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KIRKLANDPEN
Private Equity Newsletter

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Earn-Outs — (Be)Devil is in the Detail

PENpoints

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.

Private equity sponsors frequently use earnouts to bridge valuation expectations between a buyer and a seller. In an earlier *KirklandPEN*, we discussed the attraction of earnouts, but quoted a judge'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 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 the conditions for satisfying a milestone payment. 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 that the buyer's post-closing conduct (such as the failure to use necessary efforts) breached the implied covenant of good faith and fair dealing, depriving the seller of the opportunity to earn 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 had fairly developed and explicit definitions of the required post-closing

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efforts from the buyer, delineating both general standards and 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 caused sales to be lower than anticipated.

Although the court acknowledged that the contractual provisions were detailed and even covered "commercialization" of the product, it 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"), 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 the detailed contract terms. 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 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.

* * * *

The continued use of earnouts by sponsors 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 the two recent cases show that ambiguity may be a natural byproduct of the use of earnouts as a bridging mechanism, 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 *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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HSR Gun-Jumping Update

PENpoints

A recent "gun-jumping" case emphasizes the need for merging parties to avoid coordinating business activities during the HSR waiting period, even for deals with little or no antitrust concerns.

A private equity buyer — particularly when making a strategic acquisition through a portfolio company — must be careful to avoid exercising control over the target before expiration of the Hart-Scott-Rodino Act of 1976 ("HSR Act") waiting period and the closing of the transaction. This premature control over acquired assets is commonly referred to as "gun-jumping." Although gun-jumping enforcement cases are relatively rare — until recently, the antitrust agencies had not brought one since 2014 — the U.S. Department of Justice ("DOJ") and Federal Trade Commission ("FTC") remain on the lookout for gun-jumping violations, even in deals that do not otherwise raise competitive concerns. On January 18, 2017, Duke Energy Corporation ("Duke") entered into a consent agreement, agreeing to pay $600,000 in civil penalties, to address the DOJ's allegation that Duke violated the HSR Act by taking control of the acquired assets' output and profits prior to the end of the HSR Act waiting period — even though the DOJ and FTC had concluded that the transaction had no substantive antitrust issues.

The Duke case emphasizes the need to wait for the HSR Act waiting period to end before merging parties coordinate their business activities, even in transactions that present little or no substantive antitrust risk. While buyers should continue to draft contractual covenants that protect a buyer's interests in the target

company during the pre-closing period, they need to be careful to avoid "jumping the gun."

What to Avoid: Lessons Learned from Gun-jumping Enforcement Actions. Generally, provisions that prevent the seller from operating (and/or require the buyer's consent to operate) the business in the ordinary course pre-closing, prior to the merger, can raise antitrust concerns. For example, the DOJ and FTC have taken enforcement actions where, pre-closing, parties have:

- Taken control of one of target's factories and negotiated with striking workers on the target's behalf;
- Moved the target's executives into the buyer's offices and allowed the target to manage portions of the buyer's operations prior to the expiration of the HSR waiting period;
- Required buyer approval for the target to: (i) offer discounts typical in the industry; and (ii) enter into fixed price contracts longer than 30 days;
- Agreed to (i) "slow roll" negotiations with customers in order to avoid competing with each other; and (ii) coordinate prices and terms in the period between signing and closing;
- Included buyer consent provisions for: (i) routine hiring decisions regarding consultants and non-management positions; (ii) any licensing of the target's intellectual property to third parties, without any thresholds to allow for routine licensing done in the ordinary course of business; (iii) entering into agreements for relatively low amounts; or (iv) presenting business proposals to customers or prospective customers;
- Required buyer approval for the procurement of material inputs necessary to the target's ongoing business; and
- Agreed to close a mill after expiration of the HSR waiting period, but before closing the transaction.

What is Permissible: Guidance for Drafting Contractual Provisions. Contractual provisions ensuring the seller will operate in the ordinary course of business are typically permissible and many agreements contain explicit limitations, including prohibitions and buyer consent provisions, on actions that the seller is allowed to take in the time between signing and closing. These permissible restrictions include requiring the buyer's consent for and/or precluding the seller from:

- causing a material adverse effect on the business;
- entering into material contracts valued above a specified monetary threshold (provided that the threshold is not set so low that it impairs the seller's ordinary course operations);
- offering contracts with enhanced rights or refunds in the event of a merger;
- declaring or paying dividends or distributions of the seller's stock;
- issuing, selling, pledging, or encumbering the seller's securities;
- revising the seller's organizational documents;
- acquiring, or agreeing to acquire, other businesses;
- mortgaging or encumbering the seller's intellectual property or other material assets outside of the ordinary course; or
- making large capital expenditures.

* * * *

As demonstrated by Duke, an acquiring party must be cognizant of the limitations on pre-merger conduct described above, regardless of whether the deal presents any competitive concerns or the conduct could be considered permissible according to the language of the merger agreement. Buyers should be careful to draft provisions, and exercise their consent rights, in a way that protects their interest in the target, yet allows the target to continue to have control over its day-to-day operations.

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PENbriefs

Trump Administration Sets "America First" Trade Agenda in Motion

The Trump administration recently took several steps to implement its "America First" international trade agenda, including the following: (1) ordering a report on countries with whom the U.S. has a significant trade deficit; (2) ordering the Department of Homeland Security and other agencies to increase enforcement and collection of unpaid antidumping and related duties; and (3) sending a letter to Congress outlining changes to NAFTA the U.S. will seek as part of its proposed renegotiation of the treaty. To learn more, see our recent *Alert.*

U.S. Imposes Penalties on Chinese Company For Economic Sanctions and Export Control Violations

U.S. regulators, including the U.S. Department of Justice, recently settled a multiyear investigation of a Chinese telecom equipment company that revealed thousands of willful violations of U.S. economic sanctions and export controls involving Iran. The settlement requires the Chinese company to pay $1.19 billion in penalties and to be subject to an independent compliance monitor for three years. To learn more, see our recent *Alert.*

PENnotes

"Going Public: My Adventures Inside the SEC and How to Prevent the Next Devastating Crisis" Book Launch
Washington, D.C., April 26, 2017

Kirkland partner Norm Champ's new book, "Going Public: My Adventures Inside the SEC and How to Prevent the Next Devastating Crisis," was released last month. The book chronicles Norm's experiences at the SEC and sheds light on the regulatory process and government policymaking. A client book launch reception will be held in the Concorde Room at the The Hay-Adams Hotel. Click here for more information.

37th Annual Ray Garrett Jr. Corporate and Securities Law Institute
Chicago, IL, April 27-28, 2017

Kirkland is a sponsor of this event, which brings together senior officals from the U.S. Securities and Exchange Commission and leading securities practitioners. Kirkland partners Scott Falk, Robert Hayward and Keith Crow are members of the Executive Committee. Robert will also chair a session on "For Seasoned Issuers — Developments in Capital Markets." Click here for more information.

Private Equity International Private Fund Compliance Forum 2017
New York, NY, May 9-10, 2017

Kirkland is a sponsor of this year's event, which will focus on regulatory requirements and expectations, while taking a closer look at structuring the compliance function to stay in lockstep with recent and anticipated regulatory demands. Kirkland partner Norm Champ will be a panelist at the event. Click here for more information.

Institute for Energy Law Mergers, Acquisitions & Divestitures Conference
Houston, TX, May 18-19, 2017

Kirkland is a sponsor of the Center for American and International Law - Institute for Energy Law's annual Mergers, Acquisitions & Divestitures Conference. Kirkland partner Rahul Vashi will be a panelist on "Lessons Learned from Big Deals," which will explore lessons from the last 12 months of major deal making, from antitrust to regulatory hold-ups to major deal collapses to large deals that made it through. Click here for more information.

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International Bar Association International Mergers & Acquisitions Conference
New York, NY, June 6-7, 2017

Kirkland is a sponsor of this year's event, which will bring together practitioners from around the globe to discuss the latest developments and hot topics in international M&A law, including globalization, nationalism and cross-border investment, governance, stewardship and activism, and private equity and leveraged finance today. Click here for more information.

SuperReturn U.S. 2017
Boston, MA, June 12-15, 2017

SuperReturn U.S. 2017 will explore the trends and drivers of private equity and venture capital in North America, and provide networking opportunities within the global private equity community. Kirkland partner Norm Champ will be a panelist at the event. Click here for more information.

SuperReturn Energy 2017
Boston, MA, June 12-13, 2017

SuperReturn Energy will deliver strategies for investing in global energy private equity and provide an opportunity to network with key figures in the industry, as well as to find out where the pockets of opportunity are, where LPs are looking and how best to generate alpha and fundraise in today's tricky market. Click here for more information.

Kayo Women's Energy Investment Conference
Houston, TX, June 12-13, 2017

Kirkland is a sponsor of the third annual Kayo Women's Energy Investment Conference, which will cover topics including energy's female founders, the future of energy lending, energy technology, public company perspectives, E&P and M&A, metals and mining, midstream and alternative fuels. Kirkland partners Sarah Kirson and Mary Kogut will serve as panelists. More information to follow.

PLI Annual Private Equity Forum
New York, NY, July 10-11, 2017

This annual event is designed to provide an understanding of the business and legal issues related to private equity investment, including recent regulatory and enforcement developments, compliance programs and ethical issues. Kirkland partner John O'Neil will speak on "How to Market Private Equity Funds on a Global Basis." Click here for more information.

PLI Understanding the Securities Laws 2017
New York, NY, July 13-14, 2017
Chicago, IL, September 27-28, 2017

This program will provide an overview and discussion of the basic aspects of the U.S. federal securities laws by in-house and law firm practitioners as well as SEC staff. Emphasis will be placed on the interplay among various regulations, as well as legislative and regulatory changes in the wake of the election. Kirkland partner Aaron Schlaphoff will speak on "Liability for Securities Law Violations" at the New York event, and partner Bradley Reed will be a panelist on "Regulation of Proxy Solicitations" at the Chicago event. Click here for more information.

Private Equity Practice at Kirkland & Ellis

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Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2017 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2016, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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