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Don’t test your faith: drafting earn-outs

AUTHORS


Laurie N. Duke


Andrew Gray


Sophie Courtois

Transaction Tips

You are in negotiations to buy a business with little operating history. The seller is convinced the business has significant growth potential, so you agree to include an earn-out to bridge the valuation gap. As future owner, you want to run the business as you see fit. You know that how you conduct the business will affect its performance and ability to achieve earn-out targets. But as long as you don’t agree to include any performance standards in the earn-out provisions, you should be able to operate the business without any restrictions, right?

In Canada, the answer is not straightforward. While it has long been a feature of Québec law, until recently, common law provinces did not recognize a duty of good faith in the performance of contracts. However, the Canadian approach is starting to align with the United States–where courts recognize an implied covenant of good faith and fair dealing. Buyers should proceed with caution in order to minimize the risk of a seller alleging a breach of an earn-out arrangement based on a lack of good faith.

Dealmakers are increasingly using earn-outs to bridge the valuation gap between a company’s present value and its future potential. Typically, earn-out provisions will describe the earn-out target (whether financial or non-financial), the type of earn-out payment (fixed fee or formula-based), the duration and timing of earn-out payments and provide a mechanism for determining whether the earn-out criteria have been met. They may also include specific covenants with respect to the operation of the business post-closing.

The post-closing conduct of the business is an area where buyers and sellers have conflicting interests. Sellers, who are interested in maximizing earn-out payments, will want to retain certain rights with respect to the conduct of the business. They will often negotiate for an “in the ordinary course of business” as conducted prior to closing standard. By contrast, as new owners, buyers will want the ability to run the business as they see fit. They will resist the inclusion of any restrictions on operating the business, but this “silent” approach carries risks.

In Canada, a recent Supreme Court of Canada decision recognized a general organizing principle of good faith performance and a specific duty of honest performance in all contracts. In the common law provinces, it remains unclear how this organizing principle will be applied in the performance of contracts, and how far parties will need to go in order to satisfy it. However, this does open the door for a claim that an earn-out arrangement has been breached as the result of a lack of good faith, especially where the parties have not agreed to any standard of conduct.

In Delaware, the implied covenant of good faith can be used to “gap-fill” where the parties did not explicitly address the issue in question. If the agreement contains express terms, however, the courts will be reluctant to read in terms for which the parties did not specifically negotiate.

Tip

If you are a buyer negotiating an earn-out, don't stay silent when it comes to how you will run the business post-closing. Seek to expressly limit good faith obligations by explicitly disclaiming any obligation to maximize the earn-out payment and include a clear standard, such as operating the business with a view to its long-term best interests, that will govern the conduct of the business after the deal closes.

To discuss these issues, please contact the author(s).