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A Change in Delaware in the Consequences of Willful Breach of an Obligation to Negotiate an Agreement in Good Faith— SIGA v. PharmAthene

The Delaware Supreme Court's decision in *SIGA Technologies Inc. v. PharmAthene Inc.* (Dec. 23, 2015) has increased the risk associated with entering into a "preliminary agreement"—*i.e.*, an agreement to negotiate in good faith a definitive agreement based on, for example, a term sheet or letter of intent, where some material terms have been set forth and others remain to be negotiated.

In *SIGA*, the Supreme Court established that expectation damages (*i.e.,* damages based on lost profits) may be awarded for breach of a preliminary agreement based on a *lower standard of proof* with respect to the amount of damages than would generally apply. The Court held that, so long as the court finds that, but for the breaching party's bad faith negotiations, the parties would have reached a definitive agreement, "less certainty is required of the proof establishing the *amount* of damages" than would apply in the case of breach of a fully negotiated and executed agreement.

It is a foundational principle of contract law that damages cannot be awarded that are speculative—*i.e.*, too uncertain, contingent or conjectural in amount. Expectation damages have been *theoretically* recoverable for breach of an obligation to negotiate an agreement, but, because the measurement of future profits that would be received from a contemplated agreement is almost always especially uncertain, courts usually have limited recovery to *reliance* damages (which are based on out-of-pocket costs incurred in the course of good faith partial performance). Now, in *SIGA*, the Supreme Court has stated that, in the context of breach of a "preliminary agreement," it is only "the *fact* of damages—meaning that there would have been some profits from the contract—[and not] the *amount* of damages" that must be proved with reasonable certainty (emphasis in the original).

Key Points

- Based on *SIGA*, as a practical matter, expectation damages will now be a real possibility in Delaware for breaches of agreements to negotiate in good faith.
- It may be that application of the holding will be more limited than the broad language of the Court suggests. At a minimum, however, *SIGA* signals a clearly different tone and emphasis than in previous decisions in Delaware, as well as other jurisdictions (including New York and California), with respect to the recovery of expectation damages for breach of an obligation to negotiate.

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Background

SIGA and PharmAthene entered into a bridge loan and merger agreement when SIGA was in dire financial straits and the value of SIGA's drug for the treatment of smallpox was uncertain. The bridge loan and the merger agreement provided that, if SIGA at any time exercised any of its rights to terminate the merger agreement, the parties would negotiate in good faith an agreement granting PharmAthene a license on SIGA's drug, consistent with the terms set forth on a term sheet attached to the merger agreement. (The license agreement term sheet was referred to as the "LATS"). The LATS set forth many of the material terms of the contemplated license agreement, including the extent of the license and the split of profits.

Thereafter, prospects for SIGA's drug improved dramatically (resulting in a value of over $3 billion, according to the court); and the evidence at trial indicated that SIGA regretted having entered into the merger agreement (at a substantially lower valuation). When the SEC had not cleared the proxy materials for the merger by the drop dead date in the merger agreement, SIGA exercised its right to terminate the merger agreement. SIGA then refused to negotiate the license agreement on terms consistent with the LATS, insisting instead on "drastically different" terms given the vastly increased value of the drug.

The Chancery Court had concluded that SIGA had breached its contractual obligation to negotiate the contemplated license agreement in good faith after termination of the merger agreement. However, on the basis that expectation damages were too speculative the Chancery Court had ruled out the possibility of expectation damages (*i.e.*, the amount of the profits that, at the time of the breach, the parties reasonably expected that PharmAthene would realize from the sale of the licensed product under the terms of the LATS). The court ordered damages under the doctrine of promissory estoppel—which represented a significantly lesser economic return for PharmAthene than it would have received under the terms provided in the LATS.

In the first appeal of the case, the Delaware Supreme Court (May 23, 2013) affirmed the finding of a breach by SIGA, but rejected the Chancery Court's ruling out the possibility of expectation damages. The Supreme Court held that expectation damages *could* be awarded where the parties had agreed to negotiate in good faith and, but for the defendant's bad faith conduct with respect to the negotiations, the parties would have reached an agreement (and the amount of expected profits would not have been uncertain). On remand, with instructions to reconsider the possibility of expectation damages, the Chancery Court awarded $113 million in expectation damages. SIGA appealed again, primarily on the basis that, although the Supreme Court had established the *possibility* of expectation damages, the Chancery Court erred by awarding them because the amount of damages was not "reasonably certain." The Supreme Court upheld the award (with one dissenting opinion).

Discussion

- **Expectation damages may now be awarded for breach of "preliminary agreements" in Delaware—even when the amount of damages is not "reasonably certain."** The Supreme Court held that, because the defendant's bad faith breach led both to the failure of an agreement to be reached and to the amount of damages being difficult to determine, it was only the fact that there would have been some profits from the contemplated agreement—and not the amount of the lost profits—that would have to be proved with "reasonable certainty" in order for expectation damages to be awarded.

- **Likely practical application by the Delaware courts.** We expect that, as a practical matter, a determination in any given case as to whether expectation damages should be awarded for breach of a "preliminary agreement" will involve a balancing by the court of: the degree of "willfulness" of the breach; the breadth of the negotiated terms (versus the terms still open); the nature and specificity of the payment obligation; and the degree of uncertainty with respect to lost profits.

- **Delaware approach now differs from other jurisdictions (including New York and California).** As noted, in many jurisdictions, courts have hesitated to award expectation damages for breach of a contractual obligation to negotiate an agreement in good faith. As these cases, by definition, involve contemplated agreements as to which not all of the material terms have been negotiated and generally there has been no operating history, they have been regarded by the courts as inherently involving an especially high degree of uncertainty as to the amount of profits that would have been received under the contemplated agreement. Expectation damages generally have been awarded for breach of an obligation to negotiate only in the very limited circumstances in which the future profits were readily ascertainable. While it remains to be seen how broadly the *SIGA* holding will be applied in practice, the decision clearly reflects a different tone and emphasis than in the past in Delaware—as well as in other jurisdictions, including New York and California—with respect to the award of expectation damages for breach of an agreement to negotiate.

- **Potential for *a limited application* by the Delaware courts.** In *SIGA*, the LATS established a revenues-based royalty payment, set forth the split of profits, and provided for additional amounts to be paid if certain milestones were met. Notwithstanding that specificity, a determination of lost profits required, as in the case of most breaches of agreements to negotiate a license agreement, a meaningful degree of speculation about the success of the drug, the extent of the resulting profits, and the occurrence of various contingencies. However, at the time of the breach, there was arguably *less uncertainty than is often the case with respect to future profits* because the drug study results had become available, grants had been obtained, and orders for the drug had begun to be received. In addition, unlike most cases involving breach of an obligation to negotiate, at the time of SIGA's breach, SIGA had already received much of the benefit of its bargain *(i.e.*, the bridge loan financing so that the product could be developed and the market's reaction to its having entered into the merger agreement)—whereas PharmAthene had not received any benefit of the bargain (with the merger agreement terminated and the contemplated license agreement abandoned). Although the Supreme Court opinion did not address these issues and the Court's holding was broadly worded, there is a potential that the Delaware courts will limit the applicability of the holding by distinguishing from *SIGA* cases involving the more typical situation in which, at the time of breach of an obligation to negotiate a license (or other) agreement, the future profits remain largely unknown and neither party has received the benefit of its bargain.

- **Different analysis for breach of obligation to negotiate a merger agreement.** We note that the court's result in *SIGA* would be different in the case of breach of a "preliminary agreement" to negotiate a merger agreement that includes a fiduciary out and/or stockholder approval requirement, based on the uncertainty as to whether a definitive agreement, even if reached, would continue to be effective.

Practice Points

- **Parties to an agreement to negotiate in good faith should consider whether to seek to negotiate the type of damages that would apply in the case of a breach.** A party could, for example, seek to negotiate a provision that expressly excludes the possibility of expectation damages, or that provides for reliance damages in the event of a breach.

- **Potential for expectation damages likely will change the game theory involved in breach of an obligation to negotiate an agreement in good faith.** In SIGA's case, a damages award based on reliance would have led to a far better economic result than it would have received from entering into the license agreement on the contemplated terms. The real potential in Delaware for *expectation damages* for breach of an obligation to negotiate an agreement in good faith should change the calculus for a party considering whether to breach this type of obligation.

- **An obligation to negotiate an agreement in good faith should be taken seriously.** When parties have agreed to negotiate in good faith an agreement based on a term sheet or letter of intent, their failing to come to agreement on terms that were left open does not itself constitute a breach of the obligation. Rather, the commitment is to try in good faith to reach agreement on the open terms. Thus, a party cannot renounce the obligation to negotiate, abandon negotiations without good faith efforts to reach agreement, or insist on conditions or terms that are materially inconsistent with the term sheet—unless there is a legally justifiable foundation for doing so. In *SIGA*, the merger agreement and bridge loan explicitly provided that, if the merger agreement were terminated, the parties had an obligation to negotiate in good faith a license agreement reflecting the terms of the LATS. That explicit obligation, together with a LATS that included many of the material terms relating to the contemplated license agreement, together with SIGA's clear refusal to negotiate an agreement consistent with the terms set forth on the LATS, resulted in the court's finding that SIGA had breached an obligation to negotiate the license agreement in good faith.

- **The risks and benefits of entering into a "preliminary agreement" as compared to going directly to a definitive agreement should be considered.** The key advantage of an agreement to negotiate in good faith is that parties can quickly and simply set forth the basic terms of a contemplated agreement, moving far along the path of deal certainty without having to negotiate every provision of a definitive agreement. The key disadvantage is that uncertainty as to whether there is a deal and what all of the deal terms are remains until a definitive agreement is reached, creating significant potential for disputes and the risk that a court will regard the arrangement as more (or less) binding than a party may have intended. *SIGA* has meaningfully increased the risk associated with entering into a "preliminary agreement."

- **A term sheet should be explicit as to the extent to which it is or is not intended to be binding.** In *SIGA*, the fact that the footer of the LATS stated "Non-binding terms" was not sufficient to make the express obligation in the merger agreement to negotiate an agreement based on the term sheet non-binding. While not the subject of *SIGA*, the case serves as a reminder that care should be taken to ensure that the parties' intentions as to the extent to which a term sheet is intended to be binding are explicit. Labeling a term sheet as "non-binding" may in itself not be sufficient, depending on the circumstances.

- **A change in circumstances generally does not support renegotiation of terms.** Without a specific right to re-negotiate the terms set forth in an agreement, or to renegotiate the terms set forth in a term sheet that is the subject of an obligation to negotiate an agreement in good faith, a change in economic circumstances will generally not be regarded by the court as a basis for a re-negotiation of terms. Particularly where, for example, a product to be licensed is likely to increase or decrease in value between the time of negotiating the term sheet and the time that the contemplated future agreement would be negotiated, the parties should consider whether the license agreement terms will provide a fair measure of the economic value of the product.

- **A party's internal and external communications will be considered in determining its "willfulness" in breaching an obligation to negotiate in good faith.** SIGA told PharmAthene that the parties "had nothing to talk about" if PharmAthene would not re-negotiate the terms set forth on the LATS. In addition, SIGA's internal communications indicated that SIGA regretted having entered into the merger agreement and did not want to enter into the contemplated license agreement. A party's communications to its counterparty, as well as internal emails and board presentations, will be relevant in a court's determining whether a party's refusal to negotiate is based on (i) a contractual or other legally justifiable excuse for its not being bound, or (ii) a willful breach of its obligation in bad faith.

- **Calculation of expectation damages.** We note that, in *SIGA,* in determining the amount of the expectation damages award, the court, (i) following the "wrongdoer rule," resolved uncertainties against the breaching party, and (ii) took into account certain events that occurred *after* SIGA's breach to determine what the parties' expectations were at the time of breach seven years earlier (albeit noting that it relied on that evidence only "sparingly").

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