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Earnout Decision Highlights Difficulty of Drafting with Sufficient Clarity to Avoid Post-Closing Disputes—Philips

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In WT Representative LLC v. Philips Holdings USA Inc., No. 2024-0170 PRW, 2024 Del. Ch. LEXIS 293 (Del. Ch. Aug. 16, 2024), the Delaware Court of Chancery, at the pleading stage of litigation, declined to dismiss claims that Philips Holdings USA Inc., which had acquired Vesper Medical, Inc., had breached the parties' merger agreement when it failed to make a post-closing earnout. The earnout was contingent on Philips' obtaining FDA approval of Vesper's "DUO Venous Stent Systems." Philips had sole discretion with respect to the FDA approval, subject to an "outward-looking" efforts standard and an express obligation not to act in bad faith. Although the earnout provisions included detailed definitions, the court found they were ambiguous as to whether the FDA approval that was obtained—which covered all of the numerous sizes of stents included in the definition of the Systems but one (the narrowest size, which Vesper had ceased to use before the deal with Philips)—was sufficient to trigger the earnout payment.

Key Points

We note the following key points arising from the Philips decision:

- **This is yet another decision underscoring the tendency of earnouts to lead to post-closing disputes, as well as the difficulty defendants face in obtaining pleading-stage dismissal of earnout claims.** When the court deems earnout provisions to be ambiguous, a breach of contract claim for failure to pay the earnout generally will survive the pleading stage unless the defendant's interpretation of the provisions is the *only* possible reasonable interpretation. Put differently, if the plaintiff has offered *any* reasonable interpretation (even if not the better interpretation), in most cases the claim will not be dismissed at the pleading stage.
- **Most often, the judicial outcome of an earnout dispute is highly uncertain.** We note that while historically the court most frequently ruled in favor of seller-plaintiffs

at the pleading stage of litigation over earnouts, more recently (albeit not in *Philips*) the court has more often held in favor of buyer-defendants. Nonetheless, with the court's focus generally being on the specific language of the parties' agreement as well as the overall factual context, it is difficult in most cases to predict the outcome of litigation over earnouts.

- **"Outward-looking" post-closing efforts standards can present difficult practical issues.** An outward-looking efforts standard references the efforts that a comparable company would undertake to achieve the earnout milestone under comparable circumstances. We note that the court suggested in its decision in Himawan v. Cephalon, Inc., No. 2018-0075-SG, 2024 Del. Ch. LEXIS 174 (Del. Ch. Apr. 30, 2024), issued earlier this year, that, for drug development companies, there may be *no* possible comparables, given the inherently varied circumstances involved in each drug's development. In *Philips*, the plaintiff's claim that Philips breached the efforts standard was the only claim that the court dismissed. The court noted the alleged acts or failures to act that may have suggested a lack of effort by Philips to achieve the milestone, but emphasized that the plaintiff had never linked those allegations to the outward-looking requirements of the efforts standard (i.e., had never addressed whether a comparable company under comparable circumstances would have acted the similarly).

Background

Vesper, a privately held medical equipment company, created the "DUO Venous Stent System," a minimally invasive venous stent system. In December 2021, Philips acquired Vesper pursuant to a merger agreement. The merger agreement called for a $250 million purchase price to be paid at closing, as well as a post-closing payment of $100 million if the FDA granted approval, post-closing, of an application to pre-market the DUO Venous Stent System.

In 2016, Vesper had applied to the FDA for an Investigational Device Exemption ("IDE") for clinical trials using all of the numerous sizes of stents it made, including the 10mm stent (the narrowest size). In 2020, Vesper amended its IDE application to inform the FDA that it would no longer be using the 10mm stents when it began clinical trials. In late 2020, the FDA approved Vesper's amended IDE, and Vesper began its DUO Venous Stent System clinical trials (without the 10mm stent).

Soon after Philips acquired Vesper, the clinical trials were completed, and Vesper (then operated by Philips) submitted a Pre-Market Approval ("PMA") application to the FDA. The PMA application provided the DUO Venous Stent System configurations, categorized by type, diameter, length, and delivery system. Consistent with Vesper's previous amended IDE, the PMA application did not include the 10mm stents, but it included all of the other stent sizes listed in the definition of the DUO Venous Stent System set forth in the merger agreement. In late 2023, the FDA granted approval of the PMA application.

Philips did not pay the Milestone Payment, on the basis that the FDA authorization that was obtained did not trigger the Milestone Payment obligation because the authorization did not include the 10mm stents, although they were included in the definition of the DUO Venous Stent System set forth in the merger agreement. WT Representative brought suit, in its capacity as stockholders' representative; Philips moved to dismiss. In a decision issued by Delaware Superior Court Judge Paul R. Wallace (sitting at the Court of Chancery by designation), the court declined to dismiss the claims that Philips breached the merger agreement (i) by failing to pay the Milestone Payment and (ii) by acting in bad faith in connection with the earnout. The court granted dismissal, however, of the claim that Philips breached its contractual obligation to use commercially reasonable efforts to achieve the milestone.

Discussion

The Merger Agreement.

The following were the relevant terms of the merger agreement:

- **"FDA Authorization Milestone."** The milestone was defined as receipt of FDA authorization for each of the First Generation DUO Venous Stent System and the Second Generation DUO Venous Stent System. "FDA Authorization" was defined as receipt from the FDA of "an order approving a [PMA] application or supplemental application." The "First Generation DUO Venous Stent System" was defined as including the "DUO-EXTEND Stent," which was defined as "the Company's self-expanding venous stent . . . which integrates with the DUO-HYBRID Stent to treat longer lesions in the following sizes . . ." Numerous sizes of stents were then listed, including the 10mm size.
- **Sole discretion.** Philips had "sole discretion" over all matters relating to the pursuit of the milestone, including filing the PMA application. Philips expressly had no obligation to operate Vesper to maximize the Milestone Payment; and the parties acknowledged in the merger agreement that the milestone might not be achieved.

- **Efforts.** Philips was obligated to use commercially reasonable efforts to achieve the milestone. "Commercially Reasonable Efforts" was defined as "such reasonable, good faith efforts and resources as a medical device company of a similar size and with similar revenues as [Philips and its affiliates] would normally use to accomplish a similar objective . . . under similar circumstances . . . it being . . . agreed that such efforts and resources shall be consistent with those . . . commonly used by such a medical device company under similar circumstances for a similar product owned by it, or to which it has similar rights, which product is at a similar stage in its product life and is of similar market potential, taking into account all relevant factors, including…the likelihood and difficulty of obtaining Regulatory Approval in the United States . . ."
- **Bad faith.** Philips was expressly obligated not to "take any action in bad faith with the primary purpose of avoiding or minimizing . . . the Milestone Payment."

The Court Found that the Plaintiff's Interpretation of the Earnout Provisions Was Reasonable.

The plaintiff argued that, for the FDA Authorization Milestone to be achieved, the FDA authorization had to cover just the stents Philips had specified in its PMA application or, alternatively, just those that then constituted the DUO Venous Stent System (i.e., those being used by Vesper). Thus, under the plaintiff's interpretation, the milestone was achieved even though the FDA authorization did not include the 10mm stents. The court found it was reasonable to read the requirement for approval of "each of the DUO Venous Stent First Generation System and the DUO Venous Stent Second Generation System" as merely requiring approval of the Company's stent system and not of every size listed in the DUO-EXTEND Stent and DUO-HYBRID Stent definitions.

The Court Sated that Philip's Interpretation Also May Have Been Reasonable.

Philips argued that, for the FDA Authorization Milestone to be achieved, the FDA authorization had to include *all* of the enumerated stent sizes enumerated in the definition of the DUO Venous Stent System set forth in the merger agreement—which included the 10mm stents. Philips pointed to language in the merger agreement that allowed for partial Milestone Payments if only one of the generations of the System were approved, while there was "no language for partial satisfaction if not all of the stent's various sizes were approved." Although Philips' interpretation "might be considered reasonable too," the court stated, the claim for breach of contract could not be dismissed at the pleading stage because Philip's interpretation was not the *only* possible reasonable interpretation.

The Court Found that the Plaintiff Ignored the "Outward-Looking" Requirements in the Efforts Obligation.

The plaintiff asserted that, if, as Philips urged, the FDA Authorization Milestone could only be achieved if the FDA authorization included the 10mm stents, then Philips' failure to include the 10mm stents in its PMA application amounted to a breach of Philip's express contractual obligation to use commercially reasonable efforts to achieve the FDA Authorization Milestone. Philips responded that it *had* included the 10mm size stents in its PMA application; and, the court stated, Philips had "provide[d] numerous documents to so prove." However, the court stated, at the pleading stage, "[f]acing disputed material facts—stemming from attached documents that lie outside the pleadings—the Court can't yet resolve the question of whether Philips submitted the 10mm stents to the FDA in its PMA application." Although the court rejected that basis for resolution of the claim of breach of the efforts standard, the court concluded that the claim could not survive because the plaintiff had "completely ignored" the "external-looking" requirements of the efforts provision. That provision, the court stated, unambiguously required that Philips use reasonable, good-faith efforts and resources similar to a medical company of a similar size and with similar revenues to Philips, and that those efforts be consistent with those commonly used by such a medical-device company under similar circumstances for a similar product owned by it. Yet, the court stressed, the plaintiff made "no reference to similarly situated companies or products in the complaint whatsoever." Therefore, even drawing all reasonable inferences in the plaintiff's favor, the plaintiff had not adequately pled that Philips breached its efforts obligation.

The Court Found that Philips May Have Acted in Bad Faith.

The court concluded that, at the pleading stage, it was reasonably conceivable that Philips had breached the express contractual obligation in the merger agreement that it not act in bad faith with respect to the earnout. The plaintiff alleged that it was bad faith for Philips not to include the 10mm stent in its PMA application if (as Philips contended) its inclusion was required for the FDA authorization to trigger the Milestone Payment. Under these circumstances, the failure to include the 10mm "could only be explained as a bad faith attempt by Philips to avoid the Milestone Payment." As noted, Philips maintained that it *had* included the 10mm stent size in the PMA application. The court concluded, however, that as

the court was required to draw all reasonable inferences in favor of the plaintiff at the pleading stage, it was "reasonably conceivable that Philips may have "acted in bad faith by failing to sufficiently request FDA approval of the 10mm stents while aware that the Milestone Payment required approval of those same 10mm stents." Further, the court reasoned that the bad-faith claim could survive as an "alternative" to the breach of contract claim for failure to pay the Milestone Payment, "if discovery [ultimately] reveal[ed] that the parties did in fact intend for 10mm stents to trigger the Milestone Payment."

Lessons for Practitioners

Based on Philips, we offer the following points for practitioners:

- **The language of an earnout provision should be as comprehensive, specific, and clear as possible, as well as contextualized for the specific business and circumstances.** The language should be reviewed carefully not only by lawyers but by the businesspeople and experts most familiar with the specific industry, company, product, and deal. The parties should consider setting forth in their agreement general statements as to the parties' intentions with respect to the earnout, and/or illustrative examples, to provide context for interpretation of any provisions that may later be found to be ambiguous.
- **The interrelationship of earnout-related provisions should be made clear.** Parties should consider specifying how provisions, such as a buyer's right to operate in its sole discretion and an outward-looking reasonable efforts obligation, are intended to operate together—for example, as being akin to a best efforts obligation (i.e., the buyer has to pursue commercialization of a product unless it would be unreasonable to do so), or as requiring only that the buyer act in good faith. In the recent *Cephalon* decision, the Court of Chancery concluded that the best interpretation of a buyer sole discretion provision that was subject to an outward-looking reasonable efforts obligation was that the buyer was contractually obligated to continue to seek regulatory approval for a product "if a [similarly situated] reasonable actor when faced with the same restraints and risks would go forward in its own self-interest."
- **Parties should consider the desirability of more specific, rather than more general, earnout-related covenants. General provisions granting the buyer sole discretion to operate, or prohibiting the buyer from acting in bad faith to frustrate the earnout may not operate effectively to avoid post-closing disputes.** The parties should consider providing specific covenants to cover, at least, aspects of the post-closing operations that are the most critical to the acquired business's operations or to the achievement of the earnout targets, or those areas that may be most susceptible to manipulation or dispute. If the parties have discussed particular actions that they anticipate will have to be taken to ensure or maximize earnout payments, the parties should not assume that the implied covenant of good faith and fair dealing will require that those actions be taken unless they are set forth in the parties' agreement. A buyer should maintain a record of the business reasons for actions it takes during an earnout period that may negatively affect the earnout.
- **The parties' specific objectives in adopting an earnout should be scrutinized, and alternative mechanisms should be considered.** In some transactions, the earnout is utilized to bridge a relatively small valuation gap as to which the parties may have been better served with a compromise upfront rather than risking later disputes (and litigation) over the earnout. When determining whether to agree to an earnout arrangement, a seller should examine the buyer's history in dealing with prior earnouts, and should consider the buyer's likely actual business objectives and strategy. Alternative mechanisms that could be considered to bridge valuation gaps include. depending on the specific facts and circumstances, contingent value rights (which are now sometimes used even in public deals) or contingent notes (although both of these may raise securities law issues); incentive compensation payable to carryover executives (although this may invoke tax or benefits issues); or a staggered purchase (although this may present business and accounting difficulties).
- **Alternative dispute resolution mechanisms should be considered.** Given the prevalence of earnout disputes, a dispute resolution mechanism that deters litigation should be included in earnout provisions. Even where, as was the case in *Philips*, an agreement provides for specific steps to be taken to try to resolve earnout-related disputes, the dispute ultimately may nonetheless end up being litigated —unless the agreement makes clear that the alternative dispute mechanism (such as arbitration) will be final and binding on the parties.
- **Parties should consider whether an external-looking efforts standard can be implemented under the circumstances as a practical matter.** It is critical to determine upfront whether comparable companies and circumstances could be identified. If an external-looking efforts standard is utilized, credible allegations of the buyer's lack of efforts may not be sufficient to support a claim of breach of the efforts standard without linking the allegations to the external-looking requirements (i.e.,

the efforts that similarly situated companies took under similar circumstances).

- **In a shift in the court's trend, the most recent Delaware earnout decisions have tended to find against buyers.** While Delaware law principles applicable to earnouts set a high bar for sellers to succeed on earnout-related claims, and historically the judicial trend was in favor of buyers, in most of the recent major Delaware earnout decisions the court has found in favor of the seller seeking an earnout payment. This recent trend may put more pressure on buyers to settle rather than litigate earnout disputes. However, the Delaware courts continue to emphasize the specific agreement language and factual context—thus, it is still the case that the outcome in most earnout cases is highly uncertain.
- **Despite reports to the contrary, there has not been a significant increase in the use of earnouts.** There have been numerous reports that the use of earnouts vastly increased in 2023, following post-pandemic-related valuation issues. This conclusion appears to be highly misleading, however, as it is based on the inclusion in these studies of de-SPAC mergers—but the so-called "earnouts" in these deals do not actually function as traditional earnouts (but, instead, as part of the "sweetener" for sponsors and others). In our study that excluded de-SPACS, we found that that the rate of usage of earnouts in 2023 was about consistent with the rate in recent years. Also of interest, a recent study by SRSAcquiom (available to the public on SRSAcquiom's website) of deals closed in 2023 shows that only 3% of the deals included a covenant by the buyer to run the business in accordance with the seller's past practice; only 3% of the deals included a covenant by the buyer to run the business to maximize the earnout payments; and in a large majority of deals, the buyer was expressly permitted to offset indemnity claims against future earnout payments.

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Gail Weinstein counsels leading companies, private equity firms, and investment banks on M&A strategy, defense preparedness, shareholder activism, and governance.

Gail was at the forefront of market-shaping transactions during the advent of M&A in the 1980s, acting as lead legal counsel on many of the seminal contested and negotiated M&A transactions. Her decades of M&A-related experience provide critical perspective for her counseling clients on their most critical challenges today.

Gail is a well-known thought leader in the industry. She is a co-author of *Takeover Defense: Mergers and Acquisitions* (9th edition, Wolters Kluwer), by Arthur Fleischer, Jr., Gail Weinstein, and Scott B Luftglass, a treatise widely recognized as a definitive legal resource for this area. Her article, "A Proposed Post-Pandemic Framework for Ordinary Course and MAE Provisions in Merger Agreements," co-authored with David A. Cooperstein, was published by the *Yale Law Journal*. She is also a leading author of numerous articles and white papers on M&A-related subjects, providing insight for clients, peers, business and legal media, and the broader legal community.

Gail is also a member of the Corporate Laws Committee of the American Bar Association's (ABA) Business Law Section. This is the only ABA Committee that is invitation-only and is charged with providing expert commentary on, and leadership in, the development of business corporation laws, including through the promulgation, amendment and implementation of the Model Business Corporation Act (MBCA).

Gail was twice awarded the prestigious Burton Award for distinguished legal writing and analysis, for her articles "The Dramatic Transformation of M&A Law Since 2014" and "Recent Trends in Shareholder Activism." She serves on the M&A Editorial Board of *Law 360*, and she regularly presents CLE trainings and appears on Practising Law Institute panels on various M&A, corporate governance and related topics.

In addition, Gail devotes significant time to pro bono representation of and advocacy for asylum-seekers at the Southern border and various legal organizations that assist them. The 2019 documentary film *Activized*, produced by Spy Pond Productions, features Gail's work in this space. The American Bar Association Committee on Immigration honored Gail with the 2021 Pro Bono Award.

Gail serves as co-chair of our Coronavirus Task Force, which has coordinated our response to client legal needs relating to the pandemic.

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Philip Richter represents our clients in transactions involving both public and private companies, minority investments, proxy fights and unsolicited proposals, and strategic partnerships and joint ventures.

Philip is co-head of our Mergers and Acquisitions Practice. Clients seek his advice on corporate governance issues, defensive strategy, securities law compliance, and other corporate matters, and he frequently represents investment banking firms serving in a financial advisory role, drafting and executing fairness opinions.

Chambers USA and Chambers Global: America's Leading Lawyers for Business have consistently recognized Philip as a leading individual in Corporate/M&A. Philip also wins regular rankings within *The Legal 500* in M&A: Mega-Deals, M&A: Large-Deals, and Financial Services: Regulatory. The *New York Law Journal* has named Philip an "M&A Trailblazer," and *Lawdragon* has listed him among its "500 Leading Lawyers." Furthermore, *MergerLinks* recognized Phil as the #4 Advisor Lawyer in New York for FY22.

Clients have described Philip as "extremely talented and brings a practical, solutions-oriented approach to deals," with another attesting that "his technical legal skills are superb…[and]…he is a very wise and experienced business adviser, and that combination of legal and business knowledge and experience is invaluable."

Steven Epstein, Managing Partner, Fried, Frank, Harris, Shriver & Jacobson LLP

Steve Epstein is the managing partner of the firm and a member of the firm's Governance Committee. He maintains an active corporate practice and serves as a trusted advisor to some of the country's leading companies across a broad range of industry sectors. As co-head of our M&A and Private Equity Practice, Steve counsels public and private companies, financial sponsors and investment banking firms in a variety of transactional and advisory situations, including acquisitions, divestitures, takeover preparedness and corporate governance matters. Steve brings extensive knowledge and experience from different deal-making perspectives, having advised clients both as an attorney and, previously, as an investment banker at Credit Suisse.

Steve's outstanding practice has earned him accolades from *Chambers USA* as a leading individual in Corporate/M&A, *Legal 500* in M&A and *Super Lawyers*. He was named a BTI "Client Service All-Star" for 2020, 2021 and 2024 and has been recognized in NACD's "Directorship 100" as a leading advisor to corporate boards. He was previously named a Rockefeller Fellow by the Partnership for New York City.

Sought after as a thought leader in the space, Steve speaks frequently and writes extensively on developments in M&A and on emerging corporate governance trends.

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As co-head of our Private Equity Transactions Practice, Steven Steinman represents our clients in both private equity transactions and mergers and acquisitions.

Steven is consistently ranked in *Chambers USA* and *Chambers Global* for Private Equity: Buyouts and *Legal 500* for Private Equity Buyouts (where he has been named a Leading Lawyer) and M&A: Mega Deals, as well as *IFLR 1000*. He has also served as a select member of the editorial panel for *IFLR's Global Guide to Private Equity and Venture Capital*.

Steven is recognized for having "a stellar reputation in the market and has become a trusted advisor to high-profile firms" (*Legal 500*) and has "expertise in significant private equity transactions, including a wealth of experience in mid-market buyouts and exit deals" (*Chambers*).

Steven has lectured at a number of select institutions, including Columbia Law School, The University of Pennsylvania Carey Law School and The Wharton School of the University of Pennsylvania.

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