

Corporate Finance/M&A - USA

Implied covenant of good faith and scope of arbitration in earnout disputes

Contributed by **Ropes & Gray LLP**

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Even the most carefully drafted earnouts can become fertile ground for legal battles. In two recent decisions the Delaware Chancery Court explored legal issues that are commonly implicated in earnouts.

In *Fortis Advisors LLC v Dialog Semiconductor PLC*⁽¹⁾ the court considered an earnout construct under which the acquirer of the business was required to use "commercially reasonable best efforts" to achieve the earnout targets. The merger agreement also included a number of specific obligations and prohibitions on the acquirer in connection with its operation of the business during the earnout period. Although the fact-intensive issue of whether the acquirer met the standards of the earnout provision remains to be litigated, the court dismissed the seller's alternative theory that the acquirer's conduct had breached the implied covenant of good faith and fair dealing. The court noted that the implied covenant applies only where the written contract has left a gap that must be filled, with the covenant being violated if one party acts in a way that is clearly contrary to what the parties would have agreed had they addressed the gap. However, in *Fortis* the court found that the earnout provision left no gaps in defining the standard for the acquirer's conduct during the earnout period, and as a result the implied covenant was not implicated. *Fortis* confirmed that plaintiffs cannot use the implied covenant of good faith and fair dealing as an end run around a clearly drafted standard of conduct in an earnout provision.

In *Weiner v Milliken Design, Inc*⁽²⁾ the court refused to rule on certain issues relating to an earnout dispute where the earnout provision of the purchase agreement required the parties to submit earnout disputes to an arbitrator. The court reasoned that given that the parties' clearly expressed intention to arbitrate earnout disputes, the court would not interfere with the arbitrator's discretion to adjudicate the dispute. *Weiner* illustrated that the Delaware courts will give effect to arbitration provisions and parties should be aware that entrusting an arbitrator to interpret earnout or purchase price adjustment provisions may result in a different interpretation than what might have been provided by a court.

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Endnotes

(1) *Fortis Advisors LLC v Dialog Semiconductor PLC*, CA No 9522-CB (Del Ch January 30 2015).

(2) *Weiner v Milliken Design, Inc*, CA No 9671-VCP (Del Ch January 30 2015).

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