

Delaware Court of Chancery Weighs in on Earnout Provisions in Recent Cases



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The Delaware Court of Chancery has weighed in on a number of recent cases interpreting earnout provisions in transactional agreements. The Court has demonstrated a reluctance to rule against seller-plaintiffs during the pleading stage when the terms of earnout provisions are found to be ambiguous and a willingness to consider the parties' contract negotiations and course of dealing, to interpret any potential ambiguity when ruling on the merits in earnout cases. Contracting parties should be mindful that contractual language should be precise and unambiguous. Key terms and conditions should be clearly drafted to avoid disputes and ensure both parties' intentions are documented plainly in the agreement.

Medal v. Beckett Collectibles

On August 22, 2024, in [Medal v. Beckett Collectibles, LLC](#) the Delaware Court of Chancery denied Beckett Collectibles' motion to dismiss breach of contract claims brought by the former shareholders of Due Dilly Trilly, Inc. (DDT).

The specific dispute in *Medal v. Beckett Collectibles* arose from arguably ambiguous earnout provisions in the Stock Purchase Agreement (SPA), pursuant to which Beckett Collectibles acquired all of the outstanding shares of DDT. Beckett Collectibles paid consideration of \$6 million at the closing and the SPA required Beckett Collectibles to pay up to an additional \$5.625 million upon the achievement of certain milestones within 22.5 months of the closing. Also at the closing, DDT's founder, Andrew Medal (the plaintiff and sellers' representative), entered into an employment contract with Beckett Collectibles to serve as its Chief Innovation Officer for two years.

Acceleration of Milestone Payments

The primary issue before the Court was "whether the final sentence of SPA Section 2.05(b) provides for the acceleration of all unpaid Milestone Payments, or whether it only clarifies that Milestones could continue to be earned after one of the enumerated circumstances." Section 2.05(b) provides, in relevant part that, if Mr. Medal's employment was terminated by Beckett Collectibles or Mr. Medal resigned with good reason or Beckett Collectibles determined not to continue developing intellectual property: "[Beckett Collectibles] shall pay to [DDT's] Stakeholders the full amount of any unpaid Milestone Payments in accordance with Section 2.05(d)." The plaintiff focused on the wording "the full amount of any unpaid Milestone Payments," arguing that it required acceleration of all unpaid Milestone Payments. Conversely, Beckett Collectibles focused on the language, "in accordance with Section 2.05(d)," which provides that earned milestones be paid within 30 days. Therefore, Beckett Collectibles argued that the language merely offers clarification that milestones could continue to be earned.

Without weighing in on the merits, the Court acknowledged Mr. Medal's interpretation that the earnout payments accelerated was reasonable, and denied Beckett Collectibles' motion to dismiss.

Good Faith Negotiation as a Condition Precedent to Litigation

Additionally, Beckett Collectibles asserted that Mr. Medal brought this litigation without first satisfying a condition precedent set forth in the SPA, namely that in the event of a disagreement, the parties must “cooperate in good faith for a period of 30 days to attempt to resolve such disagreement” before bringing a court action. Both parties admitted that no negotiation occurred prior to filing the litigation. However, the Court noted that Beckett Collectibles did not respond to a letter seeking justification for Mr. Medal’s termination, and that following submission of certain milestone qualifications by DDT, Beckett Collectibles summarily rejected each without any written explanation as was required by the SPA. Additionally, the Court noted that the present action was filed more than 40 days after the latest unanswered letter was sent by DDT.

As with the acceleration claims, the Court found no basis for a pleading-stage dismissal, citing *Anvil Holding Corp. v. Iron Acquisition Co., Inc.* The operative agreement in *Anvil* required the parties to “negotiate the resolution of the claims for a period of not less than twenty-five (25) Business Days” before bringing litigation. The plaintiff in *Anvil* admitted that no negotiation had taken place, but the Court did not dismiss the suit. Instead, the Court noted a lack of detail as to mechanics regarding how such negotiations were to take place and the possibility that such negotiations might be futile. Likening the situation in *Beckett Collectibles* to *Anvil*, the Court held that Beckett Collectibles’ actions were “predetermined, which suggests negotiations would have been futile.”

Other Recent Case Law

Historically, Delaware courts have been reluctant to dismiss earnout disputes at the pleading stage. Recent Delaware case law reveals a potential trend toward allowing breach of contract claims to survive a motion to dismiss when the court considers earnout provisions ambiguous (see [WT Representative LLC v. Philips Holdings USA Inc.](#), decided by the Delaware Court of Chancery a few days before *Beckett Collectibles* on August 16, 2024). In *Philips Holdings*, the Court ruled in favor of the seller-plaintiff, holding that dismissal is appropriate only if the contract terms are unambiguous and that breach of contract claims for failure to pay earnout payments must survive the pleading stage “unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances.”

Recent cases also indicate that the Court will distinguish whether the contractual language requiring the parties to undertake certain efforts is “outward-facing” (*i.e.*, in comparison to other industry participants) or “inward-facing” (*i.e.*, in comparison to an acquiror’s other business). In [Fortis v. Johnson & Johnson](#), decided on September 4, 2024, the Delaware Court of Chancery ruled that Johnson & Johnson (J&J) breached its contractual obligation to use “commercially reasonable efforts” to achieve earnouts related to the development of Auris’ (the seller-plaintiff) surgical robot, iPlatform. As part of J&J’s \$3.4 billion acquisition of Auris Health, J&J agreed to use commercially reasonable efforts to achieve certain commercial and regulatory milestones which could provide up to \$2.35 billion in additional consideration to Auris’ stockholders. The merger agreement included an inward-facing earnout provision, requiring J&J to treat iPlatform similarly to its other medical devices for purposes of development and achieving certain milestones. The Court found that J&J’s actions, which involved causing iPlatform to compete directly with J&J’s own product, Verb, and ultimately combining the two products, significantly hindered iPlatform’s ability to achieve the earnout milestones. Based on the inward-facing language, the Court determined that J&J’s decision-making was not aligned with the requirements of the merger agreement, noting that J&J’s decisions caused iPlatform executives to be sidelined and the historic clinical engineering team to leave the company, which was “a devastating loss for the program.”

In another recent decision in Delaware, the Court of Chancery again ruled in favor of the plaintiffs, this time based on an “outward-facing” provision. On September 5, 2024, in [Shareholder Representative Services LLC v. Alexion Pharmaceuticals, Inc.](#) (*Alexion*), the Delaware Court of Chancery held that Alexion breached the terms of

its merger agreement with Syntimmune Inc. by failing to use commercially reasonable efforts to achieve certain milestones.

The dispute in *Alexion* arose from the 2018 acquisition of Syntimmune Inc. by Alexion and the earnout provisions in the merger agreement. The merger agreement included eight different milestones tied to different developmental stages of Syntimmune Inc.'s monoclonal antibody. The merger agreement required Alexion to use "commercially reasonable efforts" for seven years after the closing to achieve the milestones. The agreement defined commercially reasonable efforts 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 developmental stages." The Court evaluated this outward-facing language by applying the standard used in another recent Delaware earnout decision, *Himawan v. Cephalon, Inc.* (*Himawan*) (previously discussed in Quorum [here](#)).

As it did in *Himawan*, the Delaware Court of Chancery in *Alexion* interpreted the commercially reasonable efforts provision in the contract to require what it referred to as an objective standard. The Court determined that there were "no adequate exemplar companies" and no competitors that operated under the same conditions as Alexion, the same conclusion it had reached for the buyer in *Himawan*. Based on the similarity of the disputed outward-facing language in *Alexion* as compared to the contractual language in *Himawan* and the conclusion in each case that no true similar companies existed, the Court in *Alexion* implemented the same objective, "hypothetical company" analysis it adopted in *Himawan*. Therefore, the Court reviewed Alexion's efforts against the efforts a similarly situated hypothetical company "would expend under the circumstances at hand" (emphasis added), rather than identifying a comparable peer company and applying a "yardstick approach" to evaluate Alexion's commercially reasonable efforts against "the efforts of [such peer company and its] actions in the real world."

The Court did distinguish the contractual language in *Himawan* from *Alexion*, explaining how the two provisions could lead to different outcomes. Whereas in *Himawan*, the provision in question explicitly permitted the buyer to consider its own efforts and costs of engaging in commercially reasonable efforts, the provision in *Alexion* only permits the defendant to evaluate its own efforts against a hypothetical company. As a result, because the buyer's decision not to further pursue the milestones was driven in part by a unilateral initiative to launch 10 products by 2023 (a goal not likely to be shared by a hypothetical company), the Court determined that Alexion breached the merger agreement and failed to use commercially reasonable efforts to achieve earnout milestones. *Alexion* illustrates (i) how the Court will review extremely specific language and (ii) underscores the Court's focus on the contract language and the specific facts presented in earnout disputes.

Conclusion

Both *Alexion* and *Auris* emphasize the need for clear drafting regarding efforts obligations and awareness of competitive dynamics that may affect earnouts. Contracting parties should be mindful of the distinction Delaware courts may place on inward-facing as opposed to outward-facing earnout provisions. Recent cases also demonstrate the Court's willingness to scrutinize earnout provisions closely, to examine the facts and circumstances underlying the dispute and to ensure that parties fulfill their obligations as outlined in purchase agreements. The Court's emphasis on the need for clear contractual language highlights the importance of defining terms like "commercially reasonable efforts" in a manner that can withstand judicial review.

Beckett Collectibles highlights the ongoing challenges surrounding the interpretation of earnout provisions in purchase agreements. Additionally, the Delaware Court of Chancery's refusal to dismiss the breach of contract claims in *Beckett Collectibles* and *Philips Holdings* highlights the Court's tendency to favor seller-plaintiffs at the pleading stage if the contractual language is arguably ambiguous. By acknowledging multiple reasonable interpretations of the SPA

language, the Court in *Beckett Collectibles* emphasized the importance of clear communication and negotiation between parties involved in earnout disputes and was careful not to weigh in on the merits. The outcomes of these cases serve as reminders of the critical need for precise drafting in contracts to mitigate disputes and ensure that both parties' intentions are clearly documented. Given the significance of earnout provisions, and their value implications to both buyers and sellers, it is crucial to articulate the mechanics and parameters of the efforts required and triggers to achieve earnouts.