

TYPES NOT MAPPED YET November 20, 2024 | TTR not mapped yet | Don D. Grubman, Ho Jae Lee

## Lessons from Recent Decisions on Earnout Disputes

Acquisition agreements sometimes include earnouts that provide for a portion of the purchase price to be payable only upon the achievement of specified milestones after the transaction closes. It is not uncommon to utilize an earnout as a means to bridge valuation differences between a buyer and a seller. However, although they may be useful, earnout provisions can result in disputes regardless of how carefully they are drafted. Recent cases in the Delaware Court of Chancery highlight the potential risks of using earnout provisions. In this post, we will explore some of the valuable lessons to be learned from the Chancery Court decisions in *Fortis Advisors LLC v. Johnson & Johnson* (“*Johnson & Johnson*”) and *Shareholder Representative Services LLC v. Alexion Pharmaceuticals Inc.* (“*Alexion Pharmaceuticals*”) [\[1\]](#) [\[2\]](#).

### The Requirement to Devote “Efforts” to Meet Milestones

A common area of dispute in an earnout negotiation is the allocation of operational control post-closing over the acquired business that is required to meet the milestones. Ideally, a buyer wants full discretion over the conduct of an acquired business regardless of the impact that the buyer’s decisions may have on the achievement of performance targets. The seller, which wants to maximize the likelihood that milestones will be achieved, will seek to negotiate commitments from the buyer that the buyer will make certain “efforts” to achieve the performance targets. A detailed analysis of the substantive differences among “good faith efforts”, “commercially reasonable efforts”, “reasonable best efforts” “best efforts” and similar variations of the “efforts” standard is beyond the scope of this post. However, we should point out that in *Johnson & Johnson*, the Court stated that “there is no agreement in case law over whether they create different standards” and that “Delaware courts have viewed variations of efforts clauses - particularly those using the term ‘reasonable’ - as largely interchangeable.” [\[3\]](#) Instead, the *Johnson & Johnson* court noted, in useful advice for practitioners, that: “[m]ore important, then, is carefully drafting language that delineates the efforts expected of the buyer relative to the achievement of the milestones.” [\[4\]](#)

In both of the cases that we will discuss, the transaction documents imposed a “commercially reasonable efforts” obligation on the buyers to achieve the earnout milestones. However, the standards used in determining compliance with this obligation were different. In the *Johnson & Johnson* transaction, the parties used a so-called “inward-facing” standard.[\[5\]](#) An inward-facing standard is often considered more favorable to a buyer because it applies the buyer’s own standards of efforts and, depending on the wording of the provision, the buyer can compare its efforts to its own efforts in developing and/or selling other of its products that are similar to the earnout product or to its past efforts in similar situations. In contrast, in the *Alexion Pharmaceuticals* transaction, the parties used a so-called “outward-facing” standard.[\[6\]](#) An “outward-facing” standard is often considered more friendly to a seller because it compares the buyer’s efforts to the efforts of similar companies for similar products under similar circumstances. A further nuance when using an “outward-facing” standard - the parties may opt for a “yardstick approach”, where the comparison can be made to actual companies and their efforts in connection with similar products in similar stages of development, or a “hypothetical company approach”, where the comparison is to hypothetical similar companies and their hypothetical similar products.

Notwithstanding the difference in the standards used in the *Alexion Pharmaceuticals* and the *Johnson & Johnson* transactions, the results were the same. While the reasons were different, the Chancery Court concluded that the buyers in both cases breached their efforts obligations.

### The Alexion Pharmaceuticals and Johnson & Johnson Cases

#### 1. Fortis Advisors LLC v. Johnson & Johnson

In *Johnson & Johnson*, Johnson & Johnson's acquisition of Auris Health, Inc. ("*Auris*") included an aggregate of \$2.35 billion in earnout payments contingent on Auris's iPlatform and Monarch surgical robot systems reaching certain regulatory milestones. The inward-facing "efforts" clause in the merger agreement required Johnson & Johnson to use "commercially reasonable efforts" to achieve each of the regulatory milestones. The merger agreement definition of "commercially reasonable efforts" required Johnson & Johnson to expend efforts and resources in connection with research and development (and certain other activities related to achieving the milestones) with respect to Auris's robotic products consistent with Johnson & Johnson's "usual practices" with respect to "priority (emphasis added) medical device products of similar commercial potential at a similar stage in product lifecycle" to the iPlatform and Monarch systems.<sup>[7]</sup> The court noted that although the term "priority medical device" was not defined in the merger agreement, Johnson & Johnson did identify a single product - a robotic system called Velys - that was a comparable priority medical device at a similar stage.

The court determined that Johnson & Johnson breached its obligation to use "commercially reasonable efforts" to achieve the iPlatform regulatory milestones, emphasizing that (i) iPlatform received "starkly different treatment" than Velys; (ii) instead of prioritizing iPlatform, Johnson & Johnson's actions "impaired its development and ability to secure planned clearances"; and (iii) Johnson & Johnson's efforts benefitted a third Johnson & Johnson robotic surgery system "at iPlatform's expense".<sup>[8]</sup>

In contrast, the court reached a different conclusion with respect to the Monarch program and held that although Johnson & Johnson "diminished aspects of the Monarch program while prioritizing others", those actions were not a breach of the commercially reasonable efforts obligation.<sup>[9]</sup>

## 2. Shareholder Representative Services LLC v. Alexion Pharmaceuticals Inc.

In *Alexion Pharmaceuticals*, the merger agreement between Syntimmune, Inc. ("*Syntimmune*") and Alexion included an earnout of \$800 million in the aggregate tied to the development of a - monoclonal antibody - ALXN1830 - that Syntimmune had been researching and developing prior to the merger. The payments were to be made upon the achievement of eight milestones over a seven year period after closing. The outward-facing "efforts" clause in the merger agreement required Alexion to use "commercially reasonable efforts" to achieve each of the milestones. The merger agreement definition of "commercially reasonable efforts" required Alexion to use such efforts and resources typically used by biopharmaceutical companies similar in size and scope for "the development and commercialization of similar products at similar developmental stages", taking into account a list of scientific and commercial factors. <sup>[10]</sup> The merger agreement added a number of caveats to the resources and efforts obligation:

- Alexion was not required to "act in a manner which would otherwise be contrary to prudent business judgment"<sup>[11]</sup>;
- The failure to accomplish an objective was not dispositive evidence that Alexion did not utilize the requisite efforts to accomplish the objective; and
- Alexion had sole discretion over business operations and shall have no obligation or liability as a result of the failure to achieve the events that would give rise to an earnout payment.<sup>[12]</sup>

Notwithstanding the above, the court in *Alexion Pharmaceuticals* determined that Alexion breached its commercially reasonable efforts obligation when, citing safety concerns, it terminated the ALXN1830 program after Alexion was acquired by AstraZeneca. The court stated that the efforts obligation in the merger agreement "cabined" Alexion's discretion. It found that "the termination of ALXN1830 fell short of the typical efforts of a hypothetical company similarly situated to Alexion would have devoted to the program."<sup>[13]</sup> Instead, based on the trial record, the court concluded that the pursuit of merger synergies after Alexion's acquisition by AstraZeneca was the reason that Alexion terminated the ALXN1830 program.

## Lessons to be Learned to Minimize Risk

As illustrated by the *Johnson & Johnson* and *Alexion Pharmaceuticals* cases, earnout provisions can lead to post-closing disputes regardless of whether the parties utilize an "outward" or "inward" facing standard and, in some cases, regardless of how carefully these provisions are drafted to protect the respective clients. In some situations, particularly with risk averse clients, it simply may not be advisable to use an earnout. However, often earnouts are the best (and perhaps only) tool available to bridge valuation gaps. When the parties do elect to utilize an earnout, consider the following:

### 1. Customized Provisions

The courts in both the *Johnson & Johnson* and *Alexion Pharmaceuticals* cases used the term "bespoke" to describe the earnout provisions in the respective merger agreements at issue. Unlike some contractual provisions that are lawyer-driven "boilerplate" (albeit with variations commonly understood and negotiated by M&A practitioners), earnout provisions must be custom-made based on the specifics of the particular transaction, including among other things the parties involved, the earnout product, other comparable products and the applicable industry. Accordingly, lawyers and their clients must work closely together in drafting the details of the efforts and milestone provisions.

### 2. Carefully consider how the inward "outward" and "inward" facing standards would apply

When considering whether to utilize an “outward” or “inward” facing standard, the parties should carefully consider, among other things, whether in fact there are similar products or business lines internally or externally against which to measure (and, even if so, whether they are desirable comparables). If an outward facing standard is selected, be clear whether comparisons will be made to actual similar companies (if there are any) or to hypothetical similar companies. If utilizing the hypothetical company approach, the parties must understand the discretion that a court will be afforded in determining what a hypothetical similar company would or would not do with a hypothetical similar product in a hypothetical similar situation.

### 3. Future Events

In addition to the challenge of carefully drafting to take account of historical and current factors, the parties should attempt, to the extent practicable, to anticipate the potential impact of future events during the earnout period, such as the acquisition of the buyer, the sale by the buyer of the subject business or product or the termination of key personnel essential to the achievement of milestones. A buyer will seek maximum flexibility to react to those events, while a seller will seek to minimize their impact or, even better, provide for acceleration of earnout payments.

### 4. Contemporaneous Communications

Lawyers should remind their clients that in the event of a dispute, a court may review the history of the negotiations, including communication between the parties as well as internal communications. Clients must be mindful that their own words may be used by a court to determine the interpretation of ambiguous provisions.

[1] *Fortis Advisors LLC v. Johnson & Johnson*, C.A. No. 2020-0881-LWW, 2024 WL 4048060 (Del. Ch. Sept. 4, 2024).

[2] *S'holder Representative Servs. LLC v. Alexion Pharm., Inc.*, C.A. No. 2020-1069-MTZ, 2024 WL 4052343 (Del. Ch. Sept. 5, 2024).

[3] *Fortis Advisors*, 2024 WL 4048060 at \*22.

[4] *Id.* at \*23.

[5] *Id.* at \*14, 23.

[6] *S'holder Representative Servs.*, 2024 WL 4052343 at \*2, 13.

[7] *Fortis Advisors*, 2024 WL 4048060 at \*24.

[8] *Id.* at \*26

[9] *Id.*

[10] *S'holder Representative Servs.*, 2024 WL 4052343 at \*13.

[11] *Id.* at \*14.

[12] *Id.*

[13] *Id.* at \*46.

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