Key Lessons in Drafting Earnout Provisions from Recent Developments in Delaware Case Law

A Practical Guidance® Article by
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Introduction

The year 2022 is synonymous with economic uncertainty, particularly in the M&A context. The Federal Reserve's quantitative tightening and rising interest rates have drawn air out of company valuations, especially in the hyper-growth space. Because of this, among other things, the seller-friendly market of 2021 is transitioning to an environment that favors buyers. And in this transition period, the valuation gap between seller and buyer is bound to expand. One tool in the M&A practitioner's toolkit to bridge that valuation gap is the earnout. This article discusses recent developments in Delaware case law and highlights key considerations in drafting earnout provisions.

For more information on earnouts, including drafting pro-buyer and pro-seller provisions, establishing earnout targets, and discussing post-closing operation of the target business, see Earn-Out Clauses. See also Consideration in an M&A Deal — Earn-Outs.

Initial Guidance

We foresee that earnout provisions will grow increasingly prevalent in merger agreements while uncertainty still hangs over the U.S. economy. Through the Great Recession, the percentage of private transactions with an earnout provision doubled, from 19% in 2006 to twice that at 38% in 2012. According to the 2021 ABA Private Target M&A Deal Points Study of the deals surveyed in 2020–2021, 20% had earnouts. We are expecting a similar rise in frequency in earnout provisions going forward. For a discussion of recent market trends in earnouts, see Market Trends 2021/22: Earn-Outs in Public-Private Deals.

By making post-closing payments contingent on achieving certain milestones, sellers are afforded the opportunity to earn the valuation delta while buyers are protected from potentially overpaying for the company. But, as the Delaware Court of Chancery noted in Airborne Health, Inc. v. Squid Soap, L.P., "an earnout often converts today's disagreement over price into tomorrow's litigation over the outcome." 984 A.2d 126, 132 (Del. Ch. 2009). Earnout enforcement continues to be contentious and can prove treacherous for parties blinded by the earnout upside to the behavior and standard setting that are mission critical to an effective earnout provision.

Careful drafting of behavior and standard setting language has become increasingly important, as Delaware courts continue to strictly interpret earnout language and will not invoke the implied covenant of good faith and fair dealing lightly.

S'holder Representative Servs. LLC v. Shire US Holdings, Inc., No. 2017-0863-KSJM, 2020 Del. Ch. LEXIS 315 (Del. Ch. Oct. 12, 2020), is an example of this. There, the

Delaware Court of Chancery denied payout of an earnout because of its strict reading of the earnout standard. Shire US Holdings, Inc. (Shire) acquired Ferrokin Biosciences, Inc., a company developing an experimental drug called Deferitazole, used to treat excess iron levels in the blood. The parties agreed to $225 million for potential earnout payments. The conditions triggering the earnout payments pertained to starting Phase III trials for the drug.

The agreement stated that payment would be due unless (1) the drug did not commence Phase III trials and (2) the failure to commence trials was *as a result* of a "Fundamental Circumstance." The agreement defined Fundamental Circumstance as "a circumstance in which material safety or efficacy concerns made it impracticable to produce and sell or obtain regulatory approval for a drug."

After the deal closed, several obstacles to the drug successfully reaching commencement of Phase III became apparent. During clinical studies of the drug, safety concerns, as well as financial and time constraints, came to light. Around the same time, the Food and Drug Administration (FDA) ordered a halt to clinical testing of the drug, an event constituting a Fundamental Circumstance as outlined in the merger agreement. And due to the halt on clinical testing, Phase III trials never commenced.

Shire declined to pay the earnout payments as the failure to commence Phase III trials was not strictly "as a result" of the FDA order to halt the testing and was caused by other non-Fundamental Circumstance factors. The court agreed and held that an objective and reasonable third party would interpret the "as a result of" language of the earnout provision to mean that, the Fundamental Circumstance must be the *only* reason for the failure to reach Phase III trials. The court reasoned that, because the failure to reach the prescribed milestone was due to a variety of other factors in addition to the FDA order, no earnout payment was owed to the seller. In reaching this decision, the court pointed out that ambiguous phrases like "as a result of" should be clarified and defined by the parties in the merger agreement.

The Court of Chancery similarly strictly read the earnout language in S'holder Representative Servs. LLC v. Albertsons Cos., No. 2020-0710-JRS, 2021 Del. Ch. LEXIS 115 (Del. Ch. June 7, 2021) and rejected the contention that, absent good faith language, buyer was obligated to act in good faith when exercising exclusive control of the acquired company. DineInFresh, Inc. d/b/a Plated (Plated), an e-commerce subscription-based meal kit delivery company, entered into a merger agreement with Albertsons Companies, Inc. (Albertsons) which provided for an earnout payment of $125 million contingent upon Plated achieving certain financial milestones.

The agreement provided that Albertsons would have the exclusive right to make all business and operational decisions regarding its subsidiaries (including Plated), but prohibited Albertsons or its affiliates from taking any action "with the intent of decreasing or avoiding any earnout issuance." Plated missed the earnout, allegedly because Albertsons dedicated Plated's resources to get Plated's products into brick-and-mortar stores instead of focusing on the e-commerce business. The Plated shareholders sued for, among other things, a breach of the covenant of good faith and fair dealing, contending that Albertsons took actions to undermine the profitability of the acquired e-commerce business to avoid paying the earnout.

With respect to the implied covenant of good faith, the court reasoned that the agreement gave *exclusive control* of the business to Albertsons on the condition that Albertsons not intentionally hinder the earnout payment. If Plated wanted this control to be conditioned on good faith, then they could have negotiated for this and drafted the agreement as such. Instead, "Plated bargained for a provision that prevented Albertsons from intentionally scuttling the Earnout." The court did not see a gap in the earnout language that warranted implied covenant gap-filling and declined to read in a good faith condition to the exclusive control of Albertsons.

Interestingly, the court kept the dispute alive by finding that the "intent of decreasing or avoiding earnout issuance" carve-out would be breached if the acquirer's actions were done, *at least in part*, with the purpose of decreasing the earnout amount. At the pleading stage, it was reasonably conceivable to the court that Albertsons made post-closing business decisions at least in part with the intention of reducing the earnout payment.

Key Takeaways and Looking Ahead

- As interest rate hikes and runaway inflation persist, uncertainty over the U.S. economy and the larger M&A market will likely remain. Buyers will demand greater assurances of a return on their investment and earnout provisions can provide this added certainty. We predict economic conditions will likely lead to an uptick in the occurrence of earnout provisions across industries.

- It is imperative more than ever to be precise about the drafting language. The Delaware Court of Chancery will not supply terms to which the parties did not expressly agree or negotiate. The gap in which the implied covenant can fit continues to shrink under Delaware jurisprudence. In more recent Delaware jurisprudence, the court held that it would not read in an implied covenant to refrain from communicating or influencing the counterparty's employees because there was no express term to the contrary. Parties should assume that the court will go only by the plain, express terms of the agreement in resolving earnout disputes.
- Clearly identifying the earnout opportunity and milestone is not enough. M&A practitioners should think through with their clients, among other things, the standards for milestone achievement they expect and what types of behavior in the earnout period they expect to be out-of-bounds.
- Clarify, not assume. In *Shire*, the court interpreted the phrase "as a result of" to mean the only reason, and in *Albertsons*, it held that the "intent" could mean intent in part. Work to clarify key terms (whether through defining terms or by adding adjectives) when they can be construed as vague to avoid unpredictable outcomes.

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Practice Notes

- Earn-Out Clauses
- Consideration in an M&A Deal — Earn-Outs
- Market Trends 2021/22: Earn-Outs in Public-Private Deals

Templates

- Earn-Out Clause
- Life Sciences Milestone Based Earn-Out Clause (EU)
- Life Sciences Net Sales Based Earn-Out Clause
- Life Sciences Sales / Net Revenue Based Earn-Out Clause

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