contemplated for the end of 2000 in view of the regulatory approvals

[244] *Id.* at 66.
[245] *Id.*
[246] *Id.* at 67.
[247] *Id.*
[248] *Id.* at 21–22.
[249] *Id.* at 67.
[250] *Consolidated Edison, Inc. v Northeast Utilities*, 249 F.Supp.2d 387 (S.D.N.Y. 2003).

needed. Con Edison was to be the surviving entity. Assuming a closing on December 31, 2000, the price to be paid by Con Edison in cash and shares was $26.50 per share of NU stock or $3.6 billion in total, which represented a significant premium over the NU stock price before merger rumors began circulating, which was $18.56 (for a total premium of more than $1 billion).

The merger agreement had a material adverse change clause, providing that it was a condition to Con Edison's obligation to close that "[f]rom and after the date of this Agreement, no Material Adverse Change with respect to NU (including the discovery of, an deterioration in, or any worsening of, any change, event, occurrence or state of facts existing or known as of the date of this Agreement) shall have occurred."[251] A material adverse change ("MAC") was defined as "any change, effect, event, occurrence or state of facts … that is, or would reasonably be expected to be, materially adverse to the business, assets, properties, condition (financial or otherwise), results of operations or prospects of [NU] and its subsidiaries taken as a whole."[252]

Con Edison asserted that the investment bank Morgan Stanley had made a presentation to the board of trustees of NU in October 1999, just before the merger agreement was signed, in which Morgan Stanley projected that NU's consolidated forecasted earnings for the five-year period from 2001 through 2005 were $1.458 billion. Morgan Stanley made a similar presentation to NU's board in February 2001, just before the merger was slated to close (the needed approvals had not been obtained until early 2001) where it reduced its projection to $1.094 billion, a negative difference of almost $400 million. Con Edison also claimed that Morgan Stanley dropped NU's per share valuation range from $18.25-$23.50 to $15.25-$18.50. Con Edison also cited a report by NU's treasurer in which he noted that NU's subsidiary Select Energy, a company engaged in wholesale energy supply and trading, lowered its average profits margin substantially (from 8.1% to 4.5%) between October 1999, when the merger agreement was signed, and September 2000. Taking all these elements together, Con Edison asserted that there was a drastic decline in NU's financial condition and prospects, thus justifying Con Edison's claim that there had been a material adverse change. In early March 2001, Con Edison's CEO informed NU's CEO that Con Edison

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[251] *Id.* at 411.

[252] *Id.*

would not go through with the merger unless the price to be paid per share was reduced. NU refused to reduce the price, which led to Con Edison's seeking a declaratory judgment in the Southern District that it was not obligated to complete the merger.

NU of course disputed Con Edison's interpretation of these reports and presented its own explanations, claiming that no MAC had occurred. Each side moved for summary judgment. Had the federal district court judge, Judge Koeltl, ruled, it would have made for very interesting law on the theory of material adverse change as an excuse not to complete a merger. However, he found that there were disputes of material facts on these points and refused to rule on summary judgment, thus setting the issue for trial before a jury. That trial never occurred as the parties ultimately settled the case in March 2008. As to the terms of that settlement, according the relevant 10Q filed by Con Edison on May 2, 2008, NU paid Con Edison $49.5 million, and the parties dismissed their respective claims against each other relating to this proceeding. This payment apparently was intended to cover Con Edison's legal fees and other expenses in prosecuting the case so in some sense this appears to have been an admission on the part of NU of the weakness of its case, not necessarily in this particular MAC claim by Con Edison, but perhaps more significantly due in the fact that Judge Koeltl had set Con Edison's claim for damages due to "lost synergies" for trial in early 2008 (discussed in the section on damages below).

A few other cases decided under Delaware law are worth considering. In *Frontier Oil Co. v. Holly Co.* from 2005, mid-sized oil refiners Frontier Oil Co. ("Frontier") and Holly Co. ("Holly") began negotiating a merger agreement in March 2003, pursuant to which Frontier would acquire Holly in exchange for a mix of cash and Frontier stock.[253] Days prior to signing the merger agreement, Holly learned of a potential mass toxic tort lawsuit against a Frontier subsidiary stemming from oil extraction adjacent to Beverly Hills High School that was alleged to have caused cancer in its students.[254] This development ultimately led to the renegotiation of the merger agreement and the inclusion of the potential lawsuit in its Disclosure Letter (as follows):

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[253] Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 Del. Ch. LEXIS 57, at *6 (Apr. 29, 2005).

[254] *Id.* at 7–8.

> Frontier agrees with, and for the sole benefit of, Holly that [the Beverly Hills] litigation will be considered as 'threatened' . . . and that the disclosure of the existence of this 'threatened' litigation herein is not an exception to Section 4.8 . . . and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.[255]

Shortly after the merger agreement was signed, the threatened lawsuit was filed, naming Frontier's subsidiary as well as Frontier. To both parties' surprise, Frontier had guaranteed the indemnity obligations relating to its subsidiary's assumption of the original Beverly Hills School District lease.[256] It soon became clear to Frontier that Holly would not close the deal unless the merger agreement was renegotiated.[257] Although Frontier made several proposals that would insulate Holly shareholders from the potential effects of the litigation on Frontier's stock price, the parties failed to save the deal. Frontier filed suit, claiming Holly had repudiated its obligation under the Merger Agreement, while Holly claimed the Beverley Hills litigation constituted a MAE.[258]

Vice Chancellor Noble of the Delaware Court of Chancery delivered the opinion, applying the *Tyson* standard.[259] Finding that the burden of proof fell on Holly,[260] the court set out to address whether litigation can ever qualify as a MAE. Frontier argued that litigation in itself is too unpredictable to ever constitute a MAE. On the contrary, the court found that "threatened litigation can be so certain, the outcome so predictable, and the likely consequences (i.e., 'prospects') so negative, that an observer could readily conclude that the impact that one would reasonably expect to result from the litigation would be material and adverse." Accordingly, *Frontier*

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[255] *Id.* at *17.

[256] *Id.* at *39–40, *45.

[257] *Id*. at *63–64.

[258] *Id.* at *86–89.

[259] The *Tyson* standard for MAE interpretation was set out by the Delaware Court of Chancery four years prior to *Frontier*. However, although *Tyson* was heard in the Delaware Court of Chancery, the court was considering the New York law, which governed the merger agreement. *Frontier* made it clear that the *Tyson* standard would be applied in Delaware.

[260] *Id.* at *131–32.

demonstrates that the party bearing the burden of proof must establish that the alleged litigation poses "some degree and duration of the threatened effect,"[261] to constitute a MAE.

In *Frontier*, however, Holly failed "to come forward with factual and opinion testimony that would provide the court with a basis to make a reasonable and an informed judgment of the probability of an outcome on the merits," and the court declined to find an MAE claim.[262] Alternatively, the ultimate issue in *Frontier* was whether the expected cost of defense would have, or would reasonably be expected to have, a MAE on Frontier. After reviewing estimated costs of defense proffered by both parties, the court determined that Frontier could absorb the estimated cost of defending the lawsuit over the long term without experiencing a MAE.

In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* a case from 2008, Hexion Specialty Chemicals, Inc. ("Hexion") entered into a merger agreement in July 2007 for the leveraged cash acquisition of Huntsman Corporation ("Huntsman").[263] As a result of the competitive bidding process, the merger agreement was very seller-friendly, notably only allowing Hexion to avoid the agreement without paying damages via the MAE clause.[264] Following signing in April 2008, Huntsman missed quarterly results[265] and Hexion thereafter filed suit, claiming that Huntsman had suffered a MAE.[266]

Vice Chancellor Lamb explained the MAE standard, noting first that "[i]n the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy."[267] The court then emphasized that a buyer seeking to prove a MAE still had to show a significantly durational adverse event expected to impact future results and based on the business as a whole. The court stated that the important consideration to determine

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[261] Daniel Gottschalk, Comment, Weaseling out of the Deal: Why Buyers Should Be Able to Invoke Material Adverse Change Clauses in the Wake of a Credit Crunch, 47 Hous. L. Rev. 1051, 1063 (2010).

[262] Id. at *133 ("Indeed, Holly has not presented sufficient evidence to require the Court to seek to describe that level of such proof necessary to sustain an MAE claim in this context.").

[263] Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 720–21 (Del. Ch. 2008).

[264] *See Id*. at 721.

[265] *Id.*

[266] *Id.* at 730.

[267] *Id*. at 738.

whether an MAE has occurred is "whether there has been an adverse change in the target's business that is consequential to [its] long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." The court further explained that a target's decline in earnings between signing and closing might constitute an MAE if such "poor results [are] expected to persist significantly into the future."[268]

[268] *Id.*