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Soft Earn-Out 'Promises' as Potential Fraud or Merely Puffery: Delaware Chancery Court Provides Guidance in *Trifecta*

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When a portion of the purchase price in an acquisition is contingent on the earnings or other performance metric(s) of the acquired business post-closing (*i.e.*, an "earn-out" provision), buyers and sellers routinely discuss their aspirations and expectations regarding the go-forward operation and performance of the acquired business during the transaction negotiations. These discussions are a necessary part of arriving at the agreed economics for the earn-out and also help the seller get comfortable with the concept of an earn-out in the first instance. Despite the frequency of these discussions, experienced and/or well-advised buyers are generally opposed to including any specific operating requirements or restrictions on the acquired businesses during the earn-out period and most earn-out provisions preserve significant (if not substantially complete) operational flexibility in favor of the buyer. As a result, sellers frequently find themselves in a position of needing to rely on their trust of the buyer to handle matters as they discussed and expected, rather than on any express obligations in the acquisition agreement.

The seller in the Delaware Chancery Court's decision in *Trifecta Multimedia Holdings Inc. and Dave Young v. WCG Clinical Services LLC*[2] found itself in such a situation. The case arises out of the sale by Dave Young (Young) of his health care technology company, Trifecta Multimedia Holdings Inc. (Trifecta), to WCG Clinical Services LLC (WCG) in a transaction where a portion of the acquisition consideration included an earn-out provision, which ultimately was not achieved.

As described by the court in its opinion on WCG's motion to dismiss,[3] WCG made numerous promises to Young regarding the post-closing operation of Trifecta's business that were not included in the membership interest purchase agreement governing the transaction (the Purchase Agreement), but failed to follow through

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[2] *Trifecta Multimedia Holdings Inc. v. WCG Clinical Servs. LLC*, No. 2023-0699-JTL, 2024 WL 2890980 (Del. Ch. June 10, 2024).

[3] Because the court's opinion arises out of a motion to dismiss, all factual allegations made by Young in the complaint were accepted as true for purposes thereof (and derivatively, for purposes of this article).

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on such promises. WCG also took a number of actions during the earn-out period that Young alleged were made with an intention to frustrate the earn-out. Based on these actions, Young asserted causes of action for, among other things,[4] fraud in the inducement (of entry into the Purchase Agreement) and breach of the implied covenant of good faith and fair dealing. The court allowed Young's fraud claims largely to proceed, while it dismissed the breach of implied duty claim.

Fraud Claim

In accordance with well-established law in Delaware, the elements of a fraud claim are: (1) a false representation, (2) the maker of such representation's knowledge of or belief in its falsity or reckless indifference to its truth, (3) an intention to induce action based on the representation, (4) reasonable reliance by the recipient on the representation, and (5) damages. The court spent considerable time in its opinion discussing the first and fourth prongs.

False "Representations"

According to Young, WCG made numerous promises during the transaction negotiations that Young relied upon in selecting WCG as the buyer but were not included in the Purchase Agreement. Such statements included oral statements made by (fairly senior) representatives of WCG, as well as statements made by WCG in the negotiated letter of intent the parties signed earlier in the sale process.

WCG asserted that some of its alleged statements were not false representations and instead merely constituted "puffery." Under Delaware law, "optimistic statements praising [a counterparty's] own 'skills, experience, and recourses' are 'mere puffery and cannot form the basis for a fraud claim.'"[5] The court agreed with WCG that several of its statements were "nothing more than puffery" in that such statements were no more than "vague statement[s] of 'corporate optimism' designed to boost WCG's appeal as a strategic partner. They are classically vague statements that a commercial party routinely makes during deal-making Courtship."[6] The following statements made by WCG in relation to the post-closing operation of Trifecta's business were characterized in this manner:

- WCG would be "the best partner to accelerate growth" in Trifecta's business.
- The companies would be "shoulder to shoulder going after deals."
- Trifecta would benefit from WCG's "collaboration, coordination and shared relationship across WCG's 4,000+ clients."
- WCG would "support [Trifecta] with over 100 sales and marketing staff."

Conversely, certain other statements allegedly made by WCG were considered by the court to be sufficiently specific to fall outside the bounds of puffery. While the court did not specifically list which statements did not constitute puffery, other statements by WCG included the following:

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[4] Young also asserted a claim for breach of contract resulting from a failure to deliver annual revenue statements and for indemnification under the acquisition agreement for losses arising from WCG's breach. The motion to dismiss such claims were both denied by the court.

[5] *Trifecta Multimedia*, 2024 WL 2890980 at *9.

[6] *Id.*

- A certain critical Trifecta product would be the "front door" for clients.
- A competing WCG product included in the earn-out revenue for purposes of the earn-out calculation would produce at least US$14 million in "guaranteed" revenue.
- "In the previous acquisitions and integrations WCG has completed, each of which were very successful, WCG has centralized the management of key corporate functions (chief financial officer, general counsel, etc.), while allowing each of the acquired divisions to continue to operate independently (including retaining all local corporate functions) … [T]his operating structure provides the best environment for realizing the benefits of the combined business."

Scienter

To establish the scienter/intent prong of Young's fraud claim, "the pled facts [must] support an inference that 'at the time the promise was made the speaker had no intention of performing.'"[7] The court relied on Young's allegations that WCG ceased performing almost immediately after the closing, including by preventing Trifecta personnel from speaking with potential customers and not hiring a replacement sales force, and determined that an inference of intent could be sufficiently drawn to survive a motion to dismiss.

Justifiable Reliance

The third prong of a fraud claim under Delaware law is justifiable reliance. The Purchase Agreement included a fairly typical "entire agreement" integration clause which provided that it constituted the complete and entire agreement of the parties and superseded all prior and contemporaneous understandings and agreements relating to the subject matter thereof.

Relying upon the court's decisions in *Albertsons* and *Black Horse Capital*,[8] WCG asserted that the existence of such an integration clause would, in the context of a fraudulent inducement claim, by itself constitute a contractual bar to a fraud claim premised upon extra-contractual promises in the same way that it has been established in Delaware in *Kronenberg* and *Abry Partners*[9] that the inclusion of a provision in which a party expressly and affirmatively states that it did not rely on any representations and warranties not included in the agreement would constitute a complete bar to fraud claims based upon alleged extra-contractual promises. The Purchase Agreement notably did not include such anti-reliance language.

The court noted that, in its view, under *Kronenberg* and *Abry Partners*,[10] only explicit and unambiguous non-reliance language would constitute a contractual bar to a justifiable reliance claim. In doing so, the court directly and specifically rejected WCG's contention that *Albertsons*[11] created an exception to

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[7] *Id.*

[8] *S'holder Representative Servs. LLC v. Albertsons Cos., Inc.*, 2021 WL 2311455 (Del. Ch. June 7, 2021); *Black Horse Capital, LP v. Xstelos Holdings, Inc.*, 2014 WL 5025926 (Del. Ch. Sept. 30, 2014).

[9] *Kronenberg v. Katz*, 872 A.2d 568 (Del. Ch. 2004); *Abry P'rs V, L.P. v. F & W Acq. LLC*, 891 A.2d 1032, 1050 (Del. Ch. 2006).

[10] *Id.*

[11] *Albertsons*, 2021 WL 2311455.

such requirement that would allow a standard integration clause to constitute a bar to a contractual inducement claim, separate and apart from a factual misrepresentation claim. The court indicated that it viewed *Albertsons*, and the *Black Horse Capital* decision that followed it, as being inconsistent with *Kronenberg* and *Abry Partners*, and further noted that the view it expressed in *Trifecta* on this issue constituted the current majority position in Delaware. As a result, the court found that Young's fraud claim would not fail on the basis that the representations in question were made outside the Purchase Agreement.

Damages

The court did not discuss Young's damages claim as a distinct part of the fraud claim, but given that the core of Young's complaint centers on the lost earn-out payment, the final prong was sufficiently satisfied.

Accordingly, the court allowed Young's fraud claim to proceed other than with respect to statements considered "mere puffery."

Implied Covenant of Good Faith and Fair Dealing

In addition to the fraud claim, Young alleged that WCG breached the "implied covenant of good faith and fair dealing" that was incorporated into the Purchase Agreement by engaging in activities intended to frustrate the ability of Trifecta to achieve earn-out revenue milestones. The court granted WCG's motion to dismiss this claim.

According to the complaint, as part of the Purchase Agreement negotiations, Young's transaction counsel proposed to include an express requirement for WCG to undertake good faith efforts to achieve the earn-out revenue milestones. WCG's counsel responded that such a clause was unnecessary because, under Delaware law, there was an implied covenant of good faith and fair dealing which already obligated WCG to act in good faith to achieve the milestones. Relying on this alleged mutual understanding, Young did not insist on including an explicit obligation in the Purchase Agreement.

As described by the Delaware Supreme Court in its *Dieckman v. Regency GP LP* decision, under Delaware law, "[t]he implied covenant is inherent in all contracts and is used to infer contract terms to handle developments or contractual gaps that … neither party anticipated. It applies when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected. The reasonable expectations of the contracting parties are assessed at the time of contracting."[12]

The court noted that in order to invoke the implied covenant, there must be a gap in the purchase agreement that needs to be filled. The covenant will not be applied if: (1) there is no gap (*i.e.*, the language of the agreement covers a particular issue), or (2) there is a gap because the parties negotiated over a term and rejected it. Here, the parties specifically considered and discussed the inclusion of an explicit efforts requirement but elected not to do so. The court held that, because the efforts requirement was considered, there was no gap to fill by the implied covenant and dismissed this claim.

The court also observed that, because Young's claim was predicated on the existence of a

[12] *Dieckman v. Regency GP LP*, 155 A.3d 358, 367 (Del. 2017).

mutually agreed (albeit incorrect)[13] understanding that the implied covenant of good faith and fair dealing incorporated a requirement into the Purchase Agreement for WCG to use good faith efforts to achieve the earn-out, the claim constituted a breach of contract claim rather than a breach of implied covenant claim. However, the court held that such a breach of contract claim fails because of its reliance on preliminary negotiations to prove the existence of an unwritten understanding of the parties where a standard "entire agreement" integration clause was included in the Purchase Agreement. To do otherwise, the court continued, would be inconsistent with the parol evidence rule in Delaware, which prohibits the admission into evidence and consideration of preliminary discussions or other types of parol evidence to demonstrate the existence of an additional agreement in the face of a standard integration clause.[14]

Finally, the court noted that Young might have been able to make a claim for fraud based on the incorrect statements of Delaware law made by WCG's counsel, but noted that such a claim would need to be predicated on such counsel knowing that her statements were false, which may or may not have actually been the case.

Accordingly, the court dismissed the claim.

Key Takeaways

- The distinction between statements identified by the court as "mere puffery" and those considered to be specific enough to be actionable is very slight and, with the exception of the guaranteed revenue statement, virtually impossible to identify. Notwithstanding the absence of a clear line, buyers operating under earn-outs should nonetheless be cautious about making statements that could be construed as specific promises regarding their future operations, in any format or forum (including letters of intent), to the extent possible.
- Assuming an agreement with an earn-out provision includes an integration clause and non-reliance language, counsel to sellers should impart upon their clients in the clearest (and starkest) terms possible the limitations on their ability to rely on extra-contractual earn-out related assurances, and to view the same on a purely "trust me" basis. Depending on the client, sellers may not expect those limitations and could possibly value the earn-out differently as a form of transaction consideration as a result. Delaware law does not include a requirement for buyers operating under earn-outs to use any particular level of efforts to achieve the same, although buyers may not take actions for the specific purpose of frustrating earn-outs. There

[13] Under Delaware law, in the absence of any express contractual obligation to the contrary, a buyer operating a business subject to an earn-out is not required to operate such business in a manner intended to ensure or maximize earn-out payments. *Winshall v. Viacom Int'l, Inc.*, 76 A.3d 808, 811 (Del. 2013). Nonetheless, a buyer operating under an earn-out could be found to have breached the implied covenant where it took actions with the intention of negatively impacting the earn-out, such as shifting revenue out of the subject company for that purpose (*American Capital Acquisition Partners, LLC v. LPL Holdings, Inc.*, 2014 WL 354496 (Del. Ch. Feb. 3, 2014)), or actively shifting costs onto the subject company for such purposes (*Winshall*, 76 A.3d 808).

[14] Although not addressed by the court, such parol evidence would, on the contrary, be admissible under Delaware law to demonstrate the parties' understanding of an ambiguous provision. Here, the provision was absent, not vague or ambiguous.

would seem to be no advantage for a seller to attempt to remain silent on the efforts point during negotiations to preserve a potential "implied covenant" argument later.

- It is imperative that buyers, or any other party that is subject to an earn-out or earn-out-like requirement, include explicit anti-reliance language in the agreement, in addition to including a standard integration clause. The inclusion of the anti-reliance provision should be no more controversial than the inclusion of an integration clause. Buyers should not rely on the court's prior decisions in *Albertsons* or *Black Horse Capital* as having created a distinction between fraudulent inducement claims and fraud claims premised on factual misrepresentations.

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