ARTICLES

Cross-Border Earnout Disputes

Parties to M&A agreements should consider what rules of contract interpretation and legal remedies might apply in the event of a dispute over earnouts.

By Stephen Brown-Okruhlik and Laurene Oliveira – May 30, 2024

"Earnout" provisions can be a useful tool in merger and acquisition (M&A) agreements. They allow parties buying and selling a business to make a portion of the purchase price contingent on the post-closing performance of the target company. Earnouts have become increasingly common in recent years. So have earnout disputes. Parties to M&A agreements should consider what rules of contract interpretation and legal remedies might apply in the event of a dispute over earnouts. This is especially true in cross-border transactions involving the law and procedure of a foreign jurisdiction. Canada provides some good examples regarding these topics, which are discussed below.

Earnouts in Mergers and Acquisitions Deals

Earnouts in M&A transactions shift a portion of the consideration that a buyer pays to a seller to sometime after the sale of a business closes and make the payment of such consideration contingent on the future performance of the target business. Earnouts can provide an incentive to sellers to continue promoting the interests of the business after closing. They are sometimes used to retain key employees who may or may not also be sellers. Earnouts can also bridge a gap between the parties' opinions about the company's value.

Earnout provisions come in many forms and are often heavily negotiated and tailored to the circumstances of the transaction. For example, earnouts can be tied to the target company's financial indicators, like sales, revenue, or earnings before interest, taxes, depreciation, and amortization (EBITDA). They might also be triggered by one or more milestones, like the commercialization of a product or a further corporate transaction. Sometimes earnout entitlements are accelerated by the occurrence of specified events, like a change of control of the target business or the buyer.

Earnout provisions may impose express requirements on the buyer to make "best" or "commercially reasonable" efforts to achieve the earnout triggers, expressly relieve the buyer of any obligation, or be silent on the issue. They may impose specific post-closing obligations on the buyer, like continuing to run the business in its ordinary course or a prohibition on merging the target company with another entity during the earnout period. If earnout payments are triggered or quantified in reference to specific financial metrics like revenue or EBITDA, the parties might agree to refer calculations or accounting disputes to a third-party valuator. The

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provision might prescribe a specific accounting standard or practice that applies to determine or calculate an earnout entitlement, or the provision may be silent on accounting standards.

Earnout Disputes

While earnout structures have utility and flexibility, they are also fertile ground for disputes. Parties might argue about whether earnout triggers have occurred or whether one party thwarted the earnout or failed to make requisite efforts to achieve it. Parties might also disagree over the proper calculation of earnout payments. The text of an earnout provision may support multiple reasonable interpretations of the parties' rights and obligations or the scope of subject matter that must be referred to a third-party valuator (as opposed to the courts). The rules of contract interpretation are especially important in earnout disputes, given the highly context-driven nature of these provisions. Recent cases from the United States demonstrate the range of common earnout disputes and the importance of contract interpretation rules for their resolution.

Fortis Advisors, LLC v. Dematic Corp., C.A. No. N18C-12-104 AML CCLD (Del. Super. Ct. 2022), was a trial decision of the Superior Court of Delaware involving an earnout that was tied to the post-closing performance of a set of products sold by the target company. The dispute revolved around the term "Company Product" in the parties' agreement and whether products derived from the target's source code were included. The court ultimately adopted the sellers' broad interpretation of the term and found that the relevant revenue targets had been met, entitling them to an earnout payment. The decision turned in part on evidentiary presumptions under Delaware's rules of court to resolve an ambiguity in the earnout provision.

In *Retail Pipeline, LLC v. Blue Yonder, Inc.*, No. 21-2401-cv (2d Cir. Dec. 14, 2022), the Second Circuit Court of Appeals upheld the dismissal on summary judgment of a seller's claim for breach of contract and breach of the implied covenant of good faith. The plaintiff alleged that the buyer failed to develop a software that might have triggered an earnout payment. The court of appeals discussed the availability of extrinsic evidence to resolve an ambiguity within the four corners of a contract. It also relied on earlier case law for the proposition that, absent contractual language to the contrary, a buyer is not obligated under the rubric of "good faith" to operate a business to maximize earnout payments for sellers.

Finally, in *Shareholder Representative Services LLC v. HPI Holdings, LLC*, C.A. No. 2022-0166-PAF (Del. Ch. 2023), the Delaware Chancery Court dismissed, for failing to state a claim, a seller's action for an earnout payment. The parties' merger agreement included various earnout opportunities for the seller of a medical billing business. One of them related to the termination of a major customer relationship that occurred during the parties' negotiations. The earnout provisions required additional payment to the seller in certain circumstances, including if the target business entered a "new" agreement with the departing customer. The customer ultimately amended its existing agreement with the company after closing. Among other things, the Chancery Court had to consider whether the amendment constituted a "new agreement" for the purposes of the earnout.

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In each of these recent cases, the applicable contract law was key to the court's determination.

Contract Interpretation and Remedies in Cross-Border Earnout Disputes: Examples from Canada

Given the importance of contract interpretation rules to earnout disputes, it is important to consider which rules apply in cross-border transactions. Courts in different jurisdictions take different approaches to the interpretation of contracts. There may also be differences between jurisdictions as to the level of discovery involved in earnout litigation (which can be quite invasive for the businesses involved) or the availability of early disposition through a pleadings motion or summary judgment motion. Subtle but important differences in the rules of a foreign jurisdiction could have a profound impact on the outcome of an earnout dispute.

Canada provides a good example. It is the United States' largest trading partner and has a friendly business climate for American investors. Cross-border M&A transactions between the two countries are routine. All of Canada's provinces except for Quebec have a common-law legal system that will seem familiar to American businesses and attorneys. In many respects, the remedies available to contracting parties are similar in the two countries. However, parties should be aware a few unique features of Canadian law.

Contract Interpretation Principles

Canadian common law takes a "contextual approach" to the interpretation of contracts. This requires the court to consider in every case the surrounding circumstances (also called the "factual matrix") in which an agreement was entered. *See* *Sattva Capital Corp. v. Creston Moly Corp.*, 2014 SCC 53, paras. 44–46 (Can.). This is a departure from the approach in more "black letter" jurisdictions like New York or Delaware, where the court will look outside the four corners of a written agreement only if the text of the agreement includes an ambiguity (see, for example, *Fortis Advisors, LLC v. Dematic Corp.*, C.A. No. N18C-12-104 AML CCLD (Del. Super. Ct. 2022)). Canadian courts will necessarily consider the context of the parties' surrounding transaction in order to construe the meaning of an earnout provision. Contract interpretation in Canada generally involves issues of mixed fact and law rather than questions of "pure law." It may also involve expert evidence about prevailing market customs or certain aspects of the relevant industry. Contract interpretation in Canada attracts a high level of appellate deference to the findings of the trial judge or the court of first instance.

The Duty of Good Faith

The duty of good faith is an "organizing principle" under Canadian contract law. *Bhasin v. Hrynew*, 2014 SCC 7, para. 33 (Can.). It applies to all contracts and cannot be excluded by the parties' agreement. It is not an "implied term" or a "gap filler" as in other jurisdictions. The

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organizing principle is manifested in specific legal doctrines, including the duty to exercise contractual discretion in good faith. In a recent decision about this duty, the Supreme Court of Canada held that a contracting party who enjoys a discretionary power under a contract may not exercise that power in a way that is unconnected to the purpose for which the discretion was granted. *Wastech Servs. Ltd. v. Greater Vancouver Sewerage & Drainage Dist*., 2021 SCC 7, para. 84 (Can.). The purpose of a discretionary power may need to be construed from the contract as a whole and from "the purposes of the venture to which the contract gives effect." The duty of good faith is a potentially powerful limitation on discretionary powers under commercial agreements. It could become relevant in earnout disputes where one party possesses unilateral contractual discretion that affects an earnout right. Recent cases in the United States have rejected attempts by plaintiffs to rely on the duty of good faith in earnout disputes. See, for example, *Retail Pipeline, LLC v. Blue Yonder, Inc.*, No. 21-2401-cv, paras. 8 and 9 (2d Cir. Dec. 14, 2022). The analysis might be different under Canadian law.

The Oppression Remedy

Outside of simple contract law, business stakeholders have another powerful tool under Canadian corporate statutes called the "oppression remedy." See, for example, Canada Business Corporations Act, R.S.C. 1985, c C-44, s. 241(1) (Can.). This is available under provincial and federal corporate legislation to remedy conduct that unfairly oppresses, prejudices, or disregards the interests of corporate stakeholders. In cases of oppression, courts have a broad suite of remedies available, including monetary payments or unwinding transactions. The oppression remedy is available to shareholders and other security holders of the corporation, but the court also has discretion to recognize anyone it determines to be a proper person to bring an oppression claim. It is potentially an arrow in the quiver of an aggrieved earnout party in a Canadian transaction.

Conclusion

Earnouts can be a useful tool in corporate transactions to address uncertainty about future events. They can also be the source of many disputes as events unfold. Business parties and their counsel should take care in drafting earnout provisions for this reason. When an earnout structure is used in a cross-border transaction, special attention should be paid to which jurisdiction's laws will be applied to determine the parties' rights and obligations in the event of a dispute.

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