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DELAWARE COURT OF CHANCERY NARROWS ENFORCEABILITY OF *CON ED* PROVISION

By Mark D. Director, Monica K. Loseman, Brian M. Lutz, Craig Varnen, Jeff Lombard, Marina Szteinbok, Mark H. Mixon Jr. and Marc Collier

Mark Director is a partner in the Washington, D.C. and New York offices of Gibson, Dunn & Crutcher LLP. Monica Loseman is a partner in Gibson Dunn's Denver office, and Brian Lutz is a partner in Gibson Dunn's San Francisco office. Craig Varnen is a partner, and Marc Collier is an associate, in Gibson Dunn's Los Angeles office. Jeff Lombard is of counsel in Gibson Dunn's Palo Alto office. Marina Szteinbok is a counsel, and Mark Mixon is an associate, in Gibson Dunn's New York office. Contact: mdirector@gibsondunn.com or mloseman@gibsondunn.com or blutz@gibsondunn.com or cvarnen@gibsondunn.com or jlombard@gibsondunn.com or mszteinbok@gibsondunn.com or mmixon@gibsondunn.com or mcollier@gibsondunn.com.

The Delaware Court of Chancery recently narrowed the enforceability of a "*Con Ed*" provision allowing a target company to seek lost stockholder premium as damages resulting from an acquiror's breach in a failed merger. In *Crispo v. Musk et al.*, Chancellor Kathaleen St. J. McCormick denied a stockholder-plaintiff's petition for a mootness fee related to the efforts of Twitter (now known as "X") to force Elon Musk to close their merger.[1] The Court held that Twitter stockholder Luigi Crispo lacked standing to seek lost premium damages from Musk under "two objectively reasonable interpretations" of the merger agreement's provision that includes the lost share premium as available target company damages (the "Lost-Premium Provision"). Specifically, the Court held that the Lost-Premium Provision was unenforceable by stockholders because (a) the merger agreement did not clearly confer third-party beneficiary status on stockholders to seek such lost premium damages directly, or (b) the stockholder's "implicit" limited rights to seek such damages under the Lost-Premium Provision had not vested when the complaint was filed because, at that time, Twitter was pursuing a claim for specific performance. In the course of determining the viability of the stockholder's claim, the Court also held that a Lost-Premium Provision that defines lost-premium damages as exclusive to the target (a "damages-definition approach") is unenforceable under Delaware law.

The first interpretation is reflective of the Court's conclusion that a damages-definition approach to *Con Ed* provisions is an unen-

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beneficiary status on stockholders to pursue lost-premium damages.

- The Court's decision seemingly endorsed the view that the exclusive agency approach to *Con Ed* provisions stands on questionable legal footing. Nonetheless, the Court did not directly pass upon this formulation. Moreover, practitioners may consider whether methods of express stockholder appointment of the target as agent for collection of lost-premium damages might be effective. In a footnote, the Court remarked that a "charter provision designating the company as the stockholder's agent for the purpose of recovering lost-premium damages after [a] failed sale" could provide a solution. For many already-public companies, however, this approach may not be practicable.

- *Crispo* creates uncertainty regarding the enforceability and scope of *Con Ed* provisions intended to benefit stockholders. Targets that want to leverage a *Con Ed* provision to compel a buyer to close should consider making the grant and scope of third-party beneficiary status express, rather than relying on a court to infer such an intent. This approach is likely to raise considerable issues for buyers, however, as they would potentially be subject to multiple stockholder suits, and likely will be difficult for sellers to negotiate successfully.

- After *Crispo*, practitioners may want to focus attention on reverse termination fees or liquidated damages provisions sized to approximate the share premium payable in the merger, which would have the benefit of side-stepping the issue of the lost share premium as an element of expectation damages. But this approach is not without risk. A court may determine that a reverse termination fee (or liquidated damages stipulation) of magnitude approximating the lost premium also constitutes a penalty to the extent it reflects a target company's receipt of the lost premium in another guise.

- In light of the uncertainty following *Crispo*, the Delaware General Assembly could consider amendments to the Delaware General Corporation Law that authorize the exclusive agency approach.

ENDNOTES:

[1]*Crispo v. Musk*, 2023 WL 7154477, at *13 (Del. Ch. 2023).

[2]*Consolidated Edison, Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir. 2005).

EARNOUTS UPDATE 2023: CONTRARY TO RECENT REPORTS, THE USE OF EARNOUTS HAS NOT INCREASED THIS YEAR; AND DELAWARE COURTS ARE MORE OFTEN FINDING AGAINST BUYERS

By Gail Weinstein, Warren S. de Wied, Steven Epstein, Philip Richter, Randi Lally and Erica Jaffe

Gail Weinstein is senior counsel, Warren de Wied, Randi Lally, and Erica Jaffe are partners, and Steven Epstein and Philip Richter are partners and co-chairs of M&A Practice in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Contact: gail.weinstein@friedfrank.com or warren.de.wied@friedfrank.com or steven.epstein@friedfrank.com or philip.richter@friedfrank.com or randi.lally@friedfrank.com or erica.jaffe@friedfrank.com.

Since the COVID-19 pandemic began in 2020, there has been a higher proportion of M&A deals including earnouts—used, as usual, to bridge gaps in

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buyers' and sellers' views of valuation in light of economic and financial uncertainties in the marketplace generally and with respect to specific businesses. Also, earnouts have been used in some deals this year to address difficulties in upfront financing as the M&A financing environment has remained challenging.

In this article, we discuss (i) the prevalence of earnouts in M&A deals; (ii) the trend in litigation over earnout disputes; (iii) a change in the frequency of certain earnout-related buyer covenants; (iv) basic Delaware legal principles relating to earnouts; and (v) the recent major Delaware earnout decisions, which reflect a new judicial trend of more frequent holdings against buyers. We also offer earnout-related practice points.

Key Points

- **Contrary to recent reports, the uptick in the use of earnouts since the pandemic began—although continuing—has *not* dramatically increased in 2023.** Numerous recent reports have stated that the use of earnouts in M&A deals has roughly *doubled* in 2023 compared to the most recent past few years. This conclusion appears to be highly misleading, however, as it is based on the inclusion of de-SPAC mergers in the database of the deals studied. As discussed below, our study—which excludes de-SPAC mergers because the so-called earnouts in these deals do not actually function as traditional earnouts—indicates that the rate of usage of earnouts in 2023 to date has been about *consistent with* recent years (and, indeed, is *down* somewhat from 2022).

- **Contrary to recent reports, litigation over earnouts does *not* appear to have dramatically increased in 2023.** Recent reports have stated that the number of earnout disputes being litigated in Delaware courts *quadrupled* in the first quarter of 2023 compared to the first quarter of 2022. This conclusion appears to be based on a dataset that includes all litigation filed where the court papers anywhere include the word "earnout." Our study—which includes only litigation actually involving a dispute over an earnout—indicates that litigation over earnouts has *not* dramatically increased in 2023 to date.

- **Recent changes in certain earnout-related buyer covenants appear to be due to a greater proportion of strategic-buyer (rather than financial-buyer) deals.** In 2023, there has been a notable *decrease* in deals with a covenant by the buyer to operate the business during the earnout period "consistent with past practices"; and a notable *increase* in deals with a covenant by the buyer to use "reasonable efforts" to achieve the earnout. At the same time, there has been an increase in deals with strategic buyers—who are more likely than financial buyers to object to a consistent- with-past-practices covenant, and to agree to use a reasonable-efforts covenant, given that strategic buyers usually do not retain the existing management team (while financial buyers usually do).

- **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 while historically the judicial trend was in favor of buyers, in six of seven recent major earnout decisions—including, most recently, *FLMS v. Integris BioServices* (issued October 31, 2023)—a Delaware court found in favor of the seller seeking earnout payments. This recent trend may put more pressure on buyers to settle rather than litigate earnout disputes. It is to be noted, however, that the Delaware courts continue to emphasize the specific agreement language and factual context—and, thus, the outcome in earnout cases tends to be highly uncertain.

- **For practice points relating to earnouts, see**

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below. Most critically, the parties should seek to ensure clear and specific drafting that is contextualized for the business at issue, and should consider approaches that may reduce the risk of disputes and litigation.

Usage of Earnouts

Recent reports of a dramatic increase in the use of earnouts in M&A deals (excluding deals for development-stage target companies, such as in the life sciences sector)[1] appear to be based on the inclusion in those studies of de-SPAC mergers purportedly including earnout provisions. In the current formulation of de-SPAC mergers, however, the "earnout" provisions generally do not function as actual earnouts. That is, they do not function to bridge valuation expectations between buyers and sellers by providing the target stockholders with additional consideration if, post-closing, certain financial targets or milestone events are met by the acquired company. Rather, they typically function simply as an additional compensation "sweetener" for the SPAC sponsors and insiders (usually, if the combined company's post-closing stock price reaches a specified target).

When de-SPAC mergers are *excluded* from the database of deals, the use of earnouts in 2023 to date has been about consistent with their use in the most recent years since the pandemic emerged. In 2023 to date, about 37% of M&A deals (excluding development-stage company deals and de-SPAC mergers) have included an earnout. This compares to 43% of such deals in 2022, 33% in 2021, and 36% in 2020. Prior to these pandemic-affected years, the historic rate of usage of earnouts in such deals was roughly in the range of 20-30%; and, in 2019 and 2018 (the two years just before the pandemic), the rate of usage was about 20%.[2] Thus, current usage of earnouts remains above the historic, pre-pandemic rate—reflecting continued economic, valuation and financing uncertainties—but the rate has remained roughly consistent in 2023 with the rate in the most recent years (being somewhat *down* from 2022 and only slightly up from 2021 and 2020).

Prevalence of Litigation over Earnouts

Earnouts frequently lead to post-closing disputes, which often lead to litigation. Disputes may relate to the numerous inter-related provisions involving the metrics for the earnout formula; the accounting principles that will be applicable to calculation of the formula; the precise nature of the events that will constitute milestones or earnout triggers; the process for making the earnout determinations; and/or—which is most common—the seller's rights and the buyer's obligations with respect to the operation of the acquired business during the earnout period (including the general level of efforts, and any specific efforts, by the buyer that will be required with respect to enabling the business to reach the earnout targets). In analyzing the number of M&A lawsuits filed in 2023 actually involving *disputes over an earnout* (as opposed to lawsuits in which an "earnout" was mentioned for any reason in any of the court filings), it appears, contrary to recent reports, that there has *not* been a spike in litigation over earnout disputes.

Developments in Earnout Terms

According to an SRS Acquiom MarketStandard study of private deals with earnouts (excluding life sciences deals) in 2023 to date, a covenant by the buyer to operate the business during the earnout period consistent with past practices appeared in only 6% of 2023 deals, down significantly from 23% of 2022 deals; while a covenant by the buyer to use reasonable efforts to operate the business during the earnout period to achieve the earnout appeared in 40% of 2023 deals, up significantly from 30% of 2022 deals. These changes likely reflect the higher proportion of deals this year with strategic buyers—as strategic buyers are less likely than financial buyers to agree to operate in accordance with past practices, and more likely than financial buyers to agree to use reasonable efforts, given that financial buyers usually retain the

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existing management team and strategic buyers usually do not. As is consistent with recent prior years, the vast majority of deals in 2023 with an earnout have included a covenant by the buyer not to take actions post-closing for the primary purpose of preventing achievement of the earnout, and almost no deals have included a covenant by the buyer to operate the acquired business post-closing to seek to ensure or maximize the earnout.

Basic Delaware Legal Principles Relating to Earnouts

Generally, in Delaware, the courts apply their usual strict contractarian approach when interpreting earnout provisions. The courts will apply the clear and unambiguous terms of the parties' agreement; and, when the terms are unclear or ambiguous, will read the provisions in the context of the acquisition agreement as a whole and may consider extrinsic evidence to determine the parties' intentions.

The court generally has held that, except to the extent that the parties have provided otherwise, the buyer has no obligation to take or refrain from taking any action, and no implied obligation to use any form of best or reasonable efforts, to ensure or maximize payment of an earnout. (Note that the law of other states varies—with, for example, some states imposing an implied obligation on the buyer take "reasonable efforts" to achieve an earnout, at least in the absence of an express disclaimer to the contrary.)

The Delaware courts have held that the implied covenant of good faith and fair dealing, which adheres to every contract, requires that the buyer not take any affirmative action for the very purpose of frustrating the achievement of earnout targets or avoiding or minimizing earnout payments (for example, by diverting revenue from the acquired business to a subsidiary which was not subject to the earnout, without any valid non-earnout-related business reason for doing so). The Delaware courts tend not to view actions as having been taken for the purpose of frustrating payment of an earnout if (i) there is any basis for the actions to be viewed as legitimate business decisions and the sellers' complaint simply as a dispute concerning business strategy, and/or (ii) there are countervailing factors indicating substantial efforts by the buyer to support the relevant business (for example, the investment of funds in the business, hiring of additional sales people for it, and so forth).

Recent, New Trend in Delaware Decisions on Earnouts

Most earnout litigation has focused on whether the buyer has breached its general efforts obligations, or any specific covenants, with respect to its running of the business during the earnout period. Historically, in most cases, the court has found in favor of the buyer—concluding that the buyer conceivably had legitimate business reasons for running the business as it did, rather than having had a bad faith intent to frustrate the earnout. However, the most recent decisions appear to indicate a possible change in the court's direction—with the court holding in favor of the seller in six of the seven cases. At the same time, however, and importantly, because the judicial result in all cases is heavily dependent on the specific language in the parties' acquisition or merger agreement and the specific factual context, and because earnout provisions often are not sufficiently specific, litigation relating to earnouts carries a relatively high degree of uncertainty as to the outcome.

Most Recent Major Delaware Decisions on Earnouts

***FMLS v. Integris BioServices* (Oct. 30, 2023)—Earnout may be payable, as the buyer may have breached its covenants to use reasonable efforts and good faith to achieve the earnout.**

In a post-trial decision, the Court of Chancery held that the buyer's post-closing delays in hiring new scientists may have breached its covenants, set for forth in the parties' agreement, to use "commercially

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reasonable efforts" to achieve the earnout and not to use "bad faith" to frustrate the earnout.

During the pre-acquisition discussions between the parties, two key scientists at the target company departed, and the buyer allegedly promised to prioritize the hiring of new scientists post-closing. The parties' agreement required that the buyer use "commercially reasonable efforts to ensure the Earnout Business will have access to funding, personnel, compensation for employees, and support as is reasonably necessary to operate the Earnout Business reasonably consistent with the manner in which the Earnout Business was conducted by Seller immediately prior to the Closing Date" (the "Efforts Obligation"). The agreement also required that the buyer not take actions, or omit to take actions, "in bad faith that would have the purpose or effect of avoiding or reducing any Earnout Payment" (the "Good Faith Obligation"). The agreement provided that an earnout payment would be due five months after closing if revenues during that period reached a specified target; that, if the first earnout target was reached, then additional earnout payments would be due if additional specified revenue targets were hit in months six through eight; and that, if those targets were reached, additional earnout payments would be due if additional specified targets were hit in months nine through 11. If the first earnout target was *not* reached, no earnout payments would be due and the Efforts Obligation would not extend beyond the first five months post-closing.

In the first five months, revenue declined and the first earnout target was not reached. No earnout payments were made. Very soon thereafter, however, revenue surged. The seller sued, citing the buyer's failure even to put a recruitment team for new scientists into place until two months after closing and the buyer's failure to hire even one new scientist until four months after closing. The buyer argued that the Efforts Obligation was limited to ensuring the same support for the business that the business had pre-closing—and that, as the business had gone months before the closing without hiring new scientists, the buyer could take a similar amount of time post-closing. The court disagreed with the buyer, reasoning that, at least at the pleading stage, the Efforts Obligation appeared to be meant by the parties as a *protection* toward ensuring achievement of the earnout rather than as a provision permitting the buyer to withhold support.

Further, the court found it reasonable to infer, at the pleading stage, that the buyer, in delaying the hiring of new scientists, had acted with a bad faith intent to frustrate the earnout. The court cited the plaintiff's allegations that the buyer had waited to hire the first new scientist until two and a half months after having received his CV; and on two separate occasions had refused to engage recruiters the sellers introduced to the buyer. The court also noted the almost immediate increase in revenue once the new scientists had been hired and trained—which, especially given the buyer's alleged pre-agreement promises to prioritize hiring new scientists, raised the inference that the buyer knew that hiring new scientists was critical for achievement of the earnout and that the buyer may have "intended to withhold support to cause [the acquired company] to miss its revenue targets."

***Fortis Advisors v. Dematic* (Dec. 29, 2022)—Earnout is payable, as the parties appeared to have intended the term "Company Products" to include products that were integrated into the buyer's existing products.**

In a post-trial decision, the Superior Court held that, based on extrinsic evidence, the term "Company Products" in the parties' agreement should be interpreted to include products manufactured by the acquired business that were integrated, post-closing, into the buyer's existing products. The agreement provided that the buyer would make earnout payments based on post-closing sales of "Company Products"—with the term defined as the "products currently distributed or offered to third parties" by the acquired business. The

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buyer contended that the parties did not intend the term to include products that were made by integrating the acquired business' software source code or functionalities into the buyer's products. The court, finding the term ambiguous as defined in the agreement, considered extrinsic evidence, including: (i) how the products were made—from which it concluded that "source code" was the very component that was necessary to make the software functionalities operate; (ii) the recommendation by the buyer's due diligence team, before the deal was signed, that the functionality of the acquired business' products should be integrated into the buyer's platforms; (iii) the other terms of the acquisition agreement, which included a requirement that the buyer integrate the acquired business' products into the buyer's products and services during the earnout period; and (iv) pre-signing communications between the parties. The court concluded that the "more reasonable interpretation" of the term was that it included integrated products. Applying that definition, the court found that the earnout target was met and the earnout payments due.

***Menn v. ConMed* (June 30, 2022)—Earnout is not payable, as the buyer's discontinuance of the acquired business' product was based on previously identified safety concerns and not an intent to frustrate the earnout.**

In a post-trial decision, the Court of Chancery held that the buyer, when it determined to discontinue the acquired business' product, did not breach its contractual obligation to use best efforts to maximize the earnout payment—as the buyer had the express right under the parties' agreement to discontinue the product based on specified safety concerns it had identified pre-closing (which were listed on a schedule to the agreement); the buyer had made the determination to discontinue the product based on those safety concerns; and the buyer had devoted significant time and resources to trying to solve the safety problems. Of note, the buyer had already made two of three milestone payments payable on the achievement of specified objectives; and had worked hard over a period of years, including jointly with the sellers, to try to problem-solve the safety concerns.

***Schneider National Carriers v. Kuntz* (Apr. 25, 2022)—Earnout is payable, as, based on extrinsic evidence, the buyer's covenant to acquire at least "60 tractors" per year during the earnout period meant it had to *grow* the fleet by that number each year.**

In a post-trial decision, the Superior Court held that the buyer's covenant to purchase "not less than sixty (60) class 8 tractors" each year during the earnout period did not mean that the buyer's obligation was to acquire 60 or more tractors per year (which the buyer indisputably had done) but, instead, meant that the buyer was obligated to *expand* the fleet of tractors by at least 60 each year (which the buyer indisputably had not done). The court considered extrinsic evidence to determine the meaning of the covenant, including: the parties' pre-agreement statements and discussions; the assumptions in the seller's marketing of the company to the buyer and in the projections delivered to the buyer (which the buyer incorporated into its own projections and presentations to its board); the acknowledgement by the buyer that, when the parties signed their final letter of intent, they both understood the deal to require the buyer to purchase 60 "growth tractors" per year; and, most critically, the history of the negotiation and drafting of the stock purchase agreement.

***Shareholder Representative Services v. Albertson's* (June 7, 2021)—Earnout may be payable, as the buyer's shift in the focus of the acquired company's post-closing operations may have been based in part on an intent to avoid the earnout.**

At the pleading stage, the Court of Chancery declined to dismiss claims that the buyer intentionally avoided earnout payments by, immediately post-closing, shifting the focus of the acquired company's business model. The parties had agreed on specified

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milestones based on the forecasted revenues from the company's e-commerce operations, which had been the company's predominant source of revenues. At that time, the buyer had indicated repeatedly that it believed the milestones would be met. Post-closing, however, the buyer made a strong "push" for in-store sales instead of e-commerce sales—and the acquired business reached none of the milestones. The parties' agreement provided that the buyer had the exclusive right to make all post-closing business and operational decisions regarding the acquired business in its sole and absolute discretion, and that the buyer had no obligation to operate the business in a manner to maximize achievement of the earnout—but that the buyer could not take any action "with the intent" of decreasing or avoiding any earnout payment. The sellers alleged that the buyer, secretly, had always intended to de-emphasize e-commerce, knowing that this would cause the milestones not to be met. The court held that, at the pleading stage, it was reasonably conceivable that the buyer knew that shifting the business model would result in the milestones being missed; that the buyer had schemed to conceal its true intentions; and that the buyer's actions had been motivated at least in part by a desire to avoid the earnout payments.

***Shareholder Representative Services v. Shire US* (Del. Ch. Oct. 12, 2020, *aff'd.* Del. Supr. Ct. Nov. 17, 2021)—Earnout is payable, as the buyer's discontinuance of the acquired company's product was not based solely on the regulatory development specified in the parties' agreement as excusing the earnout, but also in part on business considerations.**

In a post-trial decision, the Court of Chancery held (and the Delaware Supreme Court later affirmed) that the buyer breached the parties' agreement by failing to make a milestone payment relating to the development of the acquired company's experimental drug product. The agreement provided that the buyer had sole and absolute discretion over post-closing development of the drug and disclaimed any obligation of the buyer to develop the drug in any way. The agreement required the buyer to make a milestone payment upon commencement of Phase III trials for the drug—but provided that the payment would be deemed to be due on a certain date even if Phase III trials had not begun, unless the failure to have begun Phase III trials was "as a result of a Fundamental Circumstance." Fundamental Circumstance was defined in the agreement as a circumstance in which material safety or efficacy concerns made it impracticable to produce and sell, or to obtain regulatory approval for, the drug.

After closing, safety concerns about the drug arose and, in addition, significant financial and time constraints developed with respect to the drug's development. Phase III trials were delayed (in part due to an FDA order halting clinical trials for the drug—which was a Fundamental Circumstance, as defined); and the buyer ultimately decided to discontinue development of the drug. The court interpreted the provision requiring payment of the earnout unless the trials had not occurred "as a result of" a Fundamental Circumstance to mean that the Fundamental Circumstance had to be the *only* reason for the trials not having commenced. The court found that the failure to commence Phase III trials was *also* "as a result of a series of routine drug development delays and financially motivated business decisions"—which included the very high costs of continued clinical testing, as well as timing delays that meant the drug could not be available before a competitor's similar generic product would be available. The court noted that the buyer made decisions that delayed Phase III trials even before the safety concerns arose that led to the FTC's halt order. The court, stressing the contractual context, concluded that the Fundamental Circumstance exception to the milestone payment obligation was intended to provide the buyer "with only a narrow escape" from its earnout obligation.

***Pacira v. Fortis Advisors* (Oct. 25, 2021)—Earnout may be payable, as the sellers' post-closing**

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actions to influence achievement of the milestones did not contravene the buyer's sole right to control the operations.

The Court of Chancery, at the pleading stage, declined the selling stockholders' motion to dismiss the buyer's claim that the final earnout payment was not due under the parties' agreement. The buyer contended that the earnout was not due because three individuals (who were former stockholders and former or current key employees of the acquired company) had contravened the buyer's right under the parties' agreement to sole control of the acquired company's post-closing operations. Specifically, when it became apparent post-closing that a milestone would not be achieved absent a change by regulators in the "CPT codes" applicable to the acquired company's drug product, three selling stockholders lobbied regulators for the code changes. The regulators then issued more favorable CPT codes—although it was not clear whether they were sufficient for achievement of the milestone. With that issue pending (a post-trial decision is expected shortly), the court granted the selling stockholders' motion to dismiss the buyer's claim that they had breached the parties' agreement by taking steps to try to ensure achievement of the milestone. The court noted that the agreement contained no restrictions whatsoever on the selling stockholders and that it spoke only of their "sole and exclusive right" under the earnout provision to receive milestone payments that became payable. The court stated that if the parties had wanted to impose restrictions on the sellers, they easily could have set them forth in the agreement. (We note that the sellers' post-closing actions with respect to the CPT code process were seemingly limited and benign, without any obvious conflict with the buyer's common objective to obtain more favorable CPT codes.)

Practice Points

A buyer should keep in mind that a covenant stating that the buyer has the sole right to operate the acquired business post-closing as it sees fit is, inherently, subject to: (i) any covenants in the agreement with respect to a general level of efforts or specific actions that the buyer must take during the earnout period and (ii) the obligation under the implied covenant of good faith not to intentionally frustrate the earnout. A buyer should maintain a record of the business reasons for actions it takes during the earnout period that may negatively affect the earnout.

Consider whether an earnout is appropriate. The specific objectives in adopting an earnout should be scrutinized. 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 potential litigation) with respect to the earnout. Also, alternatives to earnouts, which may accomplish the objectives of an earnout while mitigating the risk of future disputes, should be considered. For example, when (as often is the case) the seller will be involved in the management of the acquired business, performance-related employee compensation or bonuses may be a preferred mechanism to accomplish the parties' objectives, rather than an earnout (subject to tax and other considerations). Also, if an earnout-type arrangement is to be used, consideration should be given to tying payments to the occurrence of specific milestone events, such as the outcome of pending litigation or obtaining regulatory approval, rather than financial targets.

Clear, specific, detailed, and business-contextualized drafting is critical. Given the prevalence of earnout disputes, extreme care should be taken to draft earnout provisions with as much clarity and specificity as possible, and the provisions and procedures should be contextualized for *the specific business* at issue. Lawyers and business people who understand the specific company, its industry, its business operations, and its accounting practices should work closely together in crafting these provisions. Litigators should review earnout provisions, and how

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they interact with the rest of a merger agreement, to ensure clarity. Review by tax and employee benefits lawyers is also advisable, as issues relating to the treatment of items such as tax or employee expenses, accruals, rebates, reserves, and so on, often arise and can have a significant dollar impact on an earnout formula. For additional clarity, the parties may want to consider providing general statements of the parties' intent with respect to the earnout and/or hypothetical examples of earnout calculations for illustrative purposes. The parties' agreement should address in detail the metric and the process for calculating the earnout; whether the earnout will accelerate on a change of control of the assets; the parties' respective obligations post-closing with respect to achieving the earnout; and a process for resolving earnout-related disputes.

Ambiguity should be avoided—and a contemporaneous record of the parties' intentions and understandings should be maintained. Potentially ambiguous terms or phrases should be carefully defined. (As one example, if the phrase "as a result of" (the subject of the dispute in *Shire*, discussed above) is used, the drafting should make clear whether it means "solely as a result of X," "primarily as a result of X," or "as a result of X among other factors.") A record of the parties' intentions and understandings with respect to the earnout provisions should be maintained for use in the event of litigation. Parties should be aware that the court may view as persuasive evidence of the parties' intentions with respect to unclear or ambiguous provisions the back-and-forth comments to and revisions of drafts of the merger agreement as it was negotiated.

The standard that will govern the buyer's post-closing obligations with respect to the earnout should be clearly stated. The parties should consider bolstering any general statements about the buyer's post-closing obligations or discretion in running the business. For example, a buyer may wish to provide that any action it takes that has a plausible business reason will be deemed not to have been taken with an intent to frustrate the earnout. General discretion for the buyer to run the business also can be bolstered by addressing specifically any specific areas of potential concern. As one example, a buyer might wish to specify that it will have the right, in its sole and absolute discretion, to determine the terms and conditions of any and all relevant sales, including the decision to make or not to make any particular sales and the preference for certain customers over others, irrespective of the effect on the potential of achieving the earnout. The parties should consider providing specific covenants to cover 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 balance its desire to limit impingements on its discretion in running the business post-closing with consideration as to the extent to which specified parameters for operation of the business during the earnout period could limit the potential for post-closing disputes. For example, the parties could consider including specific covenants governing capital contributions, adequate capitalization, and dividend policy; hiring or firing of key personnel, employee compensation or pension costs, and appointment or removal of directors; sharing of opportunities, imposing costs on the acquired business that relate to the buyer's other businesses, allocation of overhead costs, and intracompany or affiliate transactions; sales and marketing efforts, size of sales force, rebranding of products, and priority of certain customers over others; restrictions on disposing of all or a portion of the acquired business or on acquisitions or other M&A transactions; if acquisitions are permitted, allocation

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of the costs of the acquisition, such as interest expense, and of the benefit of the income; and R&D expense, technology expense, and other specific expenses.

Risk of obtaining information from "carryover" employees. If the buyer is obtaining information from "carryover" employees of the acquired business, and even more so if those employees will receive significant earnout payments, the buyer should consider providing for a specific right to object to or to double-check the information provided, or for a process for correction, if it believes that the information provided is fraudulent or inaccurate.

Risk associated with the final earnout payment. In a number of cases, all earnout payments have been made other than the *final (often largest)* payment due. This not uncommon pattern suggests that *throughout the earnout period* the parties should monitor the performance of the business with respect to the calculation of the earnout and be aware of and try to resolve disputes as they arise.

Earnout disputes should be distinguished from other disputes. If a post-closing earnout dispute arises, the sale agreement should be carefully analyzed to distinguish and separate from the earnout dispute any issues that actually give rise to claims of breach of non-earnout-related representations and warranties, fraud, indemnification, or other issues. The agreement also should provide whether the buyer can offset indemnity claims against earnout payments.

Earnout experience should be considered when selecting a shareholder representative. We note that several earnout cases have been brought by shareholder representatives (such as Shareholder Representative Services and Fortis Advisors). If an acquisition agreement includes an earnout and a shareholder representative is to be utilized, the representative should have appropriate expertise and experience to pursue earnout claims if necessary.

As a practical matter, a seller may have some degree of leverage to exert pressure on the buyer to make earnout payments—even if earnout targets are clearly not met and there are no issues about the buyer's post-closing actions. For example, a seller, if it continues to play a major role in the company post-closing, may be able to exert influence on customers and suppliers or other aspects of the operations, or to trigger negative publicity about the business' financial or operational situation. Indeed, a seller may itself also be a customer of or supplier to the acquired business. Buyers should consider specific covenants to restrain post-closing actions by the seller or persons who will benefit from the earnout payments. (Among these could be, for example, specified consequences relating to such person competing during the earnout period.)

Parties should consider providing for arbitration of disputes by an independent accountant as an exclusive method to resolve disputes, with the arbitrator's decision being final and binding on the parties. An agreement with such a provision should specify: how the accountant will be selected; who will pay for the accountant; whether the accountant is bound by the methodologies provided in the sale agreement; whether the accountant is limited to considering the specific disputes identified by the parties or can raise other issues; whether the accountant is limited to choosing between the parties' respective results or can do a *de novo* calculation to derive its own result (or a result within a specified range of the parties' respective results); whether a party would be bound by its original earnout estimates and/or original arguments in support of those estimates (so that a party could not offer different estimates or new arguments in any dispute resolution proceedings); whether the accountant is limited to resolving disputes related to calculation of the earnout or can also resolve other disputes relating to the earnout; a timetable for the accountant's process; and the basis (if any) on which a party could bring a claim to dispute the accountant's determination—such as fraud or manifest error (sub-

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ject to the Federal Arbitration Act (FAA), if applicable). We note that, when the sale agreement provides that an arbitrator's decision will not be final and binding, each party should be mindful that considerations not reflected in its initial calculations of the earnout, and/or in the initial objections it makes to the arbitrator's decision, may later be deemed to have been waived and therefore not capable of being raised in future proceedings.

Other possibilities for mitigating the risk of litigation, and encouraging settlement of disputes that arise, should be considered. These might include, for example: (i) ***Clearer and simpler agreement terms***—*that is*, selecting agreement terms that are less likely to lead to disputes (for example, choosing a metric for the earnout target that is simpler to track and less subject to manipulation, even if at the risk of some loss of precision in capturing the value to be measured); (ii) ***Fee-shifting***—so that the party whose position is rejected (or is only minimally successful) in arbitration or litigation would bear some or all of the other party's expenses; (iii) ***Specified remedies for breaches of the sale agreement***—*as* it can be difficult to prove that benchmarks would have been achieved but for breaches by the buyer. Such remedies could include, for example, liquidated damages (which, as a stimulus to compliance with the earnout provisions, could be in excess of the aggregate payments that could be earned under the earnout formula); specified adjustments to the metrics of the earnout formula; or payment of all or a specified percentage of the earnout; (iv) ***A graduated formula***—*such as* a percentage payment on partial satisfaction of performance targets, as opposed to an all-or-nothing structure (*i.e.*, a single payment, triggered only if performance targets are fully met). A graduated formula may avoid an incentive for the buyer to just-miss achievement of the target or an incentive for the seller to stretch to just-make the target (albeit to the detriment of the business), to the extent that doing so is within the party's control. A graduated formula may also reduce the amount of discrepancy that could be subject to dispute; (v) ***A floor and/or cap on the earnout payments***—which would limit the range of discrepancy that could become subject to dispute; (vi) ***Offset rights and carrybacks***—*that is, address whether the buyer can or cannot* use the earnout payments as an offset against any required payments under indemnification claims or otherwise; whether the seller can or cannot delay other payments being made until the earnout is finally determined; and whether there will or will not be any adjustment with respect to payments made (or missed) in previous installments based on subsequent performance; (vii) ***Optional acceleration of payment***—*that is*, in the case of an earnout period that is of relatively long duration, a provision that permits the buyer and/or the seller to elect to accelerate payment of the earnout after a specified period of time or upon occurrence of a specified event or a specified performance target being reached (in other words, earlier payment in exchange for eliminating uncertainty going forward); (viii) ***A buyout***—*that is*, a right to terminate the seller's earnout right for payment of a specified amount, at one or more specified points of time during the earnout period (thus enabling the buyer to "buy its way out of" an earnout dispute (if one appears inevitable) at a pre-arranged price. A buyout right could also help to bridge a difficult negotiation by the parties over post-closing covenants (for example, if the buyer is concerned that agreeing to a particular post-closing covenant could become problematic, the parties might agree to a right of the buyer to terminate specific, or all of the, post-closing covenants in the future in return for a specified payment); (ix) ***A putback right***—*that is*, as a possible route to resolution of a material earnout dispute, one or both parties could have the right to elect to have the acquired business sold back to the seller at a specified price.[3]

ENDNOTES:

[1]These deals (most frequently seen in the life sciences sector) are usually excluded from studies deter-

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mining the rate of usage of earnouts because—as they typically involve drug or other products the value of which is wholly unknowable pending certain testing, regulatory and other milestones—they almost *always* include an earnout (typically based on the occurrence of specific "milestone" events).

[2]We have derived the statistics in this paragraph through a review of non-life-sciences deals in a database compiled by SRS Acquiom MarketStandard, from which we have excluded de-SPAC mergers.

[3]Further practice points relating to earnout terms, metrics, processes, and specifically tailored covenants, and a discussion of earlier major Delaware earnout decisions, are included in our article, The Enduring Allure and Perennial Pitfalls of Earnouts (https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/).

DOJ ANNOUNCES NEW DEPARTMENT-WIDE MERGERS & ACQUISITIONS SAFE HARBOR POLICY AND EMPHASIZES EXPANDED FOCUS ON NATIONAL SECURITY CORPORATE CRIME

By Jessica S. Carey, John P. Carlin, Michael E. Gertzman, Roberto J. Gonzalez, Mark F. Mendelsohn and David K. Kessler

Jessica Carey, Michael Gertzman, and Mark Mendelsohn are partners, and David Kessler is a counsel, in the New York office of Paul, Weiss, Rifkind, Wharton & Garrison LLP. John Carlin and Roberto Gonzalez are partners in Paul Weiss' Washington, D.C. office.
Contact: jcarey@paulweiss.com or jcarlin@paulweiss.com or mgertzman@paulweiss.com or rgonzalez@paulweiss.com or mmendelsohn@paulweiss.com or dkessler@paulweiss.com.

On October 4, 2023, Deputy Attorney General Lisa Monaco delivered a significant speech at the Society of Corporate Compliance and Ethics' 22nd Annual Compliance & Ethics Institute.[1] The DAG announced a new DOJ-wide policy on voluntary self-disclosures in the context of mergers and acquisitions, and underscored the DOJ's focus on national security-related corporate crime.

Mergers & Acquisitions Safe Harbor Policy

The Department's new "Mergers & Acquisitions Safe Harbor Policy" (the "Safe Harbor Policy") establishes a presumption that companies that take certain steps to disclose and remediate misconduct in the context of mergers and acquisitions will receive a declination. Although some DOJ divisions had already established Voluntary Self-Disclosure ("VSD") policies in the context of mergers and acquisitions, the new Safe Harbor Policy is the first such policy that applies Department-wide and extends to the full range of corporate criminal offenses, including antitrust violations, FCPA violations, environmental crimes, and sanctions and export control violations. Additionally, the Safe Harbor Policy provides more clarity regarding the DOJ's expectations of acquiring companies that identify misconduct in the due diligence process, including important guidance regarding the timetables for disclosure and remediation, the impact of aggravating factors and the nature of the benefit to be received.[2]

The DAG underscored that the Safe Harbor Policy is intended to ensure that compliance has a "prominent seat at the table" during mergers and acquisitions and to "incentivize the acquiring company to timely disclose misconduct uncovered during the M&A process."

The key characteristics of that policy are as follows:

- **Presumption of Declination**: Under the Safe Harbor Policy, an acquiring company that makes an appropriate disclosure, remediates misconduct and cooperates with an ensuing investigation will "receive the presumption of a declination."

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