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Make a fence around what matters: protecting the heart of the deal

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At bottom, contracts set out rules for a relationship. The principal operative terms of a contract are its covenants — those agreements and promises that dictate (or proscribe) activities.

While promises are surely as old as time, the first documented promise, at least in one telling, was the covenant between God and Adam, as it was amended over the generations from Noah down to David.[1]

The Bible is a well-recognized source of many legal principles in the Western tradition,[2] but one area in which its influence is rarely acknowledged is contract law. After all, although several of its early books contain rules governing the making of contracts,[3] the coarse rudiments of business are not exactly the province of philosophical — let alone religious — thought.

And yet the practitioner of contract law can learn much from the practical insights gleaned by the interpreters of these ancient texts. One in particular is sparingly employed without second thought by many who live and breathe the world of articles, sections, and subsections: making a fence around the Torah.

As a central concept within the genealogy of Rabbinic authority, "making a fence around the Torah" is a curious conceit with profound implications. The animating idea is that the Torah — the actual rules propounded by the ultimate authority — should not be breached.

Accordingly, the best means of protecting against this utmost material breach is to craft prophylactic provisions that are more stringent than the central rules. While those provisions (the "fence") may be susceptible of breach more readily, those breaches are venial or at least surmountable — unfortunate but not intolerable.

But merely by being in place, these provisions prevent a worse transgression. In other words, the heart of the agreement is insulated from failure because the parties are incentivized not to even approach the line dividing tolerable from intolerable.

In the world of twenty-first century contract law, this fence-making exercise still has its place. Indeed, many contracts, by common practice, often contain provisions that resemble the concept of a fence around the core concern.

We see provisions requiring the delivery of notices and reports and financial information within specified time frames, without pre-agreed remedies for late or omitted deliveries. Or we have general covenants to facilitate financing that are bolstered by specific covenants to take certain actions, all caveated by an "efforts" standard (whether it be commercially reasonable, reasonable best, or best efforts — woe to thee who forces his counterparty to descry a difference among these).

By being more cognizant of fence-making's advantages, parties to a contract can better identify what really matters and what merits extra protection.

All of these, at least implicitly, create fences around the agreements that really matter — to wit, information rights support other rights like financial covenants and governance rights; debt financing cooperation covenants support the actual ability to close on time and with mutually advantageous terms; and so on.

By being more cognizant of fence-making's advantages, parties to a contract can better identify what really matters and what merits extra protection. At the same time, a savvy negotiator can better protect her client against the most-deleterious breaches, as well. Take, for instance, one of the most contentious concepts in a typical acquisition agreement (and the one most likely to give rise to a dispute): an earnout.

In its ideal form, an earnout (or any contingent payment) serves the essential function of bridging a valuation gap between a buyer and a seller. The seller believes the business it's offering to sell is worth $X, the buyer believes it's worth $X minus $Y, and they agree to make a deal where the buyer may end up paying $X if certain metrics, after the closing, show that $Y did not need to be subtracted. Or thereabouts.

In any case, the brevity of the earnout provisions in an acquisition agreement often belies their complexity and the likelihood of litigation. But, by heeding the injunction to "make a fence" around what matters most, parties can produce a superior outcome.

In the position of the buyer, what matters most in an earnout is control and certainty — the buyer doesn't want a meddling seller involved in the business after closing and it wants assurance that it only must make the earnout payment if the agreed-on metrics are actually met.

While standard practice, in private equity transactions, limits a seller's rights to influence post-closing operations (e.g., with soft covenants from the buyer not to intentionally take actions to reduce the earnout or not to take certain specific actions that both parties agree will be material and adverse), there are fewer standard practices to insulate a buyer from the cost and disturbance of a disgruntled seller that has every incentive to make a ruckus.

By requiring the buyer to comply with less-onerous, less-costly covenants in the lead-up to the earnout's determination, the seller is almost able to create a culture of compliance.

Simply put: practitioners can do more to protect buyers from this risk, if only they would consider preventative provisions that guard this paramount concern.

For buyers, then, one might consider including a clause that ensures that the buyer will receive its attorneys' and experts' fees (and other costs) if it prevails in any dispute regarding an earnout — whether or not the dispute reaches a court. Thereby imposing a meaningful cost on the seller if it insists on pursuing a dispute.

Or, as an even greater disincentive to raise a half-baked objection, the buyer could insist on liquidated damages in the case that it prevails in a dispute or, as is customary in equity commitment letters, that the obligation to pay the earnout would terminate or be punitively reduced if the seller brings (or threatens to bring) any claims beyond those that the agreement specifically permits.

All of these would protect the buyer's core interest: keeping its attention on operating the business and not having to pay off the seller only because the cost (in dollars and distraction) of attending to the dispute is too high. And these provisions do so by setting incremental limits beyond that core interest.

From a seller's perspective, these provisions don't merely need to be flipped in order to "make a fence" around its core interest — although that wouldn't be an imprudent pursuit. Rather, more judiciously, what a reasonable seller should want is assurance that it will be paid what it's owed and that no games are played to avoid or reduce this payment.

As noted, certain customary covenants already exist to address game-playing. But, too often, sellers neglect to consider all the intermediate means they could have at their disposal — protections and signals they could put in place before the earnout period has ended and their only resort is to a dispute-resolution process.

In particular, sellers rarely advocate for interim steps to the earnout payment. While this could entail earlier increments of payments, if the structure permits this approach, it could also take the form of even less intrusive check-ins — e.g., delivery of monthly updates and forecasts, the ability to have periodic meetings with relevant principals, audit rights, etc.

All these interim covenants would provide the seller with a view into the buyer's operations — guaranteeing some minimum level of transparency, and thus serving as its own armament against prospective abuse — while also instituting a system for broader compliance.

In other words, by requiring the buyer to comply with less-onerous, less-costly covenants in the lead-up to the earnout's determination, the seller is almost able to create a culture of compliance, to instill an expectation on the part of each party that all aspects of the earnout determination will be carried out reliably and undisguisedly.

Even more, while there may be no immediate means of rectifying another's bad faith, a seller that has the right to see information, voice its opinion, and simply do more than stand aside and wait, will also observe warning signals that its core interest is under threat. The fences it will have installed around that core interest will likely fall first, allowing the seller to take whatever actions are available to it to reinforce its defenses.

Because contracts are, in some ways, a lavish form of fence — designed, labored over, and finished with a flourish, all in the hope that what it contains will never be violated — it should come as no surprise that a practitioner will advocate for more fencing.

But the point, as demonstrated above, is that particular parties have particular key concerns, and, by centering those concerns in drafting, practitioners can better advocate for and protect those concerns. Sometimes, the best means of accomplishing that paramount objective is by building a fence (or two or three) that must be breached before what truly matters is put in peril.

Notes:

[1] See Hahn, Scott, "Covenant in the Old and New Testaments: Some Current Research," Currents in Biblical Research 3, no. 2 (2005): 163-292, available at https://bit.ly/3WaqzWX.

[2] See Driesbach, Daniel L., "The Bible in American Law," in The Oxford Handbook of the Bible in America 17 (Paul C. Gutjahr ed., Oxford Univ. Press 2017).

[3] See Hiers, Richard H., "Ancient Laws, Yet Strangely Modern: Biblical Contract and Tort Jurisprudence," 88 U. Det. Mercy L. Rev. 473, 475 (2011), available at https://bit.ly/3UoBPOb; see also Miller, Geoffrey P., "Contracts of Genesis," The Journal of Legal Studies 22, no. 1 (1993): 15–45, available at https://bit.ly/3U9xihl.

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