

Recent UK Case Law In Relation To Earn-Outs

BY GARRETT HAYES, MATTHEW POXON & REBECCA BROWN

A \$40 million claim, a six month trial and a \$1.2 million award of damages, culminating in the resignation of the Secretary of State for Defence serves to highlight how failure to consider the extent of the rights and obligations of parties during an earn-out period can prove extremely costly. It was the case of *Porton Capital Technology Funds, Porton Capital Inc. and Ploughshare Innovations Limited v 3M UK Holdings Limited and 3M Company* in the English High Court that led to the exposure of the then Secretary of State for Defence, Dr Fox's, use of his friend Adam Werritty as an unofficial adviser and eventually led to Dr Fox resigning from his ministerial role.

In 2007, 3M UK Holdings Limited ("3M") agreed to buy Acolyte Biomedica Limited Ltd (the "business") which was part owned by Porton Capital and the Ministry of Defence (the "claimants"). The consideration for the shares was £10.4m in cash and an earn-out payment of up to £41 million to be based on net sales in 2009 of the only commercial product of the business, BacLite MRSA ("BacLite"), a diagnostic test used for the purpose of detecting the 'superbug' MRSA. As part of its obligations in connection with the earn-out, 3M was subject to ongoing obligations until the end of the earn-out period including: (i) to actively market BacLite; (ii) to diligently seek regulatory approval for BacLite; and (iii) without the written consent of the sellers (not to be unreasonably withheld) not to cease to carry on the business of the development and marketing of BacLite.

The business was not successful; despite significant investment from 3M, the US clinical trials were producing less accurate rates of detection than previous clinical trials. 3M invited the sellers to consent to the cessation of the development and marketing of BacLite. The sellers declined to provide such consent. 3M then unilaterally informed the sellers that it was ceasing the business with effect from 31 December 2008. The claimants brought proceedings alleging that the failure and termination of the business involved breaches of contract on the part of 3M, that the termination was wrongful and that the claimants had accordingly lost their share of the earn-out payment that should have been achieved based on the net sales which they claimed would have been in the region of £32 million.

The judge found that 3M had breached its obligation to diligently seek regulatory approval. In this context 3M should have pursued regulatory clearances with reasonable application, industry and perseverance. The judge also found that 3M's cessation of the BacLite business constituted a material breach of its obligation to actively market the product.

On the basis of the evidence presented to the Court, the total net sales that would have been achieved even if 3M had not breached the contract and the business had continued throughout 2009 were adjudged to have only been just over US\$2 million.

3M claimed that in refusing to consent to the cessation of the business of developing and marketing BacLite, the claimants had acted unreasonably and, as such, had repudiated the contract and could not seek damages for prior breach from 3M. The Court reasserted the established law that in determining what was reasonable, the claimants were entitled to have

regard to their own interests and were not required to balance their own interests with those of 3M.

Against the background of the estimates of sales for 2009 of around £22 million which had been made in November 2006, 3M's estimate of sales of approximately US\$28 million which was made and communicated to the sellers in January 2007, the parties mutual belief in the strong commercial prospects of BacLite and the lack of the claimants knowledge of, or involvement in, the business following its acquisition by 3M, the Court found that, on the facts, the claimants' consent had not been unreasonably withheld and 3M's cessation of the business on 8 December 2008 was a breach of their obligations.

Practice points

In this case, the earn-out payment was contemplated by the parties as being the principal return to be made by the sellers from their sale of the business. The amount of the payment would depend entirely on how successfully 3M ran the business post-completion, but the claimants had no ongoing involvement in the business and seem to have negotiated limited contractual protections to protect their position. This led to a very unsatisfactory outcome for sellers and highlights the need to carefully consider the rights and obligations of the parties during an earn-out period.

Although there is often significant alignment of interest in respect of an earn-out, there is also a natural tension between the buyer on the one hand who will want to ensure that any earn-out payment is determined by reference to some measure of ordinary course profitability and not inflated by deferring expenditure and investment, and the sellers on the other hand who will want to maximise the earn-out payment and will also want to ensure that the relevant trigger is not artificially manipulated by the buyer, for example by charging excessive management costs or increasing investment and capital expenditure during the earn-out period.

Although the nature of the contractual protections relating to earn-out payments will be driven by the characteristics of the underlying business and the type of earn-out, key points to consider in relation to an earn-out include:

- the level of involvement which the sellers are to have in the ongoing conduct of the business and the extent to which the buyer has the right to terminate the employment of the sellers during the earn-out period;
- the extent to which the buyer is to be restricted from running the business as it sees fit during the earn-out period;
- whether the determination of the earn-out payment should exclude any "one-offs" or exceptional matters such as the profit arising on the sale of significant assets or on the revaluation of any assets;
- the level of financial and other support which the buyer will be required to provide to the business during the earn-out period and the basis on which any such support is to be provided;
- the level of investment and capital expenditure to be made by the business during the earn-out period, particularly if the benefit of such expenditure will not be realised until after the end of the earn-out period;
- should the buyer be restricted from diverting commercial opportunities from the business to the buyer's group and whether the acquired business should be protected from competition by buyer's other businesses that provide the same or complimentary products or services;

- the basis on which the resources of the business can be used for the benefit of the buyer's group;
- how to deal with the impact of synergies arising as a result of the acquisition (including the benefit of any such synergies and the cost of achieving them);
- how the earn-out should be adjusted to reflect the impact of any acquisitions of other businesses made by the business or sale of all or part of the business during the earn-out period;
- whether the protections for the sellers should take the form of restrictions and obligations on the buyer in relation to the conduct of the business during the earn-out period or agreed adjustments to be made in calculating the earn-out payment if certain specified events occur or a combination of both of these;
- whether a floor or cap on the amount of any additional payment would be appropriate (although a cap can be unattractive from a tax perspective as stamp duty at 0.5% will be payable on the maximum amount of the earn-out payment at the time that the shares are purchased);
- whether the seller should request security for the buyer's obligation to make the earn-out payment; and
- the detailed mechanics of calculating, and resolving any disputes in relation to the calculation of, the earn-out payment.

The 3M case serves to highlight the requirement for careful consideration of the detailed terms of an earn-out and is a reminder that all parties should be clear as to how the earn-out will work in practice.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Ronan O'Sullivan
44.20.3023.5127
ronanosullivan@paulhastings.com

Garrett Hayes
44.20.3023.5153
garretthayes@paulhastings.com

Ross McNaughton
44.20.3023.5124
rossmcnaughton@paulhastings.com

Matthew Poxon
44.20.3023.5171
matthewpoxon@paulhastings.com

George Weston
44.20.3023.5142
georgeweston@paulhastings.com

James Wright
44.20.3023.5284
jameswright@paulhastings.com