

## Key Decisions From Delaware Courts

### *Mergers and Acquisitions*

By Francis G.X. Pileggi

A few recent decisions from the Delaware Court of Chancery provide useful information to corporate executives who are involved in the sale or purchase of businesses, or who are involved in joint ventures in which the sales price or the post-closing profit distribution is based on certain milestones being reached and requiring at least one party to use its best efforts, or related standards, in order to reach those milestones that trigger an earn-out.

The cases that follow involve two different but similar standards applicable to the efforts required to reach post-closing milestones in order to trigger payments, and an analysis by the court about whether those standards have been satisfied.

### POST-CLOSING EARN-OUT ISSUES

A Delaware Court of Chancery opinion provides useful insights into the level of effort required to reach certain revenue milestones, for example, in connection with a joint venture or a post-closing earn-out. In *BTG International, Inc. v. Wellstat Therapeutics Corporation*, C.A. No. 12562-VCL (Del. Ch. Sept. 19, 2017), the court

applied the contractually defined standard of “diligent efforts” to the promotion of a pharmaceutical product, in a post-trial opinion. This discussion of the contractually defined standard of diligent efforts is at least generally analogous to other Delaware decisions that address the standard of “reasonable best efforts” or “commercially best efforts” or the like, to perform certain tasks or to reach certain goals that trigger payments to a seller. See <http://bit.ly/2zD8R4W>. Due to the relative paucity of cases thoroughly analyzing these types of standards, this case is notable.

### **Background**

This case involved a distribution agreement between two pharmaceutical companies. BTG was the larger company and agreed to promote, distribute and sell a drug called Vistogard, that the smaller Wellstat did not have the resources to promote, distribute and sell. After extensive negotiations, the parties agreed to a contractual definition of “diligent efforts” that BTG was required to employ in order to reach various sales goals for Vistogard. In addition, the parties were required to work together to formulate and finalize a business plan that would describe the details for promoting, distributing and selling Vistogard.

### **Key Findings**

The court found that BTG failed to hire a sufficient number of sales representatives, and failed to devote other resources to sell Vistogard, but instead focused most of its efforts and resources on a completely different product in a different division of the company — with instructions from the CEO to keep the costs flat in relation to Vistogard, and not to increase the resources that were necessary to implement the business plan.

The court found that BTG failed to comply with the contractually defined standard of “diligent efforts,” and also breached the agreement by not complying with the business plan that required certain resources, including a sufficient number of sales representatives, to be devoted to the sale of Vistogard.

### **Legal Analysis**

The court provided a useful discussion of the elements of a claim for breach of contract and for awarding damages. The court also took the rare step of shifting fees due to bad faith litigation tactics, and explained its reason for doing so. It recited the familiar elements for breach of contract: 1) the existence of a contract, whether expressed or implied; 2) the breach of an obligation imposed by that contract; and 3) the resultant damage to the plaintiff.

BTG took the aggressive approach of filing a declaratory judgment action seeking a declaration that it had not breached the contract. In response, Wellstat asserted a counterclaim for breach of contract. In sum, the court treated the DJ action as a defensive tactic, which failed, in part because Wellstat did not breach the agreement such that it would have excused a performance of BTG.

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This 60-page decision provides extensive detailed factual background, which is necessary to fully appreciate the court's thorough analysis. For purposes of this relatively short overview however, the key points in the analysis are based on the court's finding that BTG failed to devote the necessary resources for Vistogard — and instead prioritized the sale and promotion of other BTG products. In addition to failing to comply with the contractual definition of diligent efforts, BTG also breached the agreement by failing to comply with the business plan that required a minimum amount of resources to be devoted to the sale and promotion of Vistogard.

The court also discussed principles applicable to claims for breach of contract damages. The basic remedy for breach of contract should give the non-breaching party “the benefit of its bargain by putting the party in the position it would have been but for the breach.” Expectation damages require the breaching party to compensate for the reasonable expectation of the value of the breached contract. These damages are to be measured “as of the time of the breach.”

Although expectation damages should not act as a windfall, the “injured party need not establish the amount of damages with precise certainty when a wrong has been proven and injury established,” said the court. “Doubts about the extent of damages are generally resolved against the breaching party.” Moreover, the court noted that: “Public policy has led Delaware courts to show a general willingness to make a wrongdoer bear the risk of uncertainty of a damages calculation where the calculation cannot be mathematically proven.”

## **POST-CLOSING PROFIT FORMULA**

The Delaware Court of Chancery recently ruled prior to trial on a claim relating to post-closing earn-out payments due in connection with an acquisition. In *GreenStar IH Rep, LLC v. Tutor Perini Corporation*, C.A. No. 12885-VCS (Del. Ch. Oct. 31, 2017), the court found that the terms of the agreement were unambiguous and that the facts alleged were sufficient to enter judgment on three of the eight counts in the complaint that sought damages and declaratory judgments relating to the failure of the buyer to make earn-out payments as required by the merger agreement.

### **Background**

This case involved the sale of GreenStar Services Corporation to Tutor Perini Corporation. The agreement provided for a right to receive post-closing earn-out consideration in the event that certain pre-tax profit milestones were achieved. The motion for judgment on the pleadings that this opinion decided related to those parts of the complaint that asserted breach of contract claims for failure to make the earn-out payments in the third, fourth and fifth years after closing.

The court determined that, based on a review of the applicable agreement and the facts alleged in the complaint, the seller was entitled to earn-out payments as a matter of law, based on the clear and unambiguous terms of the agreement. The court also determined that the buyer was not entitled to any offset based on any alleged wrongdoing asserted in the counterclaims. The court rejected claims for fraud based on the failure to plead with the necessary particularity.

The relevant provisions in the merger agreement provided for the calculation of the earn-out payments based on pre-tax profit. The agreement defined pre-tax profit as the amount calculated and included in a pre-tax profit report compiled in accordance with GAAP. If the pre-tax profit report was not objected to, then the parties would be bound by it for purposes of calculating the earn-out. If there was an objection to the pre-tax profit report, there was a procedure in the agreement providing for binding arbitration.

### **Analysis**

The court recited basic contract principles, including the truism that when, as in this matter, the language of an agreement is unambiguous, the court is bound by the language within the agreement. The court read the agreement as unambiguously providing for the calculation of the earn-out payments due based on the pre-tax profit reports. When, as in this case, there was no objection to those reports, the parties agreed that those reports would be binding in terms of determining the amount of the earn-out payments that were due.

The court specifically rejected the argument of the buyer that the unambiguous provisions of the agreement regarding the binding nature of the report should be subject to a condition that the report would not be binding if the buyer either failed to properly calculate the pre-tax profit or if the buyer allegedly relied on inaccurate financial statements. The court rejected that argument in part, because it would allow the buyer to unilaterally determine when the pre-tax profit report was not considered binding.

Likewise, in rejecting that argument, the court also rejected the argument that the implied covenant of good faith and fair dealing should allow for an implication that the report would only be binding if it was determined to be accurate.

### ***Implied Covenant of Good Faith and Fair Dealing***

The court defined the limitations of the implied covenant of good faith and fair dealing, which will not be used when contract language could have easily been drafted to expressly provide for the allegedly missing terms and when the existing contract speaks directly to the issue in dispute. Stated differently, the covenant exists solely to fulfill the reasonable expectations of the parties, and to avoid arbitrary frustrations of the parties' bargain, but in order for the implied covenant to apply, the obligation asserted and the obligation to be implied must not contradict the purposes reflected in the express language of the contract.

### ***The Holding***

In sum, the court found that there were "no gaps to be filled" and that the court would not imply a term that is inconsistent with the intent of the parties as evidenced by the express terms of the agreement. Also notable is the court's rejection of the argument that the existence of 13 affirmative defenses made it premature to grant a motion for judgment on the pleadings. The court reasoned that the "rhythmic incantation of multiple affirmative defenses, each revealed in a single sentence, cannot, alone, defeat an otherwise well-supported motion for judgment on the pleadings."



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