Legal 500
Country Comparative Guides
Hot Topic | Mergers & Acquisitions

Efforts Standards in Earnout Provisions

Contributor

Cravath, Swaine & Moore LLP

Richard Hall

Corporate Partner | rhall@cravath.com

Daniel J. Cerqueira

Partner | dcerqueira@cravath.com

Efforts Standards in Earnout Provisions

Introduction

No longer a niche feature used mostly in life sciences deals, the earnout in all its forms has gained substantial traction in the U.S. since the pandemic as a powerful solution for bridging valuation gaps in markets increasingly affected by economic volatility and heightened regulatory scrutiny. Earnouts are a valuable tool for buyers seeking to reallocate the risk of large upfront payments. They allow buyers to defer a portion of the purchase price until the target business has proven its value, thereby shifting the risk of future performance back onto the seller in exchange for a chance to share in future successes. Implementing an earnout provision allows parties to deal with otherwise irreconcilable differences in valuation without derailing the entire transaction.

A long-time favorite in life sciences transactions, earnouts have flourished recently in many other industries. Their use in non-life sciences deals more than doubled from 13% of deals in 2018 to 33% of deals in 2023.[1] In those deals, earnout payments represented a significant portion of the total value on the table, with the median total value of available earnout payments standing at around 30% of the upfront payment.[2] Earnouts therefore represent a large and growing portion of the economic value in the M&A market.

While they are relatively simple in concept, earnouts can be complicated to implement. There is no one-size-fits-all approach to designing and then drafting an earnout. They may be customized into a virtually infinite number of permutations reflecting a range of business and legal considerations and should be carefully crafted in close cooperation with business and subject matter experts.

While earnouts address certain valuation risks, they also introduce a new risk that the buyer who takes control of the business may not have the same incentives as the seller to achieve the earnout milestones. To address this risk, one of the most important components of an earnout provision is the efforts covenant. This provision gives the seller assurance that the buyer will work diligently in the seller's interest to achieve the earnout milestone.

Given the growing prevalence and economic importance of earnouts, it is important for practitioners to understand the common formulations of the efforts provision and their implications. We begin by reviewing a recent decision by the Delaware Court of Chancery which directly address a claim that a buyer had breached its earnout efforts covenant.

SRS v. Alexion Pharmaceuticals

On September 5, 2024, Vice Chancellor Zurn of the Delaware Court of Chancery delivered an opinion in *Shareholder Representative Services LLC v. Alexion Pharmaceuticals, Inc.* The case arose out of Alexion's 2018 acquisition of Syntimmune, Inc., which included a textbook example of earnouts in a life sciences acquisition.[3] Since 2013, Syntimmune had been developing a molecule, which became known as ALXN1830, to treat certain rare autoimmune disorders.[4] Syntimmune had made steady progress at first, and began its first clinical trials in 2016.[5] In 2018, Alexion acquired Syntimmune, executing a merger agreement which provided for an upfront payment of $400 million and an earnout worth up to an additional $800 million, divided among eight milestones.[6]

Under the merger agreement, Alexion was required to use "commercially reasonable efforts" to achieve these milestones and agreed to a definition of "commercially reasonable efforts" which required it to use "such efforts and resources typically used by biopharmaceutical companies similar in size and scope to [Alexion] for the development and commercialization of similar products at similar development stages."[7] The definition also listed several factors which Alexion was allowed take into consideration and expressly stated that Alexion was not required to "act in a manner which would otherwise be contrary to prudent business judgment."[8]

Clinical testing of ALXN1830 faced its first setback soon after the transaction closed, when delays caused by COVID-19 forced Alexion to reevaluate its drug pipeline and refocus on the drugs it believed would help it reach its goal of "10 launches by 2023."[9] Alexion relegated ALXN1830 to a lower priority and reallocated a significant portion of its funding.[10] A year later, Alexion was acquired by AstraZeneca, which promised shareholders synergies of $500 million from the combination.[11] ALXN1830 was again placed under a microscope right as a round of clinical testing was completed. Although the results were inconclusive, a series of internal meetings nevertheless culminated in the termination of all drug development by the end of 2021.[12]

The representatives of Syntimmune's former shareholders filed a lawsuit claiming, among other things, that Alexion had failed to meet the efforts standard.[13] Following the definition set forth in the merger agreement, Vice Chancellor Zurn applied an external standard for commercially reasonable efforts, hypothesizing what an objective company would have done in a situation similar to Alexion's.[14] Considering the factors enumerated in the merger agreement definition, including safety, efficacy, market timing and likelihood of regulatory approval, Vice Chancellor Zurn found that a similarly situated, hypothetical company would have used greater efforts to develop ALXN1830, and that Alexion was therefore in breach of the merger agreement.[15] Finding no objectively defensible reason why Alexion had halted development while four competitors proceeded to develop their own competing drugs, Vice Chancellor Zurn concluded that Alexion's acquisition by AstraZeneca, and the "idiosyncratic corporate initiative" to achieve substantial synergies, had caused Alexion to breach its obligations by abandoning development of the drug even though it was commercially reasonable to continue its research.[16]

Earnout Efforts

With the amount of money locked behind milestones, earnouts have become and will continue to be a popular battleground for litigation.[17] Of the countless claims that may be brought by sellers and their representatives, this case illustrates a common argument from aggrieved sellers that the buyer did not pursue achievement of the milestones as zealously as it had agreed to. While different courts and jurisdictions may differ in the interpretation and application of efforts standards, the reasoning applied in decisions such as *SRS v. Alexion* highlights some key principles of drafting earnout provisions to govern buyers' post-closing conduct.

Managing Ambiguity

It is a practical reality of contract drafting that ambiguity is inevitable, but ambiguity brings with it the specter of uncertainty—both for those seeking to perform the contract and for those seeking to enforce the contract. Not only is it impractical to completely eliminate ambiguity, but parties and their lawyers usually will face diminishing returns on time and effort spent addressing ambiguity *ex ante*, and time itself is frequently a limiting factor. The responsible practitioner must instead manage ambiguity by weighing the cost of further clarifying a provision against the risk of litigation over such provision and the need to devote bargaining power and resources to the most critical provisions.

As acquisition agreements become longer and more complex, the opportunity for ambiguity increases. However, responsible practitioners over time have managed ambiguity by homing in on certain provisions which face a heightened risk of litigation, such as regulatory efforts covenants, material adverse effect definitions and net working capital adjustments, and expanded and refined (and yes, lengthened) those provisions in an effort to reduce the potential ambiguity.

As earnout provisions gain in popularity across a wider swath of the M&A market, the high rate of disputes associated with these high-stakes provisions make them a worthy candidate for additional attention. The opinions outlined above demonstrate how closely these provisions will be examined in the event of litigation. While it is, as a practical matter, probably impossible to eliminate all ambiguity in earnout efforts provisions, the high risk of litigation and the substantial economic value involved lead us to believe transaction parties will, on balance, benefit from greater precision in earnout provisions.

Crafting an Efforts Standard

The earnout provision should describe the standard of effort which must be used by the buyer in pursuit of the earnout milestones. In this context, buyers generally seek to maximize their discretion in operating the business they have acquired and minimize the effort they must devote to achieving earnout milestones. Sellers, on the other hand, have an interest in ensuring that buyers operate the business in a way that is most likely to trigger the earnout payment by requiring buyers to devote all available resources to achieving the milestones.

In many common formulations, the earnout efforts covenant will start with a middle-of-the-road standard such as “commercially reasonable efforts,” “reasonable efforts,” or “reasonable best efforts.” But even in selecting a recognized standard, there is immediate ambiguity. While seasoned practitioners claim to view these terms as escalating degrees of effort, courts in Delaware treat them as functionally equivalent.[18] They may be just as ambiguous to business people seeking to operationalize the agreement post-closing. Managing ambiguity here requires that such abstract formulations be clarified by defining the standard to formalize their mutual understanding with as much specificity as possible.

Inward-Facing & Outward-Facing Standards

The merger agreement in *SRS v. Alexion* provided not only that the buyer would use “commercially reasonable efforts,” but went on to define the term by reference to the efforts of a “typical” company “similar in size and scope.”[19] This is known as an “outward-facing” standard and, together with an "inward-facing" standard which is defined by reference to the buyer's past conduct in similar situations, represent the two most common approaches when crafting an efforts definition. Selecting between these two standards is often the starting point and one of the most important decisions that parties will make when negotiating an efforts standard.

Consider first the inward-facing standard, which is also referred to as a "subjective" test, in which the buyer is required to use a level of effort which is commensurate with the buyer's own usual practice. This standard is keyed off the buyer's own internal standards and past practice. An inward-facing standard is commonly viewed as more favorable to the buyer because the buyer has only to apply a level of effort that is consistent with its own past practice. Buyers already have full knowledge of their own practice, making it more predictable for them to implement and comply with this kind of standard. Buyers should be aware, however, that if brought to litigation there would likely be extensive discovery by plaintiffs seeking to establish not only the efforts actually used by the buyer but also the usual practice of the buyer throughout its history. This investigation by plaintiffs will be more intrusive than if an outward-facing standard was used. Buyers should expect that plaintiffs will seek to use every example they can discover of the buyer's past behavior to argue for the most stringent possible standard.

Sellers, on the other hand, should be cautious of agreeing to an inward-facing standard. There is a material information asymmetry that arises due to the fact that the buyer knows its own practice much better than the seller ever could. This puts the seller at a disadvantage because the seller cannot know what efforts it is agreeing to with the same confidence as the buyer, even with the most extensive pre-signing diligence the seller is likely to be able to conduct. Add to this the risk that, in the event of litigation, the seller will have the burden of proving that the buyer deviated from its own usual practice. These factors should make the inward-facing standard a favorite of buyers.

Alternatively, efforts definitions using an outward-facing standard require the buyer to meet an objective standard of effort. Courts may apply a "yardstick approach," comparing the buyer's actions to those of actual similarly situated companies, or a "hypothetical company approach," comparing the buyer's actions to a hypothetical company of similar size and resources working under similar circumstances. Compared to an inward-facing standard, either approach arguably lends itself to more uncertainty for all parties involved.

Unlike the inward-facing standard, a buyer does not have a firm reference point on which it can rely to feel confident that it has met its obligation. Until a claim for breach is heard by a court, the parties cannot be certain how the court will think the hypothetical company should have acted. Parties should also be concerned by the fact that it is difficult to prove how a hypothetical "typical" company should have acted. No matter how much evidence of industry practice is introduced through expert witnesses and the like, it is ultimately a thought experiment for the court. A buyer that performs to its usual standard of effort, and thus would satisfy an inward-facing standard, may still find itself in breach of an outward-facing standard. Buyers will therefore be attracted to the greater certainty of an inward-facing standard, while sellers will gravitate towards the outward-facing standard, which is likely to be less well defined.

There are many factors which parties should consider when negotiating the choice of efforts standards. They should do their best to understand both industry practice and the buyer's past practice to see where the practical differences between the two, though the information asymmetry puts the seller at a disadvantage here. They should also consider whether there are similar businesses of a third party which could be used under the yardstick approach to an outward-facing standard. In some cases, a seller may conclude that an inward-facing standard will be more demanding of the buyer than the outward-facing alternative, such as where a buyer demonstrates that its usual practice is to use efforts in excess of what was standard for the industry.

Other Considerations

We expect the best path to reducing ambiguity associated with the general efforts standard (whether inward-looking or outward-looking) is to combine the general efforts standard with specific requirements or exclusions. This is the approach drafters have taken, for example, in regulatory efforts clauses. Parties may also decide that defining the efforts standard using an inward- or outward-facing standard does not sufficiently manage the inherent ambiguity when compared to the magnitude of the earnout payments and the likelihood of litigation. One additional option is to include a list of factors which may and may not be considered by the buyer when carrying out its efforts obligations. Such a list was included in the agreement examined in *SRS v. Alexion* and identified several factors which it was acceptable for Alexion to consider as well as factors which Alexion could not take into account. Including a list of permissible factors helps provide a more clear and predictable framework for evaluating the buyer's actions. Indeed, the opinion from *SRS v. Alexion* refers to these enumerated factors in finding that the agreed level of efforts had not been met.[20]

The challenge for drafters and deal participants is that additional specific requirements or exclusions will likely be very deal-dependent. It strikes us as unlikely that drafters will be able to develop a standard playlist of provisions, such as has been established for material adverse change clauses. However, as the cases unfold, we should learn from prior experience and at least start to build the list.

Examples could include:

- how to deal with a competing product of the buyer
- how to deal with a change of control of the buyer
- potential geographic expansion of the target business
- effect of a significant change in the regulatory environment.

Deal participants and their lawyers already undertake this type of exercise in connection with the drafting of the milestones or targets themselves, particularly if they are legal/regulatory or financial in nature. Now, we should do so when drafting the efforts standard.

Other Sources of Post-Closing Obligations

While the efforts covenant is the primary source of post-closing obligation applicable to an earnout arrangement, practitioners should be aware of other sources of obligations which are commonly raised in earnout disputes.

Covenant of Good Faith and Fair Dealing

A common claim made when a buyer fails to achieve an earnout milestone is breach of the implied covenant of good faith and fair dealing. The implied covenant applies to all contracts and parties are not allowed to waive it. The implied covenant functions to fill in gaps where parties have not contractually addressed a certain question or circumstance such that it falls to the court to assess the "reasonable expectations of the contracting parties … at the time of contracting." [21] The covenant is used by courts to ensure that parties "do not 'frustrat[e] the fruits of the bargain' by acting 'arbitrarily or unreasonably.'"[22]

However, the role of the implied covenant of good faith and fair dealing is necessarily one of gap-filling, as a claim for bad faith is distinct from a claim for breach. The implied covenant cannot be used to create entirely new obligations. Instead, it forms a layer of protection around the bargained for contractual provisions, allowing practitioners to draft contracts with the assumption that the parties will act in good faith. The implied covenant is therefore a useful tool for managing ambiguity, as it provides a baseline for enforceable behavior. However, it may ultimately be used to find post-closing obligations which the parties did not expressly agree to. This is something to keep in mind in the context of managing ambiguity, as practitioners should understand this lens through which courts will approach gap-filling and whether it is desirable to mitigate the uncertainty of judicial gap-filling by drafting more robust language. It is also something that practitioners should make sure clients are aware of when an unexpected circumstance lands a party beyond the four corners of the contract.

Fraud & Anti-Reliance Clauses

Sellers who are dismayed when their earnouts are not triggered may also pursue remedies based on a claim of fraud, alleging that the buyer acted fraudulently when it made certain statements it knew to be untrue in order to induce the sellers to agree to certain provisions in a merger agreement. While it can be difficult to distinguish between the platitudes, puffery and optimism that is conveyed by buyer in the course of negotiations, courts may find that specific statements, known to be false at the time they were made, rise to the level of fraud when used to induce sellers to act in a manner that benefits the buyer. In this way, statements that the parties make during negotiations can effectively become obligations themselves, bound up in the contractual agreement which they induced, if a failure to follow through on those promises would amount to fraud.

But unlike the implied covenant of good faith and fair dealing, it is possible for parties to contractually agree that they have not relied on any statements made by the other party that is not contained in the contract itself, thereby precluding a successful claim of fraud. This is known as an anti-reliance clause. An anti-reliance clause generally provides that a buyer did not rely on any extra-contractual representations of the seller. It may also include a reciprocal statement that the seller has not relied on any extra-contractual representations of the buyer, though a one-way disclaimer of reliance is much more typical. In any event, buyers should be cautious of the potential for statements they make prior to signing to be seen as inducing the seller. In situations where the seller has a continuing interest post-closing, such as through earnout payments, buyers should strongly consider whether a mutual anti-reliance clause is appropriate.

Shareholder Representatives

Notably, several recent decisions by Delaware courts concerning earnout disputes, including *SRS v. Alexion*, have involved a plaintiff who is a professional shareholder representative, such as SRS, Fortis Advisors and Wilmington Trust. While a complete discussion of the incentives of shareholder representatives is beyond the scope of this article, it strikes us as plausible that their strongest incentive in situations where the buyer does not pay out the full potential earnout is to pursue litigation on behalf of sellers. This is in contrast to selling shareholders who do not have a professional representative and may be more likely to address earnout disputes without resorting to litigation. There are several reasons why shareholders and professional representatives may not be completely aligned in this regard. Litigation may be the more conservative option for shareholder representatives as compared to attempting to negotiate a settlement with a buyer, because without direction from a majority of selling shareholders the representative may feel that it has no basis to agree to a compromise, or may even lack contractual authorization to agree to such a compromise, or may otherwise expose the seller representative to claims from selling shareholders. There is also a reputational benefit for shareholder representatives from bringing litigation, as it demonstrates to potential clients their willingness to zealously represent the interests of selling shareholders. Selling shareholders may also face costs which do not apply to shareholder representatives, such as founders who continue to work for the buyer after their company is acquired or sellers who may have other ongoing commercial relationships or are repeat players in M&A transactions. When it is time to decide whether a failed earnout merits litigation, these misalignments in the cost-benefit analysis suggest that shareholder representatives may be more inclined to litigate than others who have a larger incentive not to antagonize the buyer. As the use of earnouts increases, this is another factor to consider when negotiating earnout provisions and evaluating the likelihood of a dispute.

Footnote(s):

[1] SRS Acquiom, 2024 Deal Terms Study.

[2] *Id.*

[3] *S'holder Representative Servs. LLC v. Alexion Pharms., Inc.*, No. 2020-1069-MTZ, 2024 WL 4052343 at *1 (Del. Ch. Sept. 5, 2024)

[4] *Id.* at *9.

[5] *Id.*

[6] *Id.* at *9, 14

[7] *Id.*

[8] *Id.* at *14.

[9] *Id.* at *18.

[10] *Id.* at *19.

[11] *Id*. at *20.

[12] *Id*. at *21-27.

[13] *Id*. at *28.

[14] *Id*. at *38.

[15] *Id*.

[16] *Id*. at *39.

[17] As Vice Chancellor Laster once wrote, "an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome." *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del. Ch. 2009).

[18] *See Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347 at *87 (Del. Ch. Oct. 1, 2018) (observing the lack of support in case law "for the distinctions that transactional lawyers draw" between the various efforts clauses), *aff'd*, 198 A.3d 724 (Del. 2018) (TABLE); *Channel MedSystems, Inc. v. Boston Sci. Corp.*, 2019 WL 6896462 at *37 n.410 (Del. Ch. Dec. 18, 2019) (noting that a "commercially reasonable efforts" provision is functionally the same under Delaware law as a "reasonable best efforts provision" (citing *Akorn*, 2018 WL 4719347 at *87 & n.796)); 1 ABA Mergers and Acquisitions Committee, *Model Stock Purchase Agreement with Commentary* 213 ("[C]ase law offers little support for the position that 'reasonable best efforts,' 'reasonable efforts,' or 'commercially reasonable efforts' will be interpreted as separate standards less demanding than 'best efforts.'")).

[19] *SRS v. Alexion* at *15 (commercially reasonable efforts were defined as "such efforts and resources typically used by biopharmaceutical companies similar in size and scope to [Alexion] for the development and commercialization of similar products at similar development stages").

[20] *SRS v. Alexion* at *41-46.

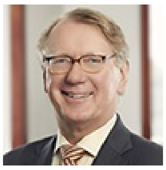
[21] *Dieckman v. Regency GP LP*, 155 A.3d 358, 367 (Del. 2017).

[22] *Baldwin v. New Wood Res. LLC*, 283 A.3d 1099, 1116 (Del. 2022).

Contributors

Richard Hall
Corporate Partner

rhall@cravath.com



Daniel J. Cerqueira
Partner

dcerqueira@cravath.com

CRAVATH, SWAINE & MOORE LLP