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July 2010

CORPORATE DEPARTMENT
ALERT

Will Sonoran Put the M&A Market in the Desert?

By David A. Jaffe

In a recent case sending shudders through the M&A bar, the United States Court of Appeals for the First Circuit has held that an acquirer of a distressed business owed the seller an implied covenant to make reasonably competent and diligent efforts to develop, market and sell the seller's products following the acquisition despite the absence of any express warranty or covenant in the acquisition agreement obligating the buyer in this regard. The implications of the case of *Sonoran Scanners, Inc. v. PerkinElmer, Inc.*[1] on M&A practitioners and on the M&A market generally are difficult to predict. If the case is followed widely, clearly the bar will have been lowered for seller-initiated lawsuits to withstand summary judgment motions without any need to prove bad faith on the part of the buyer. Conversely, if buyers are now required to negotiate express "absolute discretion" provisions in order to negate the implication of a good faith marketing and selling covenant into the acquisition agreement, the effects of *Sonoran* on acquisition activity could indeed be quite chilling until buyers and sellers are fully able to assimilate the impact of such provisions on the overall allocation of risk in acquisition agreements and the concomitant pricing expectations of parties in acquisition transactions.

In *Sonoran*, Joseph P. Donahue ("Donahue"), the founder of Sonoran Scanners, Inc. ("Seller") sought a buyer for his fledgling technology business during the year 2000 at a point in time when the company was running out of cash and had failed to generate any product sales. Donahue approached PerkinElmer, Inc. ("PerkinElmer"), a large multinational corporation, to gauge its interest in purchasing his company's computer-to-plate technology business. Following negotiations, on May 2, 2001, PerkinElmer and Seller entered into an Asset Purchase Agreement (the "Purchase Agreement") pursuant to which PerkinElmer agreed to pay Seller $3.5 million in cash at closing and earnout payments amounting to an additional $3.5 million payable over five years if certain product sale targets were met.[2] Following the closing, the business as operated by PerkinElmer was an abject failure, garnering the sale of only one unit in the first three and half years following the closing. Consequently, the earnout thresholds set forth in the Purchase Agreement were not achieved and no additional payments were made to the Seller. In September 2004, PerkinElmer exited the business through a sale of the assets purchased from Sonoran.[3]

In a suit brought in the U. S. District Court in Massachusetts[4], Donahue and Seller alleged four separate theories of liability against PerkinElmer including an alleged breach of the implied terms of the Purchase Agreement by failing to make good faith and reasonably competent and diligent efforts to develop, market and sell products. The district court granted summary judgment to PerkinElmer on all four claims. The Court of Appeals affirmed on three of the four theories but reversed and remanded on the fourth finding that, under Massachusetts law, the Purchase Agreement contained an implied

1 585 F.3d 535 (1st Cir. 2009) ("Sonoran").
2 *Id.* at 4.
3 *Id.* at 6.
4 *Sonoran Scanners, Inc. v. PerkinElmer, Inc.*, 590 F. Supp. 2d 196 (D. Mass. 2008)

contractual term requiring PerkinElmer to use reasonably diligent efforts to develop and promote Sonoran's technology.

The Court of Appeals, relying on Justice Cardozo's opinion in the ancient case of *Wood v. Lucy, Lady Duff-Gordon*,[5] and a Massachusetts case following it, *Eno Systems, Inc. v. Eno*,[6] found that PerkinElmer was bound by an implied covenant of reasonable marketing and selling efforts under the Purchase Agreement. In *Eno*, the Massachusetts Supreme Court held that one who obtains the exclusive right to manufacture a product under a patent has "an implied obligation to exert reasonable efforts to promote sales of the process and to establish, if reasonably possible, an extensive use of the invention."[7]

PerkinElmer sought to distinguish the facts of *Sonoran* from this precedent by arguing that the holding of *Eno* was limited on its facts to exclusive licensing arrangements or, under its broadest construction, to cases where an implied covenant is required because no other consideration supports the contract. PerkinElmer argued that the *Eno* case was inapposite to *Sonoran* in two material respects. First, the *Sonoran* transaction was an outright sale of assets rather than an exclusive licensing arrangement, and second, Seller received substantial tangible consideration at closing in the form of a cash payment of $3.5 million.

The Court of Appeals rejected each of PerkinElmer's arguments. With respect to the argument regarding adequacy of consideration, it held that *Eno* was not distinguishable from *Sonoran* on this basis because the licensor in *Eno* had in fact received remuneration beyond the mere promise of future payments. With respect to the argument regarding the form of transaction, the court cited to other Massachusetts cases holding that the form of transaction was irrelevant.[8] According to the court, the "key under Massachusetts law is that the instrument as a whole must make certain that the reasonable efforts term was implicit."[9]

In *Sonoran*, the court found three factors compelling in finding an implied covenant. The first factor related to the contingent portion of the purchase price representing such a significant component of the overall consideration that Seller was to receive – potentially amounting to as much as 50 percent of the total purchase price. The second factor was that virtually all of the non-contingent consideration, the cash paid by PerkinElmer at closing, went to Seller's creditors and thus did not benefit the shareholders of Seller directly. Third, the court found that the Purchase Agreement contemplated that PerkinElmer would market the technology over the next five years even if it was not expressly obligated to do so. The Court of Appeals held that these factors, combined with the absence of any language in the Purchase Agreement "negating an obligation by PerkinElmer to use reasonable efforts or conferring absolute discretion on PerkinElmer as to the operation of the business," resulted in an implied obligation on PerkinElmer to use reasonable efforts to develop and promote Seller's technology.[10] The case was reversed and remanded to the district court for further findings on that issue.

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[5] 222 N.Y. 88, 118 N.E. 214 (N.Y. 1917).

[6] 311 Mass. 334, 41 N.E. 2d. 17, 19-20 (Mass. 1942).

[7] *Id*.

[8] *Bridgewater Paper Co. v. Monadnock Paper Mills*, 161 F.2d 869 (1st Cir. 1947); *Russo v. Enter. Realty Co.*, 347 Mass. 655, 199 N.E. 2d 689 (Mass. 1964), *Graustein v. HP Hood & Sons, Inc.*, 293 Mass. 207, 200 N.E. 14 (Mass. 1936).

[9] *Eno*, 41 N.E.2d at 19.

[10] *Sonoran*, 585 F.3d at 544.

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