Delaware Supreme Court finds purchaser did not breach earn-out provision

Contributed by **Ropes & Gray LLP**

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In *Lazard Technology Partners, LLC v QinetiQ North America Operations LLC*(1) the Delaware Supreme Court upheld a Delaware Chancery Court ruling holding that a purchaser did not violate the terms of a merger agreement's earn-out provision.

Facts

The case concerned a merger agreement through which QinetiQ North America acquired Cyveillance, a cybertechnology company. The agreement provided for a $40 million upfront payment, plus up to another $40 million if Cyveillance's revenues reached a specified level. The agreement also included a provision that prohibited Qinetiq from taking "any action to divert or defer [revenue] with the intent of reducing or limiting" this earn-out payment.

After Cyveillance failed to achieve sufficient revenue to generate an earn-out payment, former Cyveillance stockholders sued, alleging that QinetiQ had failed to take actions that would have caused Cyveillance's revenue to reach the earn-out threshold. The stockholders also contended that QinetiQ had violated the implied covenant of good faith and fair dealing by failing to take such actions.

The Delaware Chancery Court rejected those claims, finding that the plaintiff had not proven that any of QinetiQ's business decisions were motivated by the desire to avoid an earn-out payment.

Decision

On appeal, the Delaware Supreme Court upheld the chancery court's ruling. In so doing, it rejected the stockholders' contention that QinetiQ was prohibited from taking actions that it knew would negatively affect the likelihood that the stockholders would receive the earn-out payment. The court noted that the relevant contractual provision required "intent" to reduce or limit the earn-out payment, which precluded conduct that was, at least in part, "specifically motivated by a desire to avoid the earn-out". Conversely, the agreement did not prohibit acting with mere knowledge that QinetiQs conduct may limit the earn-out payment.

The court also rejected the stockholders' claim that QinetiQ had violated the implied covenant of good faith and fair dealing. The court noted that in the course of negotiating the merger agreement, the sellers had attempted to negotiate for several affirmative post-closing obligations and QinetiQ had rejected all of these attempts, with the parties instead agreeing to the general prohibition against actions taken with the intent of reducing the earn-out payment. Given this history, the court refused to apply the implied covenant to give the stockholders the protections that they had failed to obtain when they negotiated the agreement.

Comment

The decision highlights the Delaware Supreme Court's willingness to rely on the language of the contract, rather than giving effect to extra-contractual claims. Additionally, it demonstrates that the Delaware courts will look sceptically at attempts to use the implied covenant of good faith and fair dealing to prevail on points that a party was unable to win at the negotiating table.

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Endnotes

(1) No 464, 2014 (CA No 6815-VCL) (Del Apr 23 2015).

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