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Corporate Insights

Recent Court Decisions Provide Guidance on Earn-outs

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Buyers and sellers often use earn-outs, in which the payment of a portion of the purchase price is delayed contingent upon the purchased business achieving performance milestones, to address differences in opinion or uncertainty in valuing a business.

Although the seller of a company has been steering the business prior to a sale, the buyer often assumes management of the business afterwards. Because the seller's achievement of the earn-out payment is dependent on the buyer's success in managing the business after the sale, buyers and sellers often negotiate terms of the effort that the buyer must take to achieve the milestones. In 2024, Delaware courts issued several opinions addressing disagreements between buyers and sellers regarding earn-outs. While the cases do not attempt to describe a systematic approach to structuring earn-outs, they do reveal the courts' interpretation of specific provisions in purchase agreements, and buyers and sellers can use the guidance provided in those decisions when negotiating their own earn-out terms.

Customization matters

While many earn-out provisions impose requirements on buyers to use "commercially reasonable efforts" or "reasonable efforts", to achieve the performance milestones, many parties detail the efforts required and courts generally apply those provisions. Some buyers and sellers negotiate very specific earn-out terms that specify the level of discretion the parties have in decision-making, exceptions to certain obligations and even a custom definition of "commercially reasonable efforts."[1]

The definition of "commercially reasonable efforts" is sometimes customized in situations where parties specify whether they will use internal- or external-facing standards. Internal commercially reasonable efforts hold the buyer accountable to the buyer's own standards of commercially reasonable efforts, often evidenced by the buyer's own treatment of previous products and efforts to achieve commercial milestones. External commercially reasonable efforts hold the buyer to the standards of the market, comparing the buyer's conduct to the commercial efforts of the buyer's competitors. Parties can go so far as to specify the size and sophistication level of the companies that will be used for comparison.[2]

Earn-out provisions can forgo traditional phrasing altogether. In one example, the earn-out provision stated that "Buyer shall not take any action intended for the primary purpose of frustrating the payment of Milestone Consideration hereunder."[3] The seller claimed the buyer had breached this provision by failing to take certain actions. The court, however, found that unlike a commitment to use reasonable efforts, the efforts standard that the parties agreed to did not provide protection against not taking actions.

Specific reasons to end product efforts

Another example of a customized level of effort arose in the sale of a medical device business, in which the buyer agreed to use "commercially best efforts" to maximize milestone payments and earn-out payments, and certain payments would be due if the buyer acquired another business, integrated that other business with the medical device business being purchased at the time and subsequently ceased development of the medical device business unless the cessation was due to one of several preapproved reasons.[4] These included the determination by the buyer that the device posed a risk of injury to patients or surgeons. The court opined that the parties could create a tailored standard that the buyer must use that provided specific reasons why the buyer could cease its efforts to promote the product. In this particular transaction, the safety concerns had been identified in due diligence, but companies could use a customized definition regardless of whether the clauses related to diligence concerns.

1 *See Himawan v. Cephalon, Inc.*, No. 2018-0075-SG, 2024 WL 1885560, at *12 (Del. Ch. Apr. 30, 2024), aff'd, No. 226, 2024, 2025 WL 287772 (Del. Jan. 24, 2025).

2 *See id.*

3 *Fortis Advisors LLC v. Medtronic Minimed, Inc.*, C.A. 2023-1055-MAA (Del. Ch. July 29, 2024).

4 *See Pavel Menn v. ConMed Corp.*, C.A. 2017-0137-KSJM (Del. Ch. June 30, 2022). The court also addressed its interpretation of the "commercially best efforts" standard which is considered rarely used, but which is beyond the scope of this article.

Cautious reliance on duty of good faith

Two separate courts addressed arguments by sellers that the buyer had an obligation to act in good faith to try satisfying earn-out conditions. In both cases, the courts highlighted that an obligation to act in good faith could be implied in a contract, but that it could not overrule the express terms of a contract and, citing earlier precedent, recounted that "rather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively 'to ensure the parties' reasonable expectations are fulfilled' the implied covenant is a limited remedy. Its application is a cautious enterprise"[5] and should not be used to fill a contract gap that was intended in the negotiations.[6] Given the relative ineffectiveness of an implied duty of good faith, buyers and sellers should consider express levels of efforts a buyer must pursue to achieve earn-outs.

Cost of earn-out payment

The decision in the Himawan case mentioned in its discussion that consideration of the amount of the milestone payments themselves were properly included in an analysis of the "efforts and costs" of achieving the milestones.[7] A seller may be surprised that the cost of the earn-out payment itself can be a factor, and buyers and sellers should consider specifying in their purchase agreements whether the earn-out costs are included in evaluating whether the buyer has met its requirements for meeting any level of effort regime. The consideration of whether the cost of the earn-out payments in an analysis is appropriate or relevant may depend on whether the earnout payment is itself a portion of greater than expected revenue from sales of an existing product, in contrast with a situation in which the product is not yet being sold and the earn-out payment is part of the costs of taking the product to market.

Conclusion

Earn-outs are an effective tool that buyers and sellers should consider when they disagree on a business' current, or projected value and can benefit both parties by aligning incentives and post-acquisition growth while mitigating risks. Recent court decisions provide helpful guidance for both buyers and sellers when crafting earn-out terms. Please consult your Squire Patton Boggs' counsel or the authors of this article to discuss your needs in this regard.

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5 *Id.* at 88.

6 *See Trifecta Multimedia Holdings Inc. v. WCG Clinical Servs. LLC*, No.I 2023-0699-JTL 2024 WL 2890980 (Del. Ch. June 10, 2024) n.65.

7 *See Himawan, et al. v. Cephalon, Inc. et al.*, C.A. No. 2018-0075-SG (Del. Ch. Apr. 30, 2024) p. 30.

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