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Del. Dispatch: Cautionary Tales Of 2 Earnout Effort Breaches

By **Gail Weinstein, Philip Richter and Steven Epstein** (October 2, 2024, 5:20 PM EDT)

This article is part of a monthly column that delves into the most significant corporate law cases emerging from Delaware and offers practice points arising from recent court decisions. In this installment, we examine the Delaware Court of Chancery's September rulings in two earnout efforts disputes.



Gail Weinstein



Philip Richter



Steven Epstein

In the Delaware Court of Chancery's two most recent earnout decisions, Fortis Advisers LLC v. Johnson & Johnson **from Sept. 4** and Shareholder Representative Services LLC v. Alexion Pharmaceuticals Inc. **from Sept. 5**, the court concluded that a buyer breached its contractual obligation to use commercially reasonable efforts to achieve an earnout.

In stockholder Fortis's suit over Johnson & Johnson's acquisition of Auris Health Inc., the parties had agreed to an inward-facing efforts obligation. In Alexion, the parties had committed to an outward-facing efforts obligation. Generally, an inward-facing standard compares the buyer's efforts to its own, or sometimes to the seller's, efforts for its products that are similar to the earnout product; an outward-facing standard compares the buyer's efforts to the efforts of similar companies for similar products under similar circumstances.

As Auris and Alexion highlight, the judicial result in claims that a buyer breached its earnout efforts obligations will depend on the precise wording of these provisions, as well as the overall factual context.

The Auris Case: Fortis Advisers LLC v. Johnson & Johnson

In the Auris case, buyer Johnson & Johnson paid an upfront purchase price of $3.4 billion at closing and agreed to make an earnout payment of an additional $2.35 billion upon achieving certain milestones relating to the further development of a market-leading surgical robot called iPlatform. The parties' agreement required that J&J use commercially reasonable efforts to develop iPlatform, defined as meaning efforts similar to those J&J expended for its other "priority medical products."

Soon after closing, J&J decided that its budget could not accommodate developing both iPlatform and another J&J robot, called Verb, in parallel, so it would "have to combine the robots or kill one of them." J&J then made iPlatform compete with Verb head-to-head in a long series of tests to determine which robot was better. Then J&J combined iPlatform with Verb, which effectively "rendered it a parts shop for Verb."

These actions caused complications and delays in iPlatform's ability to achieve the earnout milestones. iPlatform did not achieve the milestones, so J&J did not pay the earnout.

The court held that J&J breached its efforts obligation when it caused iPlatform to compete against, and then combine with, Verb.

First, the court found that these actions were inconsistent with the priority status iPlatform was to be accorded, which alone was sufficient for a finding of breach. Moreover, the court concluded that J&J knew that these actions would hinder the earnout and desired that result so it could avoid the earnout payment.

Second, the court found that J&J's treatment of iPlatform, including the competition-and-combination actions among others, were starkly different from the efforts it had expended on the single comparator priority medical product it had identified, its robot named Velys. This, the court stated, was also sufficient alone for a finding of breach. For Velys, J&J had used a less risky regulatory strategy and had provided better incentives to employees working on the project, among other factors.

Vice Chancellor Lori Will awarded damages of $1 billion and commented that, while this amount would compensate Auris' former stockholders, "what remains irretrievably lost is the transformative potential of Auris's robots."

Shareholder Representative Services LLC v. Alexion Pharmaceuticals Inc.

In this case, buyer Alexion paid an upfront purchase price of $400 million and agreed to make an earnout payment of up to $800 million, payable in installments upon the completion of each of eight milestones relating to the development of an antibody to cure certain diseases. The parties' agreement required that Alexion use commercially reasonable efforts to develop the antibody, defined to mean efforts that a typical biopharmaceutical company would use for a product at a similar stage of development under similar circumstances.

During the earnout period, Alexion was acquired by AstraZeneca, which then reviewed all of Alexion's programs, including the antibody program. Alexion then terminated the antibody program, citing new safety data from ongoing trials and related concerns about the antibody's order of entry to the market.

The court held that Alexion breached its efforts obligation when it terminated the antibody program.

The court essentially rejected Alexion's purported business reasons for the termination, emphasized that the new safety data was inconclusive and concluded that a hypothetical typical company, under similar circumstances, would have gathered more data rather than terminate the program.

Overlaying the court's analysis was the particular factual context, with Alexion having been acquired during the earnout period and its acquirer having publicly promised outsized merger synergies from that acquisition. The court concluded that the termination decision actually had been driven by AstraZeneca and its idiosyncratic objective of achieving those outsized synergies.

Vice Chancellor Morgan Zurn stated that the court would determine the damages award in a subsequent decision.

Key Points

Wins Not From Trend Favoring Sellers

While Auris and Alexion are consistent with the court's new trend of finding in favor of sellers more often than it historically had, both of these cases were decided based on unusual facts and circumstances — and so do not, in our view, reflect any strong reinforcement of the new trend.

In Auris, the court's result was based primarily on unusually strong seller-friendly earnout language in the parties' merger agreement. In Alexion, the court's result was based primarily on the particular unusual factual context involving an acquisition of the buyer and the acquirer's idiosyncratic need for merger synergies. Both cases underscore, once again, that the outcome in earnout cases is based on the language of the earnout provisions, and the specific facts and circumstances.

Interrelationship of Buyer's Right to Complete Discretion With Its Efforts Obligations

Alexion highlights that the court will interpret a provision granting a buyer complete discretion over

an earnout product in context with the buyer's efforts obligations. The outward-looking efforts standard that the parties agreed to called for a comparison with what a typical biopharmaceutical company would do in similar circumstances. As the agreement did not specify that Alexion could take into account its own self-interest when making decisions about the earnout product, the court held that it could not.

We note that in an April decision, Himawan v. Cephalon, the Court of Chancery interpreted the interrelationship of a complete discretion right with an outward-facing efforts obligation as meaning that if a similar company faced with the same circumstances and acting reasonably "would go forward in its own self-interest, [then] the buyer [was] contractually obligated to do the same."

In other words, in Himawan, the buyer had to continue efforts to achieve the earnout "unless it would be commercially unreasonable to do so." In that case, the parties' agreement expressly permitted the buyer, when deciding what efforts to make to develop the earnout product, to have "due regard for the efforts and costs."

The court's highly granular analysis of the specific wording of the efforts provisions, as compared to the language in other earnout cases, underscores how critical the precise language that the parties use in their agreement is to the court's result in each case.

Prevalence of Earnout Disputes

Auris and Alexion serve as another reminder that earnouts often lead to postclosing disputes. Also, as the outcome involves intensive judicial analysis of the factual context and the specific language of the parties' agreement, it is often difficult for buyers to obtain dismissal of earnout claims at the pleading stage of litigation, and it is often difficult to predict the ultimate outcome.

Accordingly, while an earnout often makes sense in pharma or biotech cases where almost all the value of the company depends on future developments, and those developments are highly uncertain, there are many contexts in which it may not be prudent to use an earnout.

Practice Points

Broad Spectrum of Earnout Provisions

There is a broad spectrum of possible earnout provisions. Where parties end up on the spectrum, in terms of protection for the seller compared to flexibility for the buyer, will generally depend on their respective negotiating leverage.

In addition, a buyer's history with earnouts may affect the parties' negotiations. Before a seller enters into an earnout, the seller should check that history. Buyers should be mindful of potential reputational damage, in terms of their future ability to enter earnout arrangements or obtain desired earnout terms, if they have a problematic history regarding complying with their earnout obligations.

Bespoke Provisions

The court will generally interpret earnout provisions precisely as written. Earnout provisions should be drafted as bespoke provisions, tailored to the specific product, business, company, industry and situation at hand, in a process involving lawyers and the businesspeople who understand the specific product or business best. Careful, specific, business-contextualized consideration of potential issues that may arise over the earnout is critical.

Interpreted as Written

The court generally will interpret earnout provisions as they are written. It is critical that the drafting be thoughtful, clear and highly contextualized for the specific business, product and situation. Earnout provisions should be crafted with the participation of the lawyers, businesspeople, and experts who know the product or business best.

The Inward- Versus Outward-Facing Efforts Standard

When selecting between these standards, the parties should consider whether there are in fact exemplar products under each standard; and, if so, which of those products are exemplars, what the buyer's efforts have been with respect to them and whether they comport with the parties' expectations for treatment of the earnout product.

An inward-facing standard may offer a buyer a greater degree of flexibility than an outward-facing standard. Under an inward-facing standard, depending on the facts and circumstances, a buyer may be able to adjust its efforts for its other products if beneficial for its efforts obligations to the earnout product. Also, particularly where there is a long earnout period, an inward-facing standard may better accommodate unique corporate needs or objectives that may develop over time.

Yardstick Versus Hypothetical Approach for Outward-Facing Standard

Earnout parties utilizing an outward-facing efforts obligation should consider specifying whether the comparison will be to actual actions taken by actual similar companies — a so-called yardstick approach — or instead to actions that would be expected to be taken by a hypothetical similar company — a so-called hypothetical approach.

The Alexion parties did not so specify, and the court, determining that there were no exemplar companies for the first approach, applied the hypothetical approach. This effectively led to judicial second-guessing of the buyer's business decisions for terminating the product and a finding that a hypothetical similar company would not have terminated the earnout product under similar circumstances.

We note that, in Alexion and in Himawan, the court suggested that there may be no outward-facing comparators for a drug-development company, given the unique circumstances relating to the development process for each particular drug for each particular indication.

Specific Efforts Covenants

Parties should consider expressly setting forth in their agreement any specific actions the buyer or the seller will be required to make, not be required to make or be prohibited from making in connection with efforts to develop the earnout product. If, for example, the parties have discussed particular actions that they anticipate will have to be taken, or not taken, to ensure or maximize earnout payments, the parties should set them forth in express covenants in the agreement.

If there are other specific actions the seller believes the buyer should take in furtherance of the earnout, or, on the other hand, specific flexibility the buyer wants to preserve for itself, the parties should consider setting them forth in express covenants in the agreement — particularly insofar as they relate to issues that are the most critical to the achievement of the earnout or the most likely to be subject to manipulation or dispute.

Compliance With Efforts Obligations

Before taking actions with respect to, or that may affect, an earnout product, a buyer should review the agreement to determine whether the action is permitted under the efforts standard. This inquiry will require close analysis of the specific language of the earnout provisions and their interrelationship with other merger agreement provisions.

As highlighted in Auris and Alexion, such actions might include, for example:

- Deprioritizing or terminating the earnout product;
- Causing the earnout product to compete head-on, or to combine, with the buyer's existing products;
- Failing to identify and pursue alternative regulatory strategies when others are foreclosed;
- Negatively affecting the motivation of the employees working on the earnout product;

- Changing the reporting structure for such employees;
- Decreasing the funding or other support for the earnout product; and/or
- Significantly increasing investment in other products.

Monitoring Efforts Obligation Compliance

On an ongoing basis during the earnout period, the buyer should monitor its efforts for the earnout product. If an inward-facing standard applies, the buyer should benchmark those efforts against its efforts for its comparator products.

If an outward-facing standard applies, the buyer should monitor the efforts that its peers, or other companies that are the comparators under the specified standard, are making and benchmark its efforts against those efforts.

Buyer's Competing Products

Special issues may arise where the buyer has competing or potentially competing products. The parties should consider how the competing products will be treated in relation to one another with respect to the earnout; they should consider providing explicitly in their agreement how the products will compete and whether they can be combined.

In this context, as was the case in Auris, the court may be more skeptical of the buyer's motives for having acquired the product and any postclosing lack of efforts in support of it.

Acquisition of Buyer During the Earnout Period

Certain complications may arise if a buyer is acquired during the earnout period. The buyer's acquirer, as part of its due diligence, should consider the buyer's efforts obligations with respect to any earnouts and whether they comport with the acquirer's own plans and objectives. If the earnout product is deprioritized or terminated after an acquisition of the buyer, the court may be skeptical, as it was in Alexion, that the termination was based on the idiosyncratic objectives of the acquirer.

A seller may wish to consider specifying certain consequences to the earnout in the event of an acquisition of the buyer, or an acquisition of the buyer meeting specified criteria, such as acceleration of the earnout.

Use of the Negotiating Process and Internal Communications to Interpret Ambiguous Provisions

In Alexion, in reaching the issue of whether the first milestone had been met, the court reviewed the full history of the parties' negotiations, as well as internal emails, to determine Alexion's own contemporaneous interpretation of the agreement language.

It cannot be emphasized enough that individuals should craft carefully their planning documents and internal communications, including emails, keeping in mind that they may be subject to discovery in the event of litigation. Humor, sarcasm, playing devil's advocate without stating as much and ambiguous statements should all be avoided, as they could later be misinterpreted.

Gail Weinstein is senior counsel at Fried Frank Harris Shriver & Jacobson LLP.

Philip Richter is a partner and co-head of the mergers and acquisitions practice at the firm.

Steven Epstein is managing partner and co-head of the M&A and private equity practice at the firm.

Fried Frank partners Steven J. Steinman, Maxwell Yim and Colum J. Weiden contributed to this article.

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