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Beware implied obligation in M&A deals

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M&A acquirers in Massachusetts may be surprised to learn that even when they pay a substantial price at closing, courts may still require them to continue to invest more in the business after the purchase if the contract includes an earn-out for the seller based on future results. This is true even when the contract says nothing about such an obligation.

Recently in *Sonoran Scanners, Inc. v. PerkinElmer, Inc.*, 585 F.3d (1st Cir. 2009), the 1st U.S. Circuit Court of Appeals overturned summary judgment in favor of PerkinElmer, which was sued by Sonoran and its founder following the purchase of Sonoran's business.

Sonoran was founded in 1997 to develop and market high-speed efficient computer-to-plate technology to the newspaper and graphic arts industries. As of 2001, Sonoran had developed a prototype, but had not made any sales and was running out of cash.

PerkinElmer acquired Sonoran's business through an asset purchase agreement in 2001. It paid $3.5 million at the time of closing and agreed to potential annual earn-out payments up to an additional $3.5 million over a five-year period if certain product sales targets were met each year between 2001 and 2006.

The parties further agreed to cooperate fully with each other to facilitate the transfer of the acquired assets and the operations of the business. However, the contract did not specify how PerkinElmer should run the business or what resources - if any - it was required to devote to meet the sales targets that would trigger the earn-out.

Business a failure

As part of the acquisition, Sonoran's founder and five other Sonoran employees were offered jobs with PerkinElmer, and most of them stayed on and continued to manage the acquired business.

But the acquired business was a failure. Between 2001 and 2004, only one computer-to-plate unit was sold and no amounts were paid to Sonoran under the earn-out provisions. In September 2004, PerkinElmer sold the acquired assets and shuttered the computer-to-plate business soon after.

Sonoran asserted that the failure to reach the earn-out targets was PerkinElmer's fault and sued under a variety of legal theories, including breach of contract, breach of the implied covenant of good faith and fair dealing, and unfair and deceptive business practices.

It further claimed that PerkinElmer had breached an implied obligation to use reasonable efforts to develop and promote Sonoran's technology, which was nowhere mentioned in the asset purchase agreement.

The trial court granted summary judgment to PerkinElmer, dismissing Sonoran's claims precisely because the contract included no obligation to invest in the acquired business post closing or to operate the business in any particular way.

Although the 1st Circuit agreed with the trial judge that the express terms of the contract were not breached, it disagreed that PerkinElmer had no implied obligation to promote the business.

The 1st Circuit found that, because the agreement contemplated a five-year earn-out for Sonoran and there was no language in the agreement *negating* an obligation to promote Sonoran's product or conferring absolute discretion on PerkinElmer to decide how to run the business, PerkinElmer had an implied obligation to use "reasonable efforts" to try to support the business during the earn-out period.

Implied obligation

The 1st Circuit seized upon various aspects of the purchase agreement in concluding that an implied obligation existed.

First, the contingent nature of Sonoran's additional compensation supported its argument that a "reasonable efforts" term was implicit. The court also found that the amount of the earn-out compensation in relation to the up-front payment - each amounting to 50 percent of the total potential consideration - supported an implied obligation to use best efforts.

The court commented that because a large portion of the up-front payment had actually gone to Sonoran's pre-acquisition creditors and did not benefit the shareholders directly, the asset purchase agreement contemplated a campaign to market Sonoran's technology as the primary consideration for Sonoran's shareholders to do the deal.

Lastly, the court found that the absence of language in the agreement negating an obligation by PerkinElmer to use reasonable efforts, or conferring upon PerkinElmer absolute discretion as to the operation of the business, pointed to an implied obligation to use reasonable efforts to develop and promote the acquired business.

PerkinElmer argued that even if it had an implied obligation, it did not breach it because it had invested $2.4 million of its own money in the business each year it operated it and that the lack of success of the venture was attributable to well-known financial problems in the newspaper industry.

The court did not decide whether those arguments provided a complete defense. Instead, it sent the case back to the trial court to determine whether PerkinElmer's actions amounted to a breach of the asset purchase agreement.

The lesson for M&A acquirers is clear: The inclusion of specific language in acquisition agreements stating that the purchaser has absolute discretion in the operation of the acquired business, and no obligation to invest more than the initial purchase price, could save the purchaser from an implied obligation that it did not intend to accept when it bought the business.

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