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PROTECTION UNDER EARN-OUTS

A recent English case from November 2011, *Porton Capital Technology Funds & Ors v 3M UK Holdings Ltd & Anor*, considered a claim by the sellers that the purchaser had breached certain undertakings in a share purchase agreement entered into between them relating to the conduct of the target company's business during the earn-out period. The English High Court also considered whether the purchaser's termination of the target business during the earn-out period constituted repudiatory breach of the share purchase agreement. As part of its consideration the court considered whether the sellers had unreasonably withheld their consent to such termination.

An earn-out is a mechanism where as part of a share sale or asset sale the purchase price is wholly or (more commonly) partially determined by reference to the future performance of the target company or business. The most frequently used earn-out is calculated by reference to the amount of the profit generated over a specific financial period following completion. Earn-outs may also be linked to other performance indicators such as sales turnover, net assets or such other financial indicators as are appropriate to individual businesses. Earn-outs tend to be used most often (but not always) where the target has been in business for a relatively short time but has significant growth potential. While generally the purchaser and seller interests may be aligned under an earn-out structure, as both parties benefit from maximising the target's profits post completion, there is still much scope for conflicts to arise between the parties regarding the operation of the earn-out. Under an earn-out structure, where the purchaser acquires control of the target, the seller is at risk in relation to the purchaser taking steps post completion which may adversely affect or artificially reduce the earn-out payments. To alleviate such risk the agreement entered into between the parties will normally contain provisions to (a) require the purchaser to take identified positive actions post completion to facilitate the achievement of the earn-out; and/or (b) restrict the buyer from taking certain steps that could have the effect of frustrating or artificially reducing the earn-out payment.

The above case related to a share purchase agreement entered into in 2007 pursuant to which US multinational, 3M, acquired the entire issued share capital of Acolyte Biomedica Limited (Acolyte). The claimants were some, but not all, of the sellers holding between them 60.4% of the issued share capital of Acolyte. Acolyte's business was the commercialisation of a diagnostic technology known as BacLite which was used to detect the hospital super-bug MRSA. The consideration payable by 3M was (i) £10.4 million payable on completion plus (ii) earn-out consideration in the amount of 100% of the net sales of BacLite and related products achieved during the calendar year 2009, subject to a cap of £41 million, less the amount of certain employee incentive payments. The share purchase agreement contained a number of protections in favour of the sellers during the earn-out period including undertakings from 3M to (i) actively market BacLite in the US, EU, Canada and Australia (ii) diligently seek regulatory approval for BacLite in those jurisdictions to the extent such approval was required and (iii) not to cease carrying on the Acolyte business or the development or marketing of BacLite without the written consent of the sellers, which consent was not to be unreasonably withheld or delayed. 3M for its part insisted on a provision stating that it was not obliged to operate its business in a manner that increased the earn-out payments.



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In November 2007 3M halted the clinical studies which were required in order to obtain US regulatory approval for BacLite, due to unexpected poor performance results achieved by the product across those studies. 3M ceased to take any further steps towards seeking regulatory approval for BacLite in either the US or Canada after March 2008. In July 2008, 3M sought the sellers' consent to terminate the Acolyte business in accordance with the terms of the share purchase agreement on the basis of BacLite's inadequate performance and the disproportionate costs incurred by 3M in continuing the business. 3M repeated its request in August 2008 offering the sellers compensation of just over US\$1 million (being 3M's calculation of the sellers' entitlement under the earn-out provisions if the business continued to the end of 2009) but this was refused by the sellers who demanded the maximum earn-out payment of £41 million in exchange for their consent to cease carrying on the business.

3M contended at trial that this refusal meant that the claimants were unreasonably withholding their consent in breach of the share purchase agreement and were therefore released from their obligations under the share purchase agreement or alternatively that the claimants thereby repudiated the share purchase agreement which repudiation the claimants accepted. The claimants countered that 3M was in breach of that agreement because it had neither "actively marketed", nor "diligently" sought the relevant regulatory approvals for, BacLite and 3M's termination of the BacLite business was a repudiation of the share purchase agreement.

In upholding the claimants case against 3M the court held that 3M, the purchaser, had breached certain of its post-completion undertakings, including an obligation to diligently seek regulatory approval for and actively market the target company's products. The court was of the view that "diligently" imposed a standard of reasonable application, industry and perseverance and did not mean a distinct requirement of reasonable care (if such standard had been intended by the parties, it should have been specifically provided in the share purchase agreement).

The court also found that the claimants had not acted unreasonably in withholding their consent to 3M's termination of the target's business and their refusal to consent was not a repudiation of the share purchase agreement. In the circumstances 3M's cessation of the target's business had been a repudiation of the share purchase agreement. In holding that the sellers had acted reasonably in withholding their consent to the cessation of the Acolyte business the court held that the sellers were not required to balance the costs incurred by 3M against their interest in receiving the maximum possible earn-out payment. It was for 3M to prove unreasonableness (for example that the refusal was to some ulterior motive) and it had not done so.



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Having upheld the claimants' case for breach of contract, the court held that damages should be calculated on a loss of profits basis, by reference to the net sales that would have been achieved in 2009 if 3M had not breached its obligations under the share purchase agreement. On the evidence provided, the court determined that the aggregate net sales of BacLite in 2009 would have been US\$2,152,000 but for the 3M breach and awarded damages in the amount of US\$1,299,808 (being the claimants' 60.4% share of the aggregate net sales).

This case highlights the conflicts that can arise even where the parties have contemplated and sought to include provisions for the conduct of the target business during the earn-out period. It also emphasises the importance of the parties carefully agreeing the extent of their rights and obligations during the earn-out period in light of the transaction's specific risks and challenges but also ensuring that the agreed rights and obligations are provided for in the agreement in terms which are precise, specific and unambiguous. In addition, although the case followed the established principles in relation to the giving of consent it is one of the few cases which addressed the issue of whether or not party to a commercial contract had been reasonable in refusing consent.

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