

Dr. Fresh Holdings, LLC v High Ridge Brands Co.

2019 NY Slip Op 32066(U)

July 15, 2019

Supreme Court, New York County

Docket Number: 654925/2018

Judge: Jennifer G. Schechter

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This opinion is uncorrected and not selected for official publication.

SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK: PART 54

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DR. FRESH HOLDINGS, LLC,

Index No.: 654925/2018

Plaintiff,

DECISION & ORDER

-against-

HIGH RIDGE BRANDS CO.,

Defendant.

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JENNIFER G. SCHECTER, J.:

Pursuant to CPLR 3211, defendant High Ridge Brands Co. (High Ridge) moves to dismiss the complaint. Plaintiff Dr. Fresh Holdings, LLC (Dr. Fresh) opposes the motion. The motion is denied.

Background

The facts are drawn from the complaint (Dkt. 1) and are assumed true unless conclusory or refuted by documentary evidence.

Pursuant to an Amended and Restated Purchase and Sale Agreement dated December 29, 2016 (Dkt. 2 [the PSA]), Dr. Fresh sold Dr. Fresh Blocker, LLC and its subsidiaries (collectively, the Company)¹ to High Ridge for a base purchase price of \$205 million plus the right to four quarterly earnout payments based on the Company's Gross Profit for the period between December 29, 2016 and December 31, 2017.

¹ The Company sells oral-care products through retailers in North America and Europe.

The earnout payments are governed by section 2.8 of the PSA (*see id.* at 25). For each quarter, the payment could be: (a) a fixed sum if the Company's Gross Profit exceeded a specified amount; or (b) a percentage of Gross Profit if Gross Profit was below that specified amount; or (c) nothing at all if Gross Profit was below a specified amount. For each quarter, the Gross Profit targets are cumulative of the prior quarters. In the fourth and final quarter, section 2.8(a)(iv) provides that either: (a) the earnout payment is \$10 million, minus all prior earnout payments, if the cumulative Gross Profit is at least \$59,373,408; or (b) if the cumulative Gross Profit is between \$53,801,053 and \$59,373,408, the earnout payment is a specified percentage of \$10 million, depending on the exact Gross Profit, minus all prior earnout payments; or (c) if the cumulative Gross Profit is less than \$53,801,053, no earnout payment is due (*see id.* at 26-27). Section 2.8(b) provides that Gross Profit is to be calculated "consistent with GAAP and past practices" (*id.* at 27).

Section 2.8(c) governs Dr. Fresh's right to challenge High Ridge's gross profit calculations (*see id.*). It requires High Ridge to deliver an Earnout Statement within 20 days of each Earnout Period (*id.*). It further provides that if Dr. Fresh disagrees "*with the calculation of the amount of Gross Profit or the amount of the Earnout Payment*", it shall notify [High Ridge] of such disagreement in writing (the "Seller Earnout Objection"), setting forth in reasonable detail the particulars of such disagreement, within fifteen (15) Business days after its receipt of the Earnout Statement. In the event that [Dr. Fresh] does not provide such Seller Earnout Objection within such fifteen (15) Business-day

period, [Dr. Fresh] shall be deemed to have accepted the Earnout Statement and the calculation of Gross Profit and the amount of the Earnout Payment *for such Earnout Period*, delivered by [High Ridge], *which shall be final, binding and conclusive for all purposes hereunder*" (*id.* [emphasis added]). Disagreements after a timely objection were ultimately to be resolved by submission of the disputes to an Auditor (*id.*).

High Ridge timely sent Earnout Statements to Dr. Fresh for all four quarters and made a total of \$2,176,492 in Earnout Payments. Dr. Fresh did not object to the first three Earnout Statements. It did, however, timely object to the fourth Earnout Statement covering the period between October 1 and December 31, 2017. Dr. Fresh's objections were based on High Ridge's alleged violations of covenants set forth in section 2.8(e). High Ridge allegedly violated section 2.8(e)(i) by failing to operate the Company "in a manner consistent with past practice" (*see id.* at 28). For instance, Dr. Fresh alleges that, unlike prior to closing, the Company "commingled Dr. Fresh products with its other branded products during the manufacturing, storage and delivery process and improperly booked costs related to High Ridge Brands' other branded products to Dr. Fresh," thereby increasing cost of goods sold (COGS) and lowering Gross Profit (Complaint ¶ 32). This allegedly occurred in the fourth quarter (*see id.*). The complaint alleges other changes to the Company's business practices but it is unclear when they occurred, whether they were detailed in the first three Earnout Statements or whether Dr. Fresh was in a position to

object to them at that time.² Similarly, Dr. Fresh alleges that such changes amount to a violation of section 2.8(c)(ii), which prohibits High Ridge from “taking any action the purpose of which is to reduce the Earnout Payment for any applicable Earnout Period” (*see* Dkt. 2 at 28).

In February 2018, the parties began communicating regarding Dr. Fresh’s objections. On May 31, 2018, Dr. Fresh took the position that their disputes should be referred to an Auditor in accordance with section 2.8(c). After the parties exchanged further information, High Ridge refused to submit all of the parties’ disputes to an Auditor. On October 3, 2018, Dr. Fresh commenced this action by filing a complaint that asserts a single cause of action for breach of the PSA. Dr. Fresh seeks approximately \$8 million in damages, exclusive of attorneys’ fees and expenses. High Ridge moves to dismiss, arguing that all of the alleged breaches itemized in the complaint occurred in the first three quarters and that no specific unique breach is alleged to have first occurred in the fourth quarter; thus, all of Dr. Fresh’s claims are precluded by its failure to serve any objections after the first three quarters.

Discussion

On a motion to dismiss, the court must accept as true the facts alleged in the complaint and all reasonable inferences that may be gleaned from those facts (*Amaro v Gani Realty Corp.*, 60 AD3d 491 [1st Dept 2009]). The court is not permitted to assess

² The Earnout Statements were not submitted as documentary evidence on this motion so their actual contents and supporting documentation are unknown.

the merits of the complaint or any of its factual allegations, but may only determine if, assuming the truth of the facts alleged and the inferences that can be drawn from them, the complaint states the elements of a legally cognizable cause of action (*Skillgames, LLC v Brody*, 1 AD3d 247, 250 [1st Dept 2003], citing *Guggenheimer v Ginzburg*, 43 NY2d 268, 275 [1977]). If the defendant seeks dismissal of the complaint based on documentary evidence, the motion will succeed only if “the documentary evidence utterly refutes plaintiff’s factual allegations, conclusively establishing a defense as a matter of law” (*Goshen v Mutual Life Ins. Co. of N.Y.*, 98 NY2d 314, 326 [2002]; *Leon v Martinez*, 84 NY2d 83, 88 [1994]).

High Ridge argues that section 2.8(c) of the PSA provides that Dr. Fresh’s failure to timely object to an Earnout Payment makes all calculations used to determine that payment binding, on a going forward basis for “all purposes” (*see* Dkt. 8 at 10). Thus, according to High Ridge, any breaches of the covenants set forth in section 2.8(e) that resulted in an improperly calculated Earnout Payment for a prior quarter cannot be challenged in a subsequent quarter on the ground that such breaches tainted the subsequent quarter’s Earnout Payment. High Ridge further argues that the complaint does not allege any specific covenant breach that occurred for the first time in the fourth quarter; thus, according to High Ridge, Dr. Fresh’s objections to the final Earnout Payment cannot stand.

In opposition, Dr. Fresh contends that its claims for breach of the covenants in section 2.8(e) are categorically excluded from the 15-day time period under section

2.8(c). This argument is problematic. After closing, aside from its right to Earnout Payments for a single year, Dr. Fresh had no reason to care about how the Company was run or whether it changed its business practices. The only reason Dr. Fresh cared about the Company maintaining its pre-closing business practices in the year after closing was to ensure calculation of the Earnout Payments would not be gamed. In that regard, breaches by the Company of the covenants in section 2.8(e) cannot have caused any independent harm to Dr. Fresh separate and apart from the Earnout Payments being depressed. It is clear that the covenants in section 2.8(e) all relate to ensuring the integrity of the Earnout Payments. This is reflected in section 2.8(b), which specifically requires Gross Profit to be based on the Company's "past practices" (*see* Dkt. 2 at 27). Thus, if, as Dr. Fresh alleges, the Company deviated from past practices, its damages would be based on insufficient Earnout Payments.

That the Earnout Payments are cumulative of prior quarters does not alter this analysis. It is clear from the PSA, and from common sense, that the purpose of the cumulative calculation was to ensure that the aggregate Earnout Payments reflected the Company's true performance over the course of the entire year such that a single anomalous quarter would not result in an aberrational recovery or shortfall in the total Earnout Payments.

That said, High Ridge did not meet its heavy burden of establishing that dismissal is warranted on this record. Section 2.8(c) does not particularly specify the nature of the objections that must be made at the end of each quarter. The Earnout Statements were

required to be supported by appropriate backup data, but it is unclear from the documentary evidence whether such backup included sufficient information for Dr. Fresh to understand that the Company had changed its past practices. Neither the complaint nor the documentary evidence indicates when Dr. Fresh actually became aware of the alleged changes.

It is also not clear, at this early pleadings stage, that section 2.8(c) required Dr. Fresh to object to breaches within 15 days of the Earnout Statement on grounds that it may not have had sufficient information to invoke during that period. High Ridge's argument implies that Dr. Fresh had unstated due diligence obligations during the 15-day objection period. But section 2.8(c) is silent on this issue. It is not unreasonable to interpret the agreement as requiring Dr. Fresh to object to matters explicitly disclosed in the Earnout Statements but not to issues that were incapable of being discovered or not contemplated to have been asserted within that short timeframe.

To be sure, it is not necessarily unreasonable to interpret the "for all purposes" language in section 2.8(c) to bar all objections to covenant breaches after the 15-day period. Read as a whole, however, the PSA also permits a reasonable interpretation that the "for all purposes" language in section 2.8(c) was not intended to categorically bar challenges to Earnout Payments that are based on covenant breaches rather than inaccuracies in the Earnout Statements. While High Ridge's interpretation is not unreasonable as a matter of law, given the ambiguity, discovery regarding the parties' intent must proceed.

In fact, even if Dr. Fresh waived covenant breaches that accrued prior to the fourth quarter, complete dismissal of the complaint would still not be warranted because the complaint alleges that certain breaches occurred during the fourth quarter (*see* Complaint ¶ 32 [“This improper booking accounts, in part, for the Q4 2017 increases in COGS and trade spend that are inconsistent with both Dr. Fresh’s historical Q4 COGS and trade spend and its increases historically in COGS and trade spend between Q3 and Q4”]). It is impossible to determine from the complaint and the documentary evidence when the alleged breaches first occurred. That Dr. Fresh did not provide more specificity as to the timing of the breaches is not prejudicial to High Ridge. After all, if the Company’s business practices did indeed change, High Ridge surely knows when those changes occurred.

Moreover, it is premature to determine on this scant record and at this early stage whether all breaches accruing prior to the fourth quarter are necessarily waived. While Dr. Fresh may not be able to contest certain calculations of the Earnout Payments for the periods that passed without objection, it is not foreclosed from attacking the calculations in the fourth quarter Earnout Statement. The impact of the ability to challenge the fourth and final earnout statement is unclear and cannot be decided as a matter of law. In the end, on this motion to dismiss, the parties have proffered competing reasonable interpretations and the court is precluded from deciding which interpretation is superior (*see N.Y. Univ. v Pfizer Inc.*, 151 AD3d 42, 44 [1st Dept 2017]). Perhaps discovery will

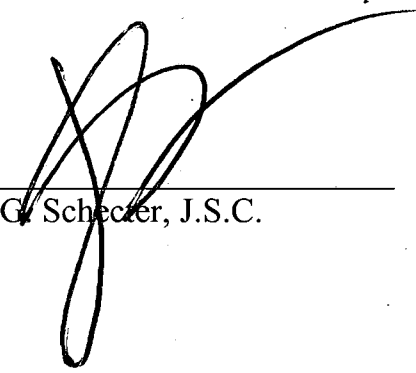
uncover proof evidencing the parties' intent (*see Kolbe v Tibbetts*, 22 NY3d 344, 355 [2013]; *Perella Weinberg Partners LLC v Kramer*, 153 AD3d 443, 446 [1st Dept 2017]).

Accordingly, it is ORDERED that High Ridge's motion to dismiss the complaint is denied; and it is further

ORDERED that a preliminary conference will be held on August 28, 2019 at 11:30 a.m., and the parties shall file their joint letter at least one week beforehand.

Dated: July 15, 2019

ENTER:



Jennifer G. Schechter, J.S.C.