A million reasons for Rangatira to be bitter about the Tuatara earn-out

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1. EXECUTIVE SUMMARY

1.1 The Court of Appeal's decision in *The Malthouse Ltd v Rangatira Ltd*[1] case highlights some of the risks with earn-out arrangements and, in contrast to other recent rulings,[2] illustrates a revival of a more traditional "black letter law" approach to contractual interpretation.

1.2 The Court did not accept either of the buyer's (Rangatira's) contentions that the surrounding evidence of the parties' intentions and/or commercial common sense meant that a deadline for the earn-out's fulfilment must be read-in or implied. Rather, the Court found that:

(a) there was no clear, explicit and objective evidence supporting the imposition of a deadline;[3] and

(b) only in very clear cases, where the commercial objective of the parties was self-evident, [4] would it depart from the plain meaning of a closely negotiated commercial contract such as this. These facts did not meet those tests.

1.3 These findings meant that Rangatira was obliged to pay almost $1M extra for its 35% stake in Tuatara Brewing Company Limited ("**Tuatara**").

1.4 This decision serves as a strong reminder to ensure that when negotiating contracts, including M&A deals, conditions must be drafted exactly to match the meaning that your side/client intends. Getting that wrong can be very expensive.

2. THE MALTHOUSE LTD V RANGATIRA LTD

2.1 In 2013 the privately-owned craft brewer Tuatara sought to significantly expand its operations through an arrangement between the founding shareholders, The Malthouse Ltd ("**TML**"), and private equity firm Rangatira Limited ("**Rangatira**"). The parties agreed that Rangatira would provide management expertise and capital in return for a 35% stake in Tuatara. The vision was to make Tuatara even more attractive to a major brewer.

2.2 However, disagreement arose over valuation. TML believed the business was worth $12 million and that Rangatira should buy in for $4.5 million. Rangatira asserted it was worth no more than $10 million and wanted to pay $3.5 million for its stake. To avoid an impasse, an "earn-out" clause was drafted into

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[1] *The Malthouse Ltd v Rangatira Ltd* [2018] NZCA 621.
[2] "A tale of two earn-outs" by John Horner, New Zealand Law Society, dated 5 October 2018; and as illustrated by the High Court in *The Malthouse Ltd v Rangatira Ltd* [2018] NZHC 816 and *Hi-Tech Ltd v Waikato Milking Systems Partnership Ltd* [2018] NZHC 1413.
[3] *Above at 1*, at [47].
[4] At [50].

the Investment Agreement - Rangatira would pay TML and Tuatara the lower price on settlement, but would pay contingent payments totalling $1 million if certain conditions were met.

2.3 The triggers for the contingent payments were:

(a) Tuatara achieving EBITDA of at least $2 million over any period of 12 consecutive months ("**EBITDA Hurdle**") before 31 December 2015 ("**Sunset Date**"); or

(b) Tuatara being sold for more than $12 million (an "**Exit Event**").

2.4 Tuatara did not meet the EBITDA Hurdle before the Sunset Date. However, Tuatara was sold to Dominion Breweries in 2017 for a reported $30.5 million,[5] far in excess of the $12 million target.

2.5 TML asked for the earn-out payment. Rangatira refused on the basis that it was implied that the Sunset Date applied to the Exit Event and this sale had occurred 13 months after the Sunset Date.

2.6 The key issue was whether Rangatira's obligation to pay the balance arose only if the Exit Event happened *before* the Sunset Date.

3. HIGH COURT - SUNSET DATE IS IMPLIED

3.1 The High Court found in favour of Rangatira, holding that the contingent payment upon an Exit Event was not intended to apply after the Sunset Date. The court considered background evidence of pre-contractual conversations and information available to the parties. This included a drafting note in a previous draft of the Investment Agreement to what became the earn-out provision, stating in relation to the Exit Event hurdle that it was "*not anticipated but inserted for completeness*". The court believed this was a reference to the likelihood of a sale before the EBITDA Hurdle was met.[6]

3.2 Based on the wording of the contract, TML argued that by expressly referring to the Sunset Date in connection with the EBITDA Hurdle and not doing so in relation to an Exit Event showed that the parties had clearly thought about the issue - that they clearly did not intend for an Exit Event to be subject to the Sunset Date.[7] The High Court rejected this argument and concluded that it was much more likely that it was an oversight and that both parties understood that an Exit Event had to occur before the Sunset Date to result in the obligation to pay.[8]

3.3 The commercial objective behind the earn-out provision was also considered. The High Court found the provision was intended to facilitate the sale of the shares to Rangatira at a price reflective of the actual value of shares *at the time* the agreement was entered into (rather than "*at some distant time in the future*").[9] In the court's opinion, ascertaining the fair value had to be linked to the value at or relatively soon after mid-2013.[10] The court found that:

> *"…It would make no commercial sense at all, in terms of ascertaining the value of the company in mid 2013, for an Exit [E]vent at a date far in the future to automatically trigger liability. There would be a disconnect between such an event and the parties' commercial objective of providing a mechanism to ascertain a fair value of the company as at 2013."*[11]

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[5] "DB Paid $30.5m for Tuatara last year" by Paul McBeth, New Zealand Herald (https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12062805).

[6] *The Malthouse Ltd v Rangatira Ltd* [2018] NZHC 816, at [93] to [97].
[7] At [101].
[8] At [102].
[9] At [103] and [104].
[10] At [108].
[11] At 2, [106]

3.4 Overall, the High Court found that the parties intended that payment contingent on the sale of Tuatara would only occur if that sale happened *prior to* the Sunset Date. Applying the *BP Refinery*[12] test, the court believed it was appropriate to connect the Sunset Date concept to the Exit Event hurdle, implying words into the relevant clause to that effect.[13] The court went even further to speculate that TML's claim that the Exit Event hurdle was open-ended and not subject to the Sunset Date was an attempt by the founding shareholders to achieve by another route an outcome which they felt they had been wrongly deprived of.[14]

4. COURT OF APPEAL FINDS SUNSET DATE DOES NOT APPLY

Approach

4.1 The Court of Appeal emphasised that the correct approach to contractual interpretation[15] is:

(a) an objective one[16] and although the background material available for examination cannot be limited, it must be reasonably relevant and objective[17]; and, perhaps correspondingly, evidence of a party's individual subjective intention is inadmissible[18]; and

(b) whilst amendments can be read into a contract, the party seeking to make them must point to clear justifying evidence[19]; and

(c) where the words in the contract have a natural and ordinary meaning, departing from that meaning for reasons of commercial common sense should only occur in the most obvious and extreme of cases.[20]

Importance of surrounding facts

4.2 Regarding the parties' conversations, in contrast to the High Court, the Court of Appeal found:

(a) they did demonstrate TML's general concerns about the possibility of a sale of Tuatara before the EBITDA Hurdle could be reached;[21]

(b) however, it was not inevitable that the conversations should therefore be understood to contain an understanding on both sides that the sale must occur before the Sunset Date for the Exit Event earn-out to be triggered[22];

(c) rather there were indications that there were no discussions about a time limit in connection with the Exit Event[23].

4.3 So, the Court rejected Rangatira's submission that the conversations constituted relevant objective background evidence that the Exit Event earn-out provision was intended solely to deal with TML's concern that Tuatara could be bought out before the EBITDA Hurdle was met.[24] Moreover, it found that though the clause may have been intended to protect the original shareholders in the event of a buy out, it did not follow (as Rangatira submitted) that it must have been time limited.

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[12] *BP Refinery (Westernport) Pty Ltd v Shire of Hastings (BP Refinery)* (1977) 180 CLR 266 (PC).
[13] At [125] to [143].
[14] At [144].
[15] 1 above at [18] (established in *Vector Gas Ltd v Bay of Plenty Energy Ltd (Vector)* [2010] NZSC 5, [2010] 2 NZLR 444 and *Firm PI I Ltd v Zurich Australian Insurance Ltd (Firm PI)* [2014] NZSC 147, [2015] 1 NZLR 432).
[16] 1 above at [19].
[17] Ibid.
[18] Ibid.
[19] 1 above at [23].
[20] At [24].
[21] At [26] to [28]
[22] At [29]
[23] At [30]
[24] At [31]

Natural meaning of provision

4.4 The Court of Appeal found that the natural meaning of the relevant contractual provision was clear – there was no time limit associated with the Exit Event hurdle. It operated independently of the EBITDA Hurdle.[25] So, in the context of an otherwise carefully-negotiated agreement, the court viewed the absence of the Sunset Date in connection with an Exit Event as deliberate.[26] Also, the court believed the subjective evidence put forward by the parties failed to shed any real light on the timing issue – clear, explicit objective evidence was needed to alter the natural, well-drafted meaning of the clause.[27]

Commercial purpose

4.5 The commercial purpose advanced by Rangatira (and accepted by the High Court) for the implication of the Sunset Date into the Exit Event clause was that it captured the value of the company at a point in time that was closely connected with the point in time at which its value was disputed by the parties.[28]

4.6 The Court of Appeal disagreed - finding that such a commercial purpose was far from evident and that this was not such a clear case as it should depart from the wording of this closely negotiated contract.[29] TML suggested an alternative commercial purpose – that the sale of Tuatara was a backstop to protect it if the EBITDA Hurdle was not met and, though open-ended, the longer it took for a sale to occur, the lower the cost in real terms of the almost $1 million in contingent payments. The court found that this argument was plausible[30] and that there was nothing troubling about a potentially open-ended contractual obligation – after all, the objective of both parties was that Tuatara would be sold to a 3rd party.[31] Overall, however, the court concluded that there was insufficient evidence of a mutually agreed upon commercial purpose, so the inquiry as to business common sense could go no further.[32]

Implied Term

4.7 Rejecting the High Court's implied term, the Court of Appeal held that applying the *BP Refinery* test, it would be inappropriate to read words into the contract. Any implied term would change the balance of the bargain the parties struck, there was no need for additional machinery to make the Exit Event hurdle effective and the implied term was far from being so obvious as to go without saying.[33]

5. OBSERVATIONS

5.1 The Court of Appeal's decision in *The Malthouse Ltd v Rangatira Ltd* sends a strong warning to those involved in deals with commercial considerations, including M&A deals, that any conditions must be drafted as clearly as possible. In particular, if there is a timeframe for a condition, this needs to be expressly stated. When evidence of discussions or verbal agreements put forward by the parties are too subjective, the courts will be reluctant to depart from the natural meaning of the contractual wording. So, it appears that the courts will depart from the natural meaning of the contract only in the most extreme cases, where the objective evidence shows that it is abundantly obvious that the contract is not an accurate reflection of the bargain actually reached.

5.2 For Rangatira, the Court of Appeal's ruling will no doubt have left a bitter taste. For the rest of us, including any lawyers and parties involved in negotiating contracts, it serves as a warning of how costly it can be to not clearly document a deal.

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[25] At [33] to [37]. At 2, [36] the court found that: *"…the drafters of the contract turned their minds to making the Conditional Sunset Date an explicit requirement in [the EBITDA Hurdle clause], and equally could have (but did not) do so in [the Exit Event clause.*
[26] At [40].
[27] At [47].
[28] 6 above at 1, [106].
[29] At [50].
[30] At [51].
[31] At [53].
[32] At [52].
[33] At [57] to [60].