

“What keeps you up at night?”

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Delaware Chancery Court interprets earn-out language in asset purchase agreement

By Dennis J. Brennan

A recent opinion of the Delaware Chancery Court dealt with the interpretation of certain language in an asset purchase agreement's earn-out clause. The opinion, *Airborne Health, Inc. v. Squid Soap, LP*, may be found at http://www.delawarebusinesslitigation.com/uploads/file/2009-11-13%20Airborne%20Health,%20Inc_%20v_%20Squid%20Soap,%20LP%20C_A_%204410-VCL.pdf.

The asset purchase agreement at issue provided for the sale of all of the assets of an innovative soap company. The purchase price consisted of \$1 million in cash at closing (which was paid), plus the potential for earn-out payments of up to \$26.5 million if certain targets were achieved. The agreement specifically provided that if the buyer failed to expend at least certain minimum amounts to market and advertise the soap products, and net sales of the soap products failed to reach specific targets by particular deadlines, the buyer was required to return the purchased assets back to the seller.

Shortly before the time that the buyer and seller entered into the purchase agreement, but unbeknownst to the seller, the condition of the buyer's business began to deteriorate for reasons unrelated to its purchase of the soap company's assets. As a result, during the period following the closing of the purchase, the buyer focused its attention on addressing its problems rather than on marketing and selling the soap business's products. Consequently, the seller commenced litigation against the buyer, seeking monetary damages rather than the return of the assets.

One of the key issues before the Delaware Chancery Court was whether the asset purchase agreement included a **covenant** by the buyer to engage in marketing and advertising efforts. The court examined the language used in the agreement and concluded that there was no such covenant; rather, the agreement provided for a **condition** that would be triggered if buyer failed to engage in the marketing and advertising efforts. The Court declined to find that the buyer's conduct violated an implied covenant, stating that an "implied covenant is not a means to re-write agreements."

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Another key issue before the court was whether the buyer breached its representations and warranties to the seller. The court examined the pertinent representations and concluded that the buyer’s representations (as to the absence of “Legal Proceedings” that were “reasonably likely to prohibit or restrain the ability of [buyer] to enter into this Agreement or consummate the transactions contemplated hereby”) addressed only the ability of the buyer to **close** the purchase of assets under the asset purchase agreement, and did not address the ability of the buyer to engage in the anticipated marketing efforts after closing.

The case teaches that in an earn-out scenario, the court will enforce the express language in the agreement, and is unlikely to re-write the agreement to add provisions that a party could have insisted upon, but did not do so. Most importantly, in this case the agreement specifically provided that the consequence of the buyer’s failure to meet the marketing and advertising expenditure thresholds and to reach sales targets would be the return of the assets, not the payment of monetary damages to the seller. The court refused to construe the contract to permit the buyer to make a claim for monetary damages. It observed that the seller, when negotiating the agreement, could have insisted upon specific representations, warranties and covenants binding the buyer — and if the agreement had contained such provisions, the seller probably would have been able to assert a claim for damages on account of the buyer’s breach. However, the final agreement between the

parties did not contain those kinds of provisions, and the seller’s remedies were limited to the return of the purchased assets as expressly contemplated by the agreement.

More generally, the case reminds us that both buyers and sellers must be extremely careful when negotiating and drafting earn-out provisions. It is important to consider not only the targets that the acquired business must reach in order for the seller to earn additional consideration, but also the level of commitment, if any, that the buyer will be required to undertake to try to cause the acquired business to meet those targets.

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