



IN THE SUPREME COURT OF THE STATE OF DELAWARE

WALTER A. WINSHALL, in his capacity as the
Stockholders' Representative,
Plaintiff Below,
Appellant and Cross Appellee

v.

VIACOM INTERNATIONAL, INC. and
HARMONIX MUSIC SYSTEMS, INC.,

Defendants Below,
Appellees and Cross Appellants.

No. 39, 2013

On appeal from the Court
of Chancery of the State of
Delaware

C.A. No. 6074-CS

**REPLY BRIEF ON APPEAL AND ANSWERING BRIEF
ON CROSS APPEAL OF WALTER A. WINSHALL,
IN HIS CAPACITY AS THE STOCKHOLDERS' REPRESENTATIVE**

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May 17, 2013

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SUMMARY OF ARGUMENT

This Summary of Argument pertains to the Cross-Appeal.

3. DENIED. The Merger Agreement does not impose a separate duty to defend. It imposes an obligation to *indemnify against breaches*, rather than a broader obligation to *indemnify and defend against claims*. Thus, absent a breach requiring indemnification, the Selling Shareholders have no obligation to reimburse Defendants for the cost of defending against infringement claims.

4. DENIED. Defendants failed to introduce any evidence that *Rock Band* infringed third-party intellectual property rights, so there was no triable issue that the Merger Agreement's representations and warranties were breached. In any case, the representations and warranties did not cover the yet-to-be-developed *Rock Band* game.

COUNTER-STATEMENT OF FACTS

Appellees and Cross Appellants Viacom International, Inc. (“Viacom”) and Harmonix Music Systems, Inc. (“Harmonix”) (together, “Defendants”) cross-appeal from the Court of Chancery’s decision on summary judgment that they are not entitled to recover their costs of defending against claims that the videogame *Rock Band* infringed the intellectual property rights (“IP”) of third parties.

Three companies brought lawsuits alleging that the manufacture and sale of *Rock Band* infringed their patents; a fourth company alleged copyright and trademark infringement. Defendants won or settled each of the cases (AR64-67), and have always denied any infringement. (AR14, 24-25, 32, 43.)

The Harmonix CEO testified that when Viacom purchased the company in October 2006, “the thing that we eventually shipped a year later as *Rock Band* didn’t really exist.... [I]t was like R&D prototypes at this point.” (AR99:18-21.) “Most of the actual creative work to be done on art production and things of that sort, like it was still ahead of us....” (AR101:11-13.) Indeed, none of the IP lawsuits alleged that any infringement occurred before Viacom bought Harmonix. “The claims for which Viacom seeks indemnification all relate to the final *Rock Band* video game that was produced in November 2007.” (Memorandum Opinion, Dec. 12, 2012 (“Mem. Op.”), Ans. Br. Ex. A, at 14.) The claimants did “not allege that any prototype of *Rock Band* before the sale infringed those rights.” (*Id.* at 15.)

ARGUMENT

I. The Amended Complaint Alleges a Breach of the Implied Covenant of Good Faith and Fair Dealing.

In Delaware, the pleading standard for a good faith and fair dealing claim is well-defined. A plaintiff need only allege “an implied contractual obligation not to engage in certain conduct, a breach of that obligation by the defendant, and resulting damage to the plaintiff.” *Amirsaleh v. Bd. of Trade of City of N.Y., Inc.*, 2009 WL 3756700, at *4 (Del. Ch. Nov. 9, 2009).¹

A. The Amended Complaint alleges that Viacom had an implied obligation not to manipulate Harmonix’s cost structure for the purpose of reducing the earn-out payment.

As Winshall argued in his opening brief, the specific covenant implied in the parties’ agreement is “that Viacom would not shortchange the [Selling Stockholders] by manipulating the cost structure for Harmonix products for the purpose of reducing the Earn-out Payments.” (A71; Op. Br. at 13.) In other words, when the Selling Stockholders bargained for a measure of Harmonix’s Gross Profit, which took into account both revenues and costs like distribution fees, they were relying upon Viacom’s good faith in negotiating the future agreements that would contribute to Harmonix’s profitability. *Rock Band*’s distribution fees were still months

¹ In their Corrected Answering Brief (“Ans. Br.”), Defendants do not challenge that damages were alleged by Appellant and Cross-Appellee/Plaintiff-below Walter A. Winshall (“Winshall”), in his capacity as the Stockholders’ Representative for the selling stockholders of Harmonix (the “Selling Stockholders”).

away from being negotiated even for the first time under the Original Distribution Agreement.

1. The parties' reasonable expectations are measured from the date of the Merger Agreement.

Defendants premise their entire defense on the idea that “Defendants did [not do] anything to reduce the earn-out payment, but rather . . . Defendants did not act to increase it.” (Ans. Br. at 13.) This argument wholly ignores the well-pled allegations of the Amended Complaint. It also runs head-long into the well-established principle that the parties' reasonable expectations must be measured from the time of contracting, not the time of breach. *See Amirsaleh*, 2009 WL 3756700, at *4 (“The parties' reasonable expectations are determined by inquiring whether the parties would have bargained for a contractual term proscribing the conduct that allegedly violated the implied covenant had they foreseen the circumstances under which the conduct arose.”); *see also Nemec v. Shrader*, 991 A.2d 1120, 1127 (Del. 2010) (evaluating whether the parties would have agreed to proscribe the conduct at issue at the time of contracting).

The parties' reasonable expectations should have been measured from September 2006, when the parties executed the Merger Agreement. (A93-A225.) Instead, as even Viacom now acknowledges, the Court of Chancery measured the reasonable expectations from a later date—the date the Original Distribution Agreement was signed. (Ans. Br. at 19-20.) This error resulted in the Court of

Chancery concluding that the Selling Stockholders could have only reasonably expected the fees set in the Original Distribution Agreement to prevail throughout the earn-out period. Had the Court of Chancery measured the expectations from the correct time period in September 2006 before the Original Distribution Agreement even existed, then the outcome of the analysis would have been much different because, in September 2006, the Selling Stockholders bargained for a measure of Harmonix's Gross Profit in 2007 and 2008. (A102-103.) The parties also agreed, and the Selling Stockholders therefore reasonably expected, that Gross Profit would be computed as the sum of the "Product Gross Profit" for all of Harmonix's products, which is equal to "the positive or negative difference, between (i) Net Revenue attributable to such product and (ii) the sum of all Direct Variable Costs attributable to such product." (A104-A105.) In the Merger Agreement, the parties further agreed that a product's Direct Variable Costs included "distribution fees" and "royalties" payable to third parties, such as Electronic Arts ("EA"). (A103.) Therefore, the Selling Stockholders reasonably expected at the time of the Merger Agreement that a decrease in distribution fees would result in an increase in Gross Profit, just as they would have reasonably expected that a decrease in revenue would result in a decrease in Gross Profit.

2. The implied obligation is consistent with the terms of the Merger Agreement.

The terms of the Merger Agreement are fully consistent with Defendants' implied obligation to refrain from manipulating Harmonix's cost structure for the purpose of reducing the earn-out payment.

First, the terms of the Merger Agreement governing the earn-out payments are the best evidence of Defendants' implied obligation. As set forth in the Amended Complaint, the earn-out provisions entitle the Selling Stockholders to a measure of Harmonix's Gross Profit, which is a function of its revenues less its Direct Variable Costs, including distribution fees. (A68; A104-A105; A109-A110.) When the parties agreed on how the Gross Profit would be calculated, they implicitly agreed that those inputs would not be manipulated for the purpose of producing an artificially low result. *See RBS Holdings, Inc. v. Gordon & Ferguson, Inc.*, 2008 WL 782616, at *5 (S.D.N.Y. Mar. 26, 2008) (“[W]here one party to a contract grants to the other party a share in the benefits of its business, there is an implied obligation on the part of the respondents not to render valueless the right conferred by the contract.” (alterations and quotation marks omitted)); *T.R. McClure & Co. Liquidating Trust v. TMG Acquisition Co.*, 1999 WL 692683, at *6-8 (E.D. Pa. Sept. 7, 1999) (“[T]he Earn-Out Agreement's terms envision that [defendant] would, if feasible, act so as to generate additional purchase price con-

sideration. It is reasonable to require that, in doing so, [defendant] act in good faith to make the parties' expectations come to fruition.”).

Second, the discretion granted to Viacom by the Merger Agreement gives rise to an obligation to exercise that discretion reasonably and in good faith; it does not give Viacom a license to deprive the Selling Stockholders of the fruits of their bargain. Viacom argues that an obligation to negotiate the 2008 Term Sheet in good faith cannot be implied in the Merger Agreement because “the Merger Agreement vests Viacom with discretion to change distribution fees.” (Ans. Br. at 16.)² Delaware law unequivocally requires exactly the opposite result. *See Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 146-47 (Del. Ch. 2009) (“When a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith.”); *Chamison v. HealthTrust, Inc. Hospital Co.*, 735 A.2d 912, 922 (Del. Ch. 1999) (finding that defendant breached covenant of good faith by exercising its contractually-granted discretion unreasonably), *aff’d*, 748 A.2d 407 (Del. 2000) (TABLE).

Third, Viacom was not, as Defendants argue, free to manipulate Harmonix’s contracts to lower its Gross Profit simply because the Merger Agreement did not cap the earn-out payments. (Ans. Br. at 17.) If any inference can be drawn from

² Defendants also make reference to an “Operating Plan and Budget” incorporated to or contemplated by the Merger Agreement. (AR96.) That one-page document makes no reference to distribution fees, and has nothing to do with the parties’ reasonable expectations about what fees would prevail in the future.

the uncapped earn-out payments (especially at the pleading stage), it is that the Selling Stockholders expected to enjoy their full measure of the firm's Gross Profits, not that Viacom was free to manipulate Harmonix's bottom line.

Fourth, Defendants suggest that there can be no implied covenant restraining them from manipulating Harmonix's cost structure for the purpose of reducing the earn-out payment because there is no explicit contractual language to that effect. Delaware law proves Viacom wrong again: "even the most carefully drafted agreement will harbor residual nooks and crannies for the implied covenant to fill." *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member*, 50 A.3d 434, 440-41 (Del. Ch. 2012), *rev'd on other grounds*, 2013 WL 1914714 (Del. May 9, 2013); *accord Amirsaleh v. Bd. of Trade of City of N.Y., Inc.*, 2008 WL 4182998, at *1 (Del. Ch. Sept. 11, 2008).

Defendants suggest that *Airborne Health* is on point in this respect. It is not. In that case, Squid Soap alleged that Airborne, which had purchased its business, had breached the covenant of good faith and fair dealing by its "failure to spend on marketing or achieve sales." 984 A.2d at 145. That case was resolved on a very basic principle: "The implied covenant does not apply when the subject at issue is expressly covered by the contract." *Id.* at 146 (internal quotation marks omitted). The purchase agreement that Squid Soap was suing upon had specified that if Airborne did not spend \$1 million in marketing and achieve \$5 million in net sales

after twelve months, it had to return the company to the seller for nominal consideration, which the buyer offered to do after failing to hit its targets. *Id.* at 132, 135. The parties had therefore already agreed on what would happen if Airborne did (or failed to do) the precise thing that Squid Soap complained about.

3. Winshall does not allege that Viacom was under an obligation to maximize the earn-out payment.

To avoid any confusion, Winshall does not allege that Viacom was under an obligation to maximize the earn-out payment or even Harmonix's Gross Profit. Rather, Winshall alleges that Defendants had an implied obligation to approach Harmonix's contracts in good faith, and not structure them to artificially keep costs high during the earn-out period in exchange for disguised compensation that would not benefit the Selling Stockholders. Where a buyer promises the seller an earn-out payment, his obligation to approach that promise in good faith is well-recognized.³ Discovery is needed to determine what agreement would have prevailed if Defendants had acted in good faith.

³ See, e.g., *RBS Holdings*, 2008 WL 782616, at *5 (“[W]here one party to a contract grants to the other party a share in the benefits of its business, there is an implied obligation on the part of the respondents not to render valueless the right conferred by the contract.” (alterations and quotation marks omitted)); *T.R. McClure & Co.*, 1999 WL 692683, at *6-8 (“[T]he Earn-Out Agreement’s terms envision that [defendant] would, if feasible, act so as to generate additional purchase price consideration. It is reasonable to require that, in doing so, [defendant] act in good faith to make the parties’ expectations come to fruition.”).

B. The Amended Complaint alleges that Viacom breached its implied obligation.

The Amended Complaint pleads that Viacom breached the covenant of good faith and fair dealing implied in the Merger Agreement by trading away an asset of Harmonix—“the worldwide distribution rights to Rock Band and its sequels” on all platforms—in exchange for benefits to other Viacom businesses—namely, EA’s “firm commitment to purchase millions of dollars of advertising from MTV Networks and other Viacom media outlets” as well as “the acceleration of cash payments” that were “not otherwise due,” both of which were “undertaken for the purpose of reducing the Earn-Out due for 2008.” (A72, A75.)

1. Defendants *admit* to engaging in the bad faith conduct alleged in the Amended Complaint.

Defendants acknowledge engaging in the exact behavior they are accused of: “Viacom . . . was within its rights to consider the effect on its own business of enhancing Gross Profit for the benefit of Plaintiff and those he represents.” (Ans. Br. at 20.) Circularly, Defendants contend that the desire to avoid earn-out payments is a “legitimate business purpose” and that they had the right to engage in any behavior to lower them. (*Id.*) The desire to avoid an earn-out obligation, however, is *not* a legitimate business justification for manipulating Harmonix’s costs.

Actions with legitimate business justifications “hav[e] *independent* significance to the corporation,” *Glinert v. Wickes Cos.*, 1990 WL 34703, at *8 (Del. Ch. Mar. 27, 1990) (emphasis added), *aff’d*, 586 A.2d 1201 (Del. 1990) (TABLE), *i.e.*, an action performed only for the purpose of reducing a counter-party’s earn-out payment has no legitimate business justification. A good example comes from *Airborne Health*. In that case, the reason for Airborne’s failure to market Squid Soap more was not bad faith, but “legal and financial burdens of [a legal] settlement and systematic market damage” resulting from a scandal Airborne suffered. *Airborne Health*, 984 A.2d at 147. In this case, not only is no legitimate business justification for intentionally deflating Harmonix’s Gross Profit apparent on the face of the Amended Complaint, but Defendants appear to concede engaging in the precise bad faith conduct for the precise reason Winshall alleged: manipulating the distribution agreement with EA to artificially reduce the 2008 Gross Profit.

If Viacom were correct that its desire to avoid earn-out payments is a “legitimate business purpose” for manipulating a company, then every earn-out case cited as an example in Winshall’s opening brief was wrongly decided.⁴

⁴ See *O’Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188, 1195-97 (10th Cir. 2004) (applying Delaware law and holding that allegation of buyer’s diversion of business to less profitable product line to avoid earn-out obligation was sufficient under heightened federal pleading standard); *MWI Veterinary Supply Co. v. Wotton*, 2012 WL 2576205, at *8 (D. Idaho July 3, 2012) (holding that allegations that buyer had purposefully and without justification suppressed product line in order to avoid earn-out payments were sufficient under heightened pleading

Defendants also unsuccessfully try to distinguish *Keating* on the ground that “the agreement there expressly contemplated that new contracts would increase the earn-out payments.” (Ans. Br. at 21.) *Keating* is on all fours. What the agreement at issue in *Keating* contemplated was that *higher revenue* would increase the earn-out payment. *See Keating*, 2009 WL 261091, at *1 (“plaintiffs are entitled to a share of revenue from contracts”). Here, the Selling Stockholders and Harmonix specifically agreed that *lower expenses*, including distribution fees, would increase Harmonix’s Gross Profit and the corresponding earn-out payment. Winshall has adequately alleged that, in bad faith, Defendants artificially increased expenses in the earn-out period that otherwise did not belong there, just as the defendant in *Keating* had artificially pushed revenues out of the earn-out period.

standard); *Keating v. Applus+Technologies, Inc.*, 2009 WL 261091 (E.D. Pa. Feb. 4, 2009) (applying Delaware law and holding that allegation that buyer had delayed contract signing until after earn-out period in order to avoid earn-out payments was sufficient under heightened pleading standard); *Hodges v. MedAssets Net Revenue Sys., LLC*, 2008 WL 476140, at *6-7 (N.D. Ga. Feb. 19, 2008) (applying Delaware law and holding that allegation that buyer diverted sales from the acquired company’s products to its own in order to reduce earn-out payments was sufficient under heightened federal pleading standard); *Interwave Tech., Inc. v. Rockwell Automation, Inc.*, 2005 WL 3605272, at *10-12 (E.D. Pa. Dec. 30, 2005); *see also Kuchera v. Parexel Int’l Corp.*, 719 F. Supp. 2d 121, 125-27 (D. Mass, 2010) (denying defendant’s motion for summary judgment where plaintiff alleged that defendant’s “representatives took actions specifically designed to thwart [plaintiff’s] ability to reach its earn-out targets”); *T.R. McClure & Co.*, 1999 WL 692683, at *6-8 (sustaining good faith and fair dealing claim where plaintiff alleged that the buyer of a company had suppressed sales in order to reduce earn-out payment).

2. A breach of the covenant of good faith and fair dealing does not require a culpable mental state.

Defendants also suggest that their alleged conduct cannot give rise to a good faith and fair dealing claim because it did not involve fraud, deceit, or misrepresentation. (Ans. Br. at 18.) Such allegations are not required to allege a breach of the covenant of good faith and fair dealing. *See ASB Allegiance Real Estate Fund*, 50 A.3d at 442-45. The Court of Chancery recently undertook a painstaking review of whether such malicious intent is necessary to prove a good faith and fair dealing claim and found that it is not. *Id.* It concluded that, while fraud is one way of breaching the implied covenant, it is certainly not the only way, and that to conclude otherwise would improperly inject tort principles into a contract claim. *Id.*

3. Viacom’s conduct deprived the Selling Stockholders of the “fruits of their bargain.”

“[T]he implied covenant requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain.” *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 442 (Del. 2005) (internal quotation marks omitted). In this case, the primary fruits of the Selling Stockholders’ bargain were the earn-out payments that made up the majority of the compensation they received for selling Harmonix to Viacom. When Defendants engaged in their scheme to reduce Harmonix’s Gross Profit during the earn-out period and thereby

reduce the earn-out payment, they deprived the Selling Stockholders of their reasonably expected compensation.

Winshall acknowledges that if the *only* purpose of the 2008 Term Sheet was to enable EA to distribute *The Beatles: Rock Band*, the Selling Stockholders did not have a reasonable expectation to consideration for that product. However, the Amended Complaint and all the inferences to which Winshall is entitled at the pleading stage demonstrate that this was not the only purpose of the 2008 Term Sheet. In fact, the Amended Complaint, the Original Distribution Agreement, and the 2008 Term Sheet demonstrate that EA sought and received in the 2008 Term Sheet the valuable right to distribute *Rock Band 2* during the 2008 holiday season. Moreover, Defendants' tacit admission that they rejected offers for lower distribution fees in 2008 lends further support to the inference that EA sought and received valuable rights to products distributed in 2008 via the 2008 Term Sheet. (Op. Br. at 23-34.)

II. The Original Distribution Agreement Supports the Allegations in the Amended Complaint.

Winshall's opening brief explains why the Court of Chancery erred in considering the Original Distribution Agreement, erred in its interpretation of it and, having permitted Defendants to introduce it and new arguments with their reply brief, erred in excluding Winshall's response. (Op. Br. at 23-34.) Defendants' brief cites no case in which a court considered, on a motion to dismiss, a document outside of the pleadings, such as the Original Distribution Agreement, which neither gives rise to the right sued upon nor allegedly violated that right simply because it was a "contract" or referred to in the complaint. More importantly, Defendants do not engage with Winshall's principal argument that EA was *required* to reach a new distribution agreement with Harmonix in 2008 to distribute many of the products that it sold during the earn-out period, and cannot explain how EA would have done so absent a new distribution agreement.

A. The Original Distribution Agreement should not have been considered for the first time with Viacom's reply brief.

The Original Distribution Agreement was not properly considered by the Court of Chancery. The Original Distribution Agreement—while part of the factual fabric of this case—is not integral to, quoted in, or incorporated by reference into the Amended Complaint. The Amended Complaint alleges that when Defendants undertook to negotiate the 2008 Term Sheet with EA, they rejected lower dis-

tribution fees in 2008 to reduce the earn-out payment to which the Selling Stockholders were entitled, thereby breaching an obligation implied by the Merger Agreement. (A74-75.) Nothing about this theory of liability requires consideration of the Original Distribution Agreement.⁵

Regardless of whether the Original Distribution Agreement was properly considered, Winshall did not waive any arguments concerning the Original Distribution Agreement by failing to raise them in his opposition brief below *before* Defendants had even introduced the Original Distribution Agreement or arguments based upon it. Defendants dispute neither that they first submitted the Original Distribution Agreement with their reply brief nor that they first argued that the Original Distribution Agreement gave EA the right to distribute all Harmonix products through 2008 in that brief. Defendants cannot have it both ways. They

⁵ The cases cited by Defendants are therefore inapposite. See *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 69 (Del. 1995) (considering proxy statement that plaintiff alleged contained material omissions); *In re BJ's Wholesale Club, Inc. S'holders Litig.*, 2013 WL 396202, at *9 n.79 (Del. Ch. Jan. 31, 2013) (considering whole email that plaintiff had “selectively quote[d]” from); *Freedman v. Adams*, 2012 WL 1345638, at *4, *5 (Del. Ch. Mar. 30, 2012) (considering proxy statement that plaintiff alleged contained material omissions or misstatements), *aff'd*, 58 A.3d 414 (Del. 2013); *Fletcher Int'l, Ltd. v. ION Geophysical Corp.*, 2011 WL 1167088, at *3 n.17 (Del. Ch. March 29, 2011) (considering share purchase agreement that allegedly breached plaintiffs’ contractual rights by causing the issuance of new stock). Defendants also cite *In re New Valley Corp. Deriv. Litig.*, 2001 WL 50212 (Del. Ch. Jan. 11, 2001), which *rejected* the consideration of extraneous materials and reasoned that the exception to the general rule that documents outside of the pleadings may not be considered “is narrowly tailored to specific types of documents and specific uses of those documents.” *Id.* at *5. *Midland Food Servs., LLC v. Castle Hill Holdings V, LLC*, 792 A.2d 920, 925 (Del. Ch. 1999), concerns a distinct, narrow exception that prevents the “filing of misleading complaints that strategically omit crucial information,” in that case the fact that the method by which the plaintiffs acquired the interest upon which they sued clearly violated the *Bangor Punta* doctrine. *Id.* at 925 n.5, 929.

cannot claim that the Court of Chancery properly considered the Original Distribution Agreement, but also maintain that Winshall never was entitled to an opportunity to respond to it. The law is clear that defendants cannot introduce new arguments in their reply brief for precisely that reason. *See Franklin Balance Sheet Inv. Fund v. Crowley*, 2006 WL 3095952, at *4 (Del. Ch. Oct. 19, 2006) (“Under the briefing rules, a party is obliged in its motion and opening brief to set forth all of the grounds, authorities and arguments supporting its motion [and] should not hold matters in reserve for reply briefs.”).

B. Consideration of the Original Distribution Agreement only confirms that EA and Harmonix were required to reach a new distribution agreement in 2008.

The Original Distribution Agreement did not permit EA to distribute *Rock Band 2* in 2008. (Op. Br. at 6, 27-29; A353.) In fact, it required a new, written agreement for EA to do so. (*Id.*) The same is true for other products that EA distributed under the 2008 Term Sheet. (Op. Br. at 6, 29; A353.) In addition to requiring the parties to reach a new distribution agreement to include *Rock Band 2*, the Original Distribution Agreement gave Harmonix the right to demand lower distribution fees than had prevailed under the Original Distribution Agreement in certain circumstances: “the Parties may revisit and renegotiate terms that may be affected by substantial changes in variable costs, such as licensed content costs.” (A353.) Indeed, the cost structure of the *Rock Band* games had in fact changed,

permitting Harmonix to demand concessions before signing the final agreement giving EA the right to distribute *Rock Band 2*. (A465-A466.)

Defendants argue that Viacom could have simply left the Original Distribution Agreement in place through 2008 and the earn-out payment would have been unaffected. However, Defendants offer no explanation for how EA could have distributed *Rock Band 2* or versions of *Rock Band* for platforms like PlayStation 2 under the terms of the Original Distribution Agreement. Further, Defendants cannot establish that Harmonix needed a right to terminate the Original Distribution Agreement in order to secure lower distribution fees. It was EA that, in 2008, needed a new distribution agreement to distribute the Harmonix products that it did not yet have rights to.

III. The Lower Court Correctly Found That the Merger Agreement Does Not Impose an Independent Duty to Pay Defense Costs.

A. Question Presented

Does the Merger Agreement require the Selling Shareholders to reimburse Defendants for the cost of defending against third-party infringement claims even if there was no breach of the contractual representations and warranties?

B. Standard of Review

Winshall agrees that the standard of review is *de novo*.

C. Merits

The substantive indemnity provision in the Merger Agreement, § 8.2(a), plainly conditions indemnification on the existence of a breach of the Agreement:

(a) Indemnification by [Selling Shareholders]. Subject to the limitations set forth in this Article VIII, each [Selling Shareholder] agrees ... to ... indemnify Parent [Viacom], the Surviving Corporation [Harmonix] and their respective Affiliates ... (each a “Parent/MergerCo Indemnified Party”) against and hold them harmless from and against any and all Losses, which may be sustained or suffered by any such Parent/MergerCo Indemnified Parties based upon, arising out of or by reason of:

(i) the breach of any representation or warranty of the Company contained in this Agreement.... (A153.)

Ignoring this language, Defendants contend that the Merger Agreement allows them to recover their costs of defending lawsuits alleging that *Rock Band* infringed the IP of third parties, regardless of whether there was any breach of the Agreement’s representations and warranties. As the Court of Chancery explained:

Viacom's interpretation of the Merger Agreement is odd. If the Sellers were really to be responsible for paying for the defense of Viacom against any claim that involved an arguable breach of representations and warranties, regardless of whether a breach of representations and warranties was ultimately proven, we should expect to find the relevant contractual provision stating this in as many words.

(Mem. Op. at 11-12.) Yet no such provision can be found in the Merger Agreement.

1. The Merger Agreement has an *indemnify against breaches* clause, not an *indemnify and defend against claims* clause, so Defendants must prove an actual breach to recover.

Defendants contend that the Merger Agreement imposes an “independent duty to pay defense costs” that is “separate from and broader than the duty to indemnify.” (Ans. Br. at 35-36.) But when the parties to a merger agreement intend to create separate duties to indemnify and to defend, they employ an *indemnify and defend against claims* clause. All of the merger cases cited by Defendants concern “indemnify and defend” provisions.⁶ Similar language is found in all the insurance cases cited by Defendants.⁷ As the court below pointed out, “[t]he cases

⁶ See *Molex Inc. v. Wyler*, 334 F. Supp. 2d 1083, 1085 (N.D. Ill. 2004) (stock purchase agreement required seller to “indemnify *and defend* Molex for any loss or expenses relating to any claim made by persons not disclosed”) (emphasis added); *Convergent Wealth Advisors LLC v. Lydian Holding Co.*, 2012 WL 2148221, at *1 (S.D.N.Y. June 13, 2012) (stock purchase agreement required sellers to “indemnify, *defend*, and hold harmless, the Buyer ... from ... all Losses ... based on events occurring prior to closing”) (emphasis added) (internal quotation marks omitted); *LaPoint v. AmerisourceBergen Corp.*, 970 A.2d 185, 190 (Del. 2009) (merger agreement required buyer to “indemnify, *defend* and hold harmless”) (emphasis added).

⁷ Insurance policies typically include separate coverage of defense costs even for claims that are “groundless” or “false.” See, e.g., *DynCorp v. Certain Underwriters at Lloyd's, London*, 2009 WL 3764971, at *4 (Del. Super. Nov. 9, 2009) (policy required insurer to defend claims “even if

that Viacom cites in support of its argument all involve contracts with this kind of clear and unambiguous language.” (Mem. Op. at 12 n.46.)

Such language, however, is absent from § 8.2(a) of the Merger Agreement, which requires the Selling Shareholders to “indemnify” Viacom against breaches, not to “indemnify and defend.” Omitting the duty to defend from § 8.2(a) was especially conspicuous because *Viacom* assumed precisely this duty in a companion provision, § 8.6(a), which requires it to indemnify *and defend* the Selling Shareholders from losses caused by Viacom’s breaches:

Section 8.6. Indemnification by [Viacom]

(a) Indemnification. Subject to the limitations set forth in this Article VIII, ... [Viacom] ... shall indemnify, *defend* and hold harmless each Merger Consideration Recipient [seller] against any and all Losses actually incurred or suffered by any such [seller] as a result of:

(i) the breach of any representation or warranty of [Viacom] ... set forth in this Agreement.... (A159 (emphasis added).)

The courts have held that there is no duty to defend when the contract says “indemnify” rather than “indemnify and defend.” For example, in *Lear Corp. v. Johnson Elec. Holdings Ltd.*, 2003 WL 21254253, at *4, *6 (N.D. Ill. May 30, 2003), *aff’d*, 353 F.3d 580 (7th Cir. 2003), the district court held that a stock

groundless, false, [or] fraudulent”); *United Westlabs, Inc. v. Greenwich Ins. Co.*, 2011 WL 2623932, at *3 (Del. Super. July 1, 2011) (policy required insurer to defend “even if any of the allegations of the Claim are groundless, false or fraudulent...”), *aff’d*, 38 A.3d 1255 (Del. 2012) (TABLE); *see also Pac. Ins. Co. v. Liberty Mut. Ins. Co.*, 956 A.2d 1246, 1250 (Del. 2008) (insurer has “duty to defend any ‘suit’”).

purchase agreement with an “indemnify and hold harmless” clause “only defines duties to indemnify and contains no duty to defend.” The Seventh Circuit agreed, explaining that “no duty to defend means no duty to pay for the outlays of defense on a current basis. Payment abides the decision about indemnity.” 353 F.3d at 584.⁸ Likewise, in *Moriarty v. Hills Funeral Home, Ltd.*, 221 F. Supp. 2d 887 (N.D. Ill. 2002), the court held that under an asset purchase agreement with an *indemnify against breaches* clause, the seller had no obligation to pay defense costs unless the buyer demonstrated that the seller breached a representation or warranty:

The clause does not directly provide that Hills Ltd. will be indemnified or held harmless for any and all claims made or lawsuits filed against Hills Ltd. related to preclosing activities. Instead, the clause provides for indemnity only when there is an inaccuracy or breach of one of Pepper’s representations or warranties. If such an inaccuracy or breach occurred, then Hills Ltd. is entitled to recover litigation expenses arising directly or indirectly from the inaccuracy or breach.

Id. at 896 (footnote omitted).

2. The notice provision in the Merger Agreement does not impose a duty to pay defense costs in the absence of a duty to indemnify.

Defendants do not rest their position on the *substantive* indemnification provision, § 8.2(a), but rather on the *procedural* provision, § 8.2(d)(i), which states:

⁸ Defendants incorrectly cite *Lear* for the proposition that “[d]efense may be required even if there never turns out to be any liability to indemnify.” (Ans. Br. at 39.) That quotation, however, was specifically referring to insurance policies, which the court was *distinguishing* from the stock purchase agreement at issue. *See Lear*, 353 F.3d at 583.

Parent shall give the Stockholders' Representative written notice of any claim, suit, investigation, action, assertion, event or proceeding by or in respect of a third party as to which a Parent/MergerCo Indemnified Party *may request indemnification pursuant to Section 8.2(a)*.... Parent shall have the right to direct ... the defense or settlement of any such claim at the expense of the *applicable indemnifying parties*. (A156 (emphasis added).)

Defendants contend that the mere act of providing notice of a third-party claim gives them the right to recover the costs of defense, regardless of whether they are entitled to indemnification. The key, according to Defendants, is that § 8.2(d)(i) uses “present-tense language,” even though the validity of the claim, and thus the right to indemnification, may not be known until it is later resolved. (Ans. Br. at 34.) Thus, Defendants say they “may request indemnification” even when they are not entitled to it; and making a request creates an “obligation to pay defense costs [that] is separate from the obligation to indemnify.” (*Id.* at 2.)

This makes no sense. If the parties intended to establish two “separate” and “independent” duties, why would the Agreement say that a request by the buyer for the *first* item (indemnification) obligates the Selling Shareholders to provide the *second* item (defense)? As the Court of Chancery observed, Defendants’ “interpretation of the Merger Agreement contradicts its plain text and evident logic.” (Mem. Op. at 12-13.) That interpretation should be rejected for five reasons.

First, the text of § 8.2(d) plainly states that the obligation to pay defense costs *depends* on the existence of a duty to indemnify under § 8.2(a). The first sen-

tence of § 8.2(d)(i) specifically refers to claims for which Defendants “may request indemnification pursuant to Section 8.2(a)...” The last sentence states that “the defense or settlement of any such claim [is] at the expense of the applicable indemnifying parties.” The Selling Shareholders, however, cannot be regarded as “applicable indemnifying parties” unless they have a duty to indemnify. Nor are Defendants helped by § 8.2(d)(ii), which, as the court below explained, “follows on directly from § 8.2(d)(i), and discusses only the treatment of ‘such claim[s]’ as are mentioned in § 8.2(d)(i)—*i.e.*, claims made ‘pursuant to Section 8.2(a)...,’ which for purposes of this motion involve a breach of a representation or warranty.” (Mem. Op. at 11.)

Second, Defendants’ interpretation is contradicted by the Escrow Agreement that accompanies the Merger Agreement. Defendants argue that if the parties had wanted to limit Viacom’s recovery of defense costs to indemnified claims, then the notice provision would have used the wording “*entitled to indemnification,*” instead of claims for which it “*may request indemnification.*” (Ans. Br. at 35.) But the parties *did* use precisely that wording in the corresponding notice provision of the Escrow Agreement:

If any [Defendant] is *entitled to indemnification* pursuant to the terms of Article VIII of the Merger Agreement and for which any [Defendant] is entitled pursuant to Section 8.2 of the Merger Agreement to seek payment for such Losses from the Escrow Cash, then Parent or the Company shall give notice (an “Indemnity Notice”) to the Stockholders’ Representative.... (B27, §4(c)(i) (emphasis added).)

Delaware law recognizes the well-known “rule that related contemporaneous documents should be read together.”⁹ Hence, the phrase “may request indemnification” in § 8.2(d)(1) of the Merger Agreement should be given the same meaning as “entitled to indemnification” in § 4(c)(i) of the Escrow Agreement because both provisions cover exactly the same point – giving notice of a third-party claim that would allow Defendants to seek payment of “Losses” (which includes “reasonable attorneys’ fees and expenses” under § 10.7 (A170)). In short, Defendants may obtain payment of their legal fees under § 8.2(d) only when they are “entitled to indemnification.”

Third, if the obligation to pay defense costs were *not* limited to indemnified claims, then there would be no contractual limit on the lawsuits subject to this obligation. Under Defendants’ interpretation, all they have to do is send a notice, and the Selling Shareholders “could thus be on the hook for defending against frivolous claims that had nothing at all to do with the state of Harmonix when they sold it to Viacom.” (Mem. Op. at 12.) Defendants suggest that they are only allowed to send notice of “claims which *allege* wrongdoing covered by the Merger Agreement’s representations and warranties.” (Ans. Br. at 36 (emphasis added).)

⁹ See *Ashall Homes Ltd. v. ROK Entertainment Group, Inc.*, 992 A.2d 1239, 1250 & n.56 (Del. Ch. 2010). For other statements of this rule, see 11 Richard A. Lord, *Williston on Contracts* § 30.26 (4th ed. 1999); *Restatement (Second) of Contracts* § 202(2) (1981) .

But the limit that Defendants propose – focusing on a claimant’s allegations rather than the existence of a breach – is not contained in the contract.

Fourth, Defendants’ tortured argument ignores a simple fact: if the parties had intended to require the Selling Shareholders to reimburse Defendants for the cost of defending every infringement claim, regardless of its merit, they could have used plain language to achieve that result. For example, they could have included an *indemnify and defend against claims* clause, such as that found in other merger agreements. *See* note 6, *supra*. They could have used the language found in insurance policies. *See* note 7, *supra*. They could have negotiated for a broader warranty, such as that found in the Uniform Commercial Code.¹⁰ Instead, the parties negotiated an *indemnity against breaches* clause that is well understood to cover defense costs only when there is a breach.

Fifth, contrary to Defendants’ argument, § 8.2(d)(i) does not allow Defendants to recover defense costs on an ongoing basis before their right to indemnification is determined. (*See* Ans. Br. at 34.) Under Delaware law, an “indemnify and hold harmless” clause does not confer a right of *advancement*, *i.e.*, the right to payment of “litigation expenses as they are incurred regardless of whether [the party] will ultimately be entitled to indemnification.” *Majkowski v. Am. Imaging*

¹⁰ The UCC provides a warranty not only against actual infringement but against any “rightful claim” of infringement. *See* 6 *Del. C.* § 2-312(3).

Mgmt. Servs., LLC, 913 A.2d 572, 586 (Del. Ch. 2006) (noting that “Delaware law has traditionally recognized that indemnification and advancement are two distinct and different legal rights”). The Merger Agreement plainly does not provide this right, for the effect of a notice is simply to freeze the funds in the escrow. Defendants had no right to draw on the escrow to pay their ongoing expenses – and they never attempted to do so. Indeed, when discussing a similar provision in *LaPoint*, 970 A.2d at 195, this Court made clear that no such right to recover legal costs exists unless and until a breach is shown: “Under Section 8.2(b) of the Merger Agreement, until ABC was adjudicated to have ‘breach[ed] any covenant, representation, warranty or agreement,’ ABC was not required to indemnify the [sellers] for their attorneys’ fees.” *Id.* at 195 (first alteration in original).

In a last-ditch attempt to avoid judgment, Defendants ask for a remand because they contend the Agreement is “at the very least ambiguous.” (Ans. Br. at 40.) But Defendants never offered any extrinsic evidence in the court below. Thus, even if the contract were ambiguous, that would not be a reason to reverse summary judgment. *See Intel Corp. v. Am. Guar. & Liab. Ins. Co.*, 51 A.3d 442, 451 (Del. 2012) (“Intel chose not to introduce any extrinsic evidence in the proceedings below We will not remand the matter to allow Intel to now do so.”).

IV. The Court of Chancery Properly Granted Summary Judgment to Winshall Because There Was No Breach of the Representations and Warranties in the Merger Agreement.

A. Question Presented

Did the lower court err in granting summary judgment that there was no breach of the representations and warranties in the Merger Agreement?

B. Standard of Review

Winshall agrees that the standard of review is *de novo*.

C. Merits

In their Answering Brief, Defendants rely on two representations in the Merger Agreement.¹¹ One provision, § 4.15(o)(i), does not apply to patents:

[N]either the operation of the Business, nor any activity of the Company, nor any manufacture, use, importation, offer for sale and/or sale of any Current Game ... infringes on, constitutes a misappropriation of (or in the past constituted a misappropriation of), or violates (or in the past infringed on or violated) any intellectual property rights of a third party *except for the rights of any person or entity under ... any Patent*. (A128-29 (emphasis added).)

The other provision, § 4.15(k), applies to “Company Developed Software”:

[W]ith respect to ... the Company Developed Software ... used in Games in development or in current Games..., the Company ... has adequate rights therein as is necessary for the current use (if any) of such Company Developed Software and Software.... (A128.)

¹¹ In the court below, Defendants also cited a third representation, § 4.15(o)(ii), that Harmonix’s senior officers had no *knowledge* of any infringement. Based on the undisputed evidence, the court found no evidence that the officers had such knowledge. (Mem. Op. at 18-19.) Defendants have abandoned this claim on appeal; their brief does not mention § 4.15(o)(ii).

1. Defendants offered no evidence that *Rock Band* infringed any third-party IP.

Defendants never alleged – let alone presented evidence – that *Rock Band* infringed any third-party IP. Thus, Defendants cannot claim that “[t]he record demonstrates a breach of the representations and warranties concerning Harmonix’s business contained in Sections 4.15(k) and 4.15(o)(i).” (Ans. Br. at 43.) Defendants never raised any genuine issue of fact about the truth of the matters represented and warranted in those provisions, even if they covered *Rock Band*. To the contrary, Defendants have steadfastly denied any infringement, and they offered no evidence in opposition to the testimony of Harmonix’s CEO that “we took great pains to make sure that we were never infringing third parties’ IP.” (AR98:6-8.) All that Defendants argue in their Answering Brief is that certain third parties “alleged” infringement. (Ans. Br. at 45.) But third-party allegations are not evidence that an actual breach of warranty occurred, and they cannot defeat summary judgment. *See* Ct. Ch. R. 56(e) (“an adverse party may not rest upon the mere allegations ... but ... must set forth specific facts showing that there is a genuine issue for trial”).

2. The representations and warranties in the Merger Agreement did not cover *Rock Band*.

When Viacom acquired Harmonix, the business plan was to develop a new videogame, *Rock Band*. If the parties had intended the representations and war-

ranties to cover this planned game, they would have said so *clearly* because such a provision would have been highly unusual. Why would the Selling Shareholders make representations and warranties about a *future* game that the buyer would ultimately design, develop, and commercialize? In fact, the contractual terms are all defined to exclude the future. Section 4.15(o)(i) refers to “Current Games” (defined as games “that are *currently* commercially available”) and “the Business” (defined as “the business of the Company as *currently* conducted”). (A130-31, §§ 4.15(w)(i) and (vii) (emphasis added).) Similarly, § 4.15(k) refers to “the current use” of Company Developed Software. The Agreement had no representations or warranties about the final, published *Rock Band* game that would be completed, manufactured, and sold in the future under Viacom’s ownership.

Defendants invoke § 4.15(k), which represents that Harmonix “has adequate rights therein as is necessary for the use current use ... of ... Company Developed Software....” As shown below, Harmonix’s work on *Rock Band* did not constitute “Company Developed Software” at the time of the acquisition. But even if it did, Defendants failed to present evidence that Harmonix lacked “adequate rights” as “necessary” for the “current use” – which was not the manufacture and sale of an existing game, but the early-stage development work on a future game. Indeed, the IP litigants never even alleged that Harmonix’s development work prior to the acquisition infringed their rights. Defendants concede that “the third-party claims

made allegations regarding the ‘final, published version of *Rock Band*.’” (Ans. Br. at 45.) Defendants try to get around this fact by stating: “To the extent that Harmonix was allegedly infringing upon third-party intellectual property rights, that infringement started at the moment it began employing the intellectual property at issue in its development of *Rock Band*.” (*Id.*) But Defendants presented no evidence that Harmonix ever “employ[ed] the intellectual property at issue” – let alone that it “began” doing so *before* Viacom bought the company.

Furthermore, Defendants did not raise a triable issue by asserting that “the concept of the note highway was in place at that point in time.” (Ans. Br. at 46.) This “concept” was not the subject of Activision’s claim, for concepts cannot be copyrighted.¹² Rather, its claim was that the *artwork* in the published *Rock Band* game was similar to the “unique, distinctive, and stylized appearance” of Activision’s *Guitar Hero* game. (B173.) But the artwork in *Rock Band* was created after Viacom bought Harmonix. As Harmonix’s CEO testified:

Most of the actual creative work to be done on art production and things of that sort, like it was still ahead of us, you know, in September, October of 2006.... [A]t that point because we weren’t really in production yet, it was what I call programmer art, kind of temporary

¹² The Copyright Act makes this clear: “In no case does copyright protection for an original work of authorship extend to any idea, procedure, process, system, method of operation, concept, principle, or discovery, regardless of the form in which it is described, explained, illustrated, or embodied in such work.” 17 U.S.C. § 102(b). Thus, the courts have rejected claims of copyright on the functional features of videogames. *E.g.*, *Atari, Inc. v. N. Am. Philips Consumer Elecs. Corp.*, 672 F.2d 607, 617 (7th Cir. 1982); *Apple Computer, Inc. v. Microsoft Corp.*, 35 F.3d 1435, 1444 (9th Cir. 1994).

fake art while you're working on the functional design. (AR101:11-102:13.)

In any event, § 4.15(k) does not apply because the work on *Rock Band* at the time of the acquisition did not constitute “Company Developed Software.” There are no facts in the record from which a trier of fact could find that any component of the *Rock Band* software had been “developed” when Viacom bought Harmonix. Defendants respond that “the Merger Agreement does not define ‘developed.’” (Ans. Br. at 44.) But it does draw a distinction between “developed” and “in development.” The term “Software” is expressly defined to include *either* “operational or in development” computer software. (A132, § 4.15(w)(xvii).) By contrast, “Company Developed Software” is defined as “Software developed by the Company....” (A130, § 4.15(w)(iii).) The use of the past tense – “developed” – refers to software that has *already* been created. This distinction is crystallized in § 4.15(k), which refers to “Company Developed Software” used in “Games in development.” This provision recognizes that previously “developed” software may be used in the development of new games. But Defendants have not identified any previously “developed” software that was being used in the development of *Rock Band* when Viacom bought the company.

Finally, even if this language were ambiguous, Defendants lose because of the principle – cited by the Court of Chancery but never addressed in Defendants’

Answering Brief – that “[u]nder Delaware law, indemnity provisions are to be construed strictly rather than expansively.”¹³

3. Defendants did not file a timely notice of the Konami suit.

The Court of Chancery held that an additional reason for denying indemnity as to the Konami lawsuit was Defendants’ failure to provide notice within 18 months of the closing. (Mem. Op. at 20.) Section 8.1 of the Agreement is clear:

Notwithstanding the foregoing, the [Selling Shareholders] ... will have no liability with respect to any claim for any breach or inaccuracy of any representation or warranty in this Agreement unless [Viacom or Harmonix] notifies the Stockholders’ Representative ... of such a claim on or before the date which is eighteen (18) months following the Closing Date.... (A152.)

Viacom did not notify Winshall of the Konami lawsuit until July 2008, which was 21 months after the closing. Nevertheless, in an attempt to circumvent the contractual deadline, Defendants state that they sent a letter just before the deadline asserting that they “reserved the right to seek indemnification for additional claims that might be made by third parties.” (Ans. Br. at 8.) Under Defendants’ theory, a boilerplate reservation of rights on the last day would be sufficient to give “notice” of any future claim for indemnification, even if it did not provide any meaningful notice at all. But one party to a contract has no right to

¹³ Mem. Op. at 16 n.53. See, e.g., *Petrolane Inc. v. Tex. E. Corp.*, 2003 WL 21999420, at *5 (Del. Ch. Aug. 22, 2003) (“indemnity provisions are to be strictly construed”), *aff’d*, 841 A.2d 308 (Del. 2004) (TABLE); *Fountain v. Colonial Chevrolet Co.*, 1988 WL 40019, at *11 (Del. Super. Apr. 13, 1988) (“Delaware courts construe indemnity agreements strictly against the indemnitee”).

nullify the protections granted to the other side by unilaterally “reserv[ing] the right” to ignore a contractual deadline.

Defendants respond that their April 2008 letter notified Winshall “that Defendants were asserting a claim that the Selling Shareholders had breached their representations and warranties....” (Ans. Br. at 49.) But the April letter referred to claims made by Gibson, 1st Media, and Activision. Konami brought an entirely different claim based on the alleged infringement of different patents. Section 8.1 makes clear that the 18-month deadline applies on a *claim-by-claim* basis. There is “no liability with respect to *any claim* for any breach or inaccuracy of any representation or warranty in this Agreement unless [Viacom or Harmonix] notifies the Stockholders’ Representative ... of *such a claim*.” (A152, § 8.1 (emphasis added).) Thus, Defendants had to provide notice of the Konami claim within 18 months, and they failed to do so.

CONCLUSION

For the foregoing reasons, the judgment in favor of Winshall on Counts II and III of the Amended Complaint should be affirmed, the judgment dismissing Count I should be reversed, and that count should be remanded to proceed with discovery.

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May 17, 2013