DELAWARE CORPORATE LAW BULLETIN

Chancery Court Refuses to Alter Contractual Allocation of Risk Between Sophisticated Parties

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Emphasizing Delaware's pro-contractarian policy, Vice Chancellor warns of "detriments of imprecise drafting"

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INTRODUCTION

Risk allocation is one of the key drivers of commercial contract negotiation and drafting. For instance, the detailed representations and warranties typically given by the seller of a business or other asset to the buyer in a definitive purchase agreement "serve an important risk allocation function." At the same time, when post-closing disputes arise between a buyer and a seller over which party should bear the risk of a particular loss, Delaware courts are disinclined to interpret "clear and unambiguous" contract language to alter contractually agreed upon risk allocation. This is especially true when the parties are "sophisticated" and the risk in question was known to the parties at the time of signing but not specifically addressed in the contract. In short, "Delaware courts 'respect the ability of sophisticated businesses . . . to make their own judgments about the risk they should bear and the due diligence they undertake, recognizing that such parties are able to price factors such as limits on liability.' "

Julius v. Accurus Aerospace Corp., No. 2017-0632-MTZ, 2019 WL 5681610 (Del. Ch. Oct. 31, 2019) ("*Julius v. Accurus*"), involved such a dispute. According to Vice Chancellor Morgan T. Zurn of the Delaware Court of Chancery ("*Chancery Court*"), Delaware adheres to a "pro-contractarian policy" which denies contracting parties the right to "'come to court to enforce a contractual right that it did not obtain for itself at the negotiating table.' Delaware law presumes parties are bound by the language of the agreement they negotiated, especially when the parties are sophisticated entities that have engaged in arms-length negotiations."

I. FACTUAL BACKGROUND

A. ZTM's Relationship with Boeing

ZTM, Inc. ("*ZTM*" or "*Company*") "manufactured large, complex precision aerospace parts and assemblies for major commercial aviation and military customers." The Boeing Company ("*Boeing*") "was the

'bread and butter' of ZTM's business," accounting for approximately 66% of sales in 2014 and projected to grow to approximately 70% of sales by 2016.

The commercial relationship between ZTM and Boeing followed the "industry-standard pattern." The two companies signed a Long Term Agreement ("*LTA*") outlining "the terms on which the supplier [ZTM] will manufacture parts for the customer [Boeing]." Specific subcontracts (which typically expired before the scheduled expiration of the LTA) would be signed as an amendment to the LTA when Boeing awarded ZTM the right to produce specified parts on agreed-upon terms following a bidding process. However, there was no guarantee when ZTM submitted a renewal bid on an expiring subcontract that Boeing would not award the business instead to a competing bidder. Parts awarded to a competing bidder "roll[ed] off" the LTA on the subcontract's expiration date. The ability to rebid on expiring subcontracts with Boeing was the "lifeblood" of ZTM's business. Accordingly, in the ordinary course of business, ZTM representatives contacted Boeing seeking permission to rebid on parts under subcontracts scheduled to expire in 2016 and 2017.

B. ZTM Seeks a Buyer

In 2015, ZTM founder and controlling stockholder Bradley E. Julius ("*Julius*") began a process to sell ZTM, touting the Company "as the 'second largest interior shop for Boeing Commercial.' " Among the potential bidders contacted by the Company's broker was Liberty Hall Capital Partners, L.P ("*Liberty*"), a private equity firm which, through Accurus Aerospace Corporation ("*Accurus*" and, together with Liberty, "*Buyers*"), invests in "aerospace manufacturing companies." Among other information, ZTM provided Liberty with projections which included "information on the airplane part numbers under contract, part quantities, the contract expiration dates, pricing, gross margins, sales, projected sales, and other financial information," as well as details on the expiration dates of current subcontracts with Boeing and the status of rebids. Although it could offer no guarantee, ZTM indicated to Liberty its belief that "the prospective buyer would have the opportunity to bid" on parts subject to subcontracts expiring at the end of 2016. Apparently, Liberty "'heavily relied' on these projections" in submitting an offer on March 11, 2016, to buy ZTM for $80 million. Further, Liberty's "primary negotiator" admitted that he was aware of the nature of the rebidding process with Boeing, including that, post-

sale, "there was no guarantee that Accurus would win a bid to continue manufacturing expiring parts."

Subsequently, on June 3, the parties signed an Asset Purchase Agreement ("*APA*"). The purchase closed on July 29 ("*Closing*"). According to the APA's integration clause, "[t]he Transaction Documents constitute the entire agreement and understanding of the Parties and supersede all prior agreements, undertakings, negotiations, and communications, both written and oral, among the Parties, or any of them, with respect to the subject matter hereof."

In addition to the APA, the Transaction Documents included an Escrow Agreement ("*Escrow Agreement*") under which Accurus deposited $3 million of the purchase price "for the exclusive purpose of satisfying Accurus in the event Accurus suffered indemnifiable losses" caused by a breach of representations and warranties by ZTM in the APA. The APA contained numerous representations and warranties concerning ZTM's business and financial condition, but no "explicit representation or warranty as to the accuracy of the projections . . . shared with [Buyers] prior to entering into the APA." In fact, the projections were not referenced in the APA at all, nor did the APA "guarantee that Buyers would be able to renew expiring parts, or even that Boeing would allow Buyers to bid on such parts."

C. Post-Closing Dispute and Resulting Litigation

After the Closing, the Buyers realized through correspondence with Boeing that fifty-three parts ("*Lost Parts*") referenced in the projections as subject to subcontracts, accounting for approximately 10% of ZTM's projected 2017–2019 sales, had been awarded by Boeing to other suppliers *as far back as 2013*. Neither ZTM nor the Buyers were aware prior to Closing that, as a result of these awards, ZTM effectively had lost the opportunity to rebid on the Lost Parts.

Understandably frustrated with this significant loss of revenue, on September 26, 2017, Accurus delivered an indemnification claim in accordance with the procedures set forth in the APA and the Escrow Agreement, demanding that no funds be disbursed under the Escrow Agreement pending resolution of the responsibility for the revenue losses from the Lost Parts. In response, Julius, on his own behalf and on behalf of the other selling stockholders of ZTM (collectively, "*Sellers*"), filed suit in Chancery Court seeking (among other relief) (1) a declaratory judgment that the Buyers breached the APA and the Escrow Agreement by withholding the escrowed funds and (2) specific performance of the Escrow Agreement to obtain release of those funds. The Buyers counterclaimed, claiming that they had overpaid for the

Company due to the breach of the following "express representations in the APA" ("*Disputed Representations*"):

- *Section 3.25(d)*: "[ZTM] has disclosed to Buyer any material disputes, complaints, or issues with respect to any customers or suppliers . . . ." ("*No Business Issues Representation*")
- *Section 3.25(a)*: "Since the Balance Sheet Date, no customer, distributor, or supplier of the Business has terminated or materially reduced or altered its business relationship with [ZTM] . . . or materially changed the terms on which it does business with [ZTM], or threatened that it intends to cancel, terminate, or otherwise materially reduce or alter its business relationship with [ZTM]." ("*No Business Reduction Representation*")
- *Section 3.7(a)*: "Since the Balance Sheet Date . . . there has not been any … event, occurrence, or development that has had, or reasonably could be expected to have, individually or in the aggregate, a Material Adverse Effect." ("*No MAE Representation*")
- *Section 3.28*: "No representation or warranty made by [ZTM] in this Agreement . . . contains any untrue statement of a material fact, or omits to state a material fact necessary to make the statements contained therein, in light of the circumstances in which they are made, not misleading." ("*No Misstatements/Omissions Representation*")

For purposes of the APA, the "Balance Sheet Date" was December 31, 2015. On April 15, 2019, the Buyers and Julius both filed cross-motions for summary judgment.

II. VICE CHANCELLOR ZURN'S ANALYSIS

The key question for Vice Chancellor Zurn was "whether Sellers represented that Buyers would undoubtedly have the opportunity to bid on the Lost Parts under the APA's plain and unambiguous terms." After the Buyers ultimately acknowledged the projections were neither part of, nor covered by, the APA, the Vice Chancellor looked only to the "plain language of the APA's representations or warranties to determine whether the parties accounted for the risk of unknown and undisclosed lost parts." On the basis of this examination, the Vice Chancellor concluded that "Buyers' bargained-for representations and warranties did not protect them against the risk that they would be unable to bid on the Lost Parts." Accordingly, because the Sellers had not breached

the APA, the Buyers had not suffered a loss entitling them to indemnification and "must release the escrowed funds" to the Sellers.

A. The Sellers Did Not Breach Their Representations and Warranties in the APA

According to the Buyers, the Sellers breached the Disputed Representations by "failing to notify Buyers that (1) Boeing had awarded the Lost Parts to other suppliers in 2013 and 2014 and (2) therefore, Accurus did not have the opportunity to bid on the Lost Parts." In effect, the Buyers claimed that they had purchased not only ZTM's assets, but also "the opportunity to re-bid" on the Lost Parts.

Applying accepted principles of Delaware contract interpretation, Vice Chancellor Zurn explained that the "parties are bound by the language of the agreement they negotiated, especially when the parties are sophisticated entities that have engaged in arms-length negotiations." Because the APA provided no guarantee that there would be an opportunity to rebid on the Lost Parts post-Closing and because there was no obligation for the Sellers (had they known Boeing had awarded the Lost Parts to other suppliers) to so notify the Buyers, the Sellers had not breached any of the Disputed Representations.

1. No Business Issues Representation

The Buyers alleged that the loss of the opportunity to rebid on the Lost Parts represented a breach by the Sellers of the No Business Issues Representation. Analyzing several definitions of the term "issue," the Vice Chancellor concluded that, because there was no "actual dispute or question raised by ZTM or Boeing that ZTM or Boeing intended to resolve" related to the Lost Parts, there was no "issue"—as that term was used in the No Disputes Representation—when it came to the Lost Parts. Rejecting the Buyers' argument that interpreting "issue" as synonymous with "dispute" created redundancy, the Vice Chancellor explained that "[m]y interpretation reflects conservative verbosity, not improper redundancy. . . . Although the Court prefers to avoid surplusage when interpreting a contract, I decline to dismiss the plain and ordinary meaning of 'issues' to achieve that goal."

2. No Business Reduction and No MAE Representations

Likewise, the Vice Chancellor determined that the Sellers had not breached their No Business Reduction Representation or their No MAE Representation. Both representations were subject to "dispositive

temporal cutoffs": each covered only events occurring *after* the "Balance Sheet Date," that is, December 31, 2015. The parties acknowledged that Boeing awarded the Lost Parts to ZTM's competitors in 2013 and 2014, long before the Balance Sheet Date. However, the Buyers contended that the triggering event for purposes of these representations did not occur until after the Balance Sheet Date when Boeing could have given ZTM the opportunity to rebid for the Lost Parts but failed to do so. The Vice Chancellor rejected this argument, explaining that the relevant triggering event for purposes of these representations occurred when Boeing awarded the Lost Parts to other suppliers and thereby "conclusively eliminated ZTM's opportunity to bid on the Lost Parts." This occurred well in advance of the Balance Sheet Date and, therefore, had no relevance for the purpose of either the No Business Reduction Representation or the No MAE Representation.

3. No Misstatements/Omissions Representation

Finally, the No Misstatements/Omissions Representation operated as a "catch-all [sic] provision" providing general assurance that there were no material untrue statements in or omissions from the Sellers' representations and warranties in the APA. Once again, Vice Chancellor Zurn turned to the APA's plain language, noting that the APA neither guaranteed there would be an opportunity to bid on the Lost Parts nor required the Sellers to notify the Buyers of the lost opportunity. In short, because the Disputed Representations "failed to shift to Sellers any risk that Accurus would not have the opportunity to bid on the Lost Parts," the "Buyers cannot now rely on the APA's catchall provision 'to enforce a contractual right that it did not obtain for itself at the negotiating table.' " The Sellers informed the Buyers during the due diligence and contract negotiation phases "that the Lost Parts were expiring in 2016," yet the "Buyers failed to protect the uncertain future of the Lost Parts in the APA." As such, "[b]y failing to negotiate for contractual protections related to the Lost Parts, Buyers bore the full risk of loss."

B. The Buyers Did Not Breach the Escrow Agreement or APA

In addition to their plea for specific performance, the Sellers claimed that the Buyers breached the Escrow Agreement and the APA by ordering the withholding of escrow funds based on "a meritless breach theory." Vice Chancellor Zurn rejected this claim, noting that the Sellers did not contest that the Buyers followed "negotiated and agreed-upon . . . procedures" for claiming indemnity as stipulated in the

APA and the Escrow Agreement. Just making a claim for breach, even one that ultimately turns out to be unsuccessful, "is not evidence of a breach of contract."

CONCLUSION

In her opinion, Vice Chancellor Zurn instructed that *Julius v. Accurus* "teaches an important lesson about the benefits of allocating risk among contracting parties and detriments of imprecise drafting." In essence, the Buyers were in search of a remedy not expressly provided by the APA when they discovered post-Closing, undoubtedly much to their chagrin, that future revenues had disappeared even before they signed the APA. Neither the contract language nor the equities favored the Buyers, however, as they were made aware during due diligence of the possibility that they might not be allowed to rebid on the Lost Parts. Having failed to price this risk into the purchase price or otherwise expressly account for it in the APA, the Buyers were left with makeweight arguments that ultimately were foreclosed by the APA's integration clause—limiting the Buyers' recourse to the actual representations and warranties set forth in the APA no matter what they may have been told of the Sellers' expectations during due diligence—and the limited breadth of the Disputed Representations. Having failed to allocate this risk to the Sellers in the APA, the Buyers faced a high bar in asking the Chancery Court for relief. The Vice Chancellor's response was quite simple and straightforward: "If preserving opportunities to bid on potentially lost parts was so valuable to Buyers, they could have bargained for explicit protections against lost opportunities. They failed to do so."