

Share purchase agreement: validity of earn-out notice

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The Court of Appeal has considered whether a notice setting out a buyer's calculation of an earn-out was invalid because the buyer failed to comply with the terms of the underlying share purchase agreement in preparing the calculation.

Background

Where a transaction involves an earn-out (i.e. deferred payment calculated by reference to the post-completion performance of the target), the share purchase agreement will set out in detail how the earn-out is to be calculated. In this case, which involved the sale of two groups of companies, the agreement provided for the earn-out to be by reference to the pre-tax profits of those groups for the two calendar years ending 31 December 2011.

Following completion, the buyer changed the accounting reference date of the groups. This meant the audited accounts for the period required by the share purchase agreement were not available when the buyer came to calculate the earn-out. As a result, the buyer based the earn-out on the audited consolidated accounts of the buyer's group for a different period and otherwise on management accounts. The court had to consider whether this invalidated the notice, i.e. made it of no effect, or simply rendered it defective but capable of correction by expert determination under the terms of the share purchase agreement.

Decision

The Court of Appeal held that the buyer had not served a valid notice. The court held that there is a boundary between errors of the kind which do not invalidate a notice, such as accidental mathematical mistakes, and substantial departures from the contractual terms, which do. In this case the wholly non-compliant basis on which the buyer presented the notice was on the invalidity side of that line.

Comment

This decision is not surprising on its facts. However, it is a reminder that it is important to ensure that an earn-out calculation follows the exact requirements of the underlying share purchase agreement. It is also a reminder that the party which makes the calculation, usually the buyer, must be in a position to comply with those requirements and should not prejudice its ability to do so.

Treatt plc v. Barratt and others [2015] EWCA Civ 116

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