

KIRKLAND M&A UPDATE

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Earnouts – (Be)Devil is in the Detail

Two recent Delaware decisions highlight the potential benefits of being clear and detailed when drafting earnouts.

In an earlier [M&A Update](#), we discussed the attraction of using earnouts to bridge valuation gaps but quoted VC Laster’s astute description of earnouts as “often convert[ing] today’s disagreement over price into tomorrow’s litigation over outcome.” Since then, we have seen a continued steady pace of lawsuits brought by disappointed sellers asserting that an earnout milestone in fact has been satisfied or that the buyer’s failure to use the requisite efforts caused the failure to hit the milestone or maximize the earnout.

Two recent Delaware Chancery Court decisions highlight some of the recurring issues that characterize earnout litigation and offer guidance to parties negotiating earnouts and milestones in acquisition agreements.

In [Gilead](#), Chancellor Bouchard ruled on an earnout dispute from Gilead’s 2011 acquisition of Calistoga Pharmaceuticals. The dispute centered on whether the sellers were entitled to a specific \$50 million milestone payment where the European regulatory approval actually received by Gilead for the acquired drug was much narrower than the approval sought in its application. After much deliberation, the court decided that the milestone payment was not owed because the merger agreement used the term “indication” in describing the approval required to trigger the milestone, which the court held meant the same as “disease” as opposed to a “sub-population of people suffering from a disease”.

While it may have seemed obvious that the parties could not have intended that Gilead would owe a large milestone payment for an extremely narrow regulatory approval, the court found that the merger agreement’s use of the word “indication” to describe the milestone trigger was ambiguous and therefore proceeded to examine extrinsic evidence to discern the parties’ true intentions, parsing dozens of drafts and pre-signing and post-signing emails and internal notes as well as courtroom testimony.

The lesson for buyers and sellers is to leave no room for ambiguity as to what type of approval satisfies a milestone. Both industry and colloquial terms used in defining a milestone (on the assumption of “everyone knows what we mean here”) are susceptible to misinterpretation when litigated years later. Parties may want to use clear examples in the contract itself (e.g., under a “for the sake of clarity...” introduction) of what will, and what will not, satisfy the milestone. Also, in case a court determines that a contract is ambiguous, parties should ensure that documents outside the agreement, like summaries for boards, term sheets, pre-contract letters of intent, etc., don’t shorthand the description of the milestones and are instead very clear on the intended hurdle.

In the second [decision](#), VC Laster ruled on a motion to dismiss a high-profile dispute relating to Valeant’s acquisition of Sprout and its “female Viagra” product.

One of the key issues in prior earnout cases has been whether an aggrieved seller can assert a breach of the residual implied covenant of good faith and fair dealing relating to the buyer’s post-closing conduct (such as the failure to use necessary efforts) that allegedly deprived the seller of the opportunity to reap or maximize the earnout. Delaware generally only allows implied covenant claims to be made if the covenant is used to “gap-fill” where the parties did not explicitly address the question and therefore left room for the residual covenant. If the purchase agreement has express terms relating to the buyer’s required post-closing efforts, courts have been reluctant to allow disappointed sellers to assert that the implied covenant provides a second bite at an allegation of good faith efforts shortfall.

In the Sprout case, the agreement did have fairly developed and explicit definitions of the required post-closing diligent efforts from the buyer, delineating both general standards for the required efforts plus four specific requirements on matters like minimum spending and staffing. The sellers alleged that the buyer's high pricing of the acquired product, while not contrary to any of the general standards or specific requirements, violated the implied covenant of good faith by being unreasonable and therefore causing sales to be lower than anticipated.

The court acknowledged that the contractual provisions were detailed and even covered "commercialization" of the product. In spite of that, the court held that it could not dismiss an argument that pricing was separate from commercialization (stating that that term "maps imperfectly onto the idea of pricing"), therefore leaving room for an implied covenant claim arising out of the buyer's pricing decisions. The court made a similar finding about the buyer's decision to sell the product through a particular pharmacy channel.

While the decision came on a motion to dismiss, it still may be somewhat surprising that there was room for an implied obligation given how detailed the explicit

contract terms were. To narrow the risk that the residual implied covenant overrides expectations derived from negotiated express contract provisions, parties may wish to err on the side of over-inclusiveness and repetition when drafting efforts requirements, including examples where relevant. In addition, parties can consider including in the contract language stating they expressly intend that the explicit contract efforts provisions supersede the implied covenant to further bolster arguments that the parties did not intend to leave room for judicial gap-filling.

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The continued use of earnouts to bridge valuation gaps, particularly in the private company M&A context, is an inevitable feature of dealmaking. Equally, given the stakes for sellers, we expect that lawsuits by disappointed sellers will be an inevitable feature of deals with earnouts. While acknowledging that ambiguity may be a natural byproduct of the use of earnouts as a bridging mechanism, as shown by the two recent cases, parties can reduce the risk of lawsuits, or at least unfavorable outcomes, by being as clear and detailed as possible when drafting the contractual earnout terms.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf

Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
<http://www.kirkland.com/dwolf>
+1 212-446-4884

David B. Feirstein

Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
<http://www.kirkland.com/dfeirstein>
+1 212-446-4861

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