

Polsinelli Pulse

MITIGATING LITIGATION RISK AT THE DEAL TABLE AND BEYOND

NEWSLETTER FROM THE M&A LITIGATION PRACTICE

Table of Contents

The Risks and Rewards of Earnout Provisions in M&A Deals 1

Understanding Subrogation in Representations and Warranties Insurance Policies 3

The Impact of the Court of Chancery’s Recent Clarification on Arbitration v. Expert Determination 5

Shareholder Spotlight - Q&A with Michael Malone 7

The Risks and Rewards of Earnout Provisions in M&A Deals



Michael Malone
Shareholder
Nashville



Oliver J. Davis
Shareholder
Nashville

It’s basic business: sellers want to sell high, and buyers want to buy low. Oftentimes, buyers and sellers are able to agree on value. But when they can’t, they may be able to bridge the valuation gap through an “earnout,” which is an agreement between the parties where a seller can obtain an additional consideration if the business achieves certain financial or performance targets.

While an earnout can be a useful tool to get a transaction across the finish line when the parties agree on everything but the purchase price, buyers and sellers should beware: earnout disputes are common and

present material post-closing litigation risk. Dealmakers and their counsel should be careful when structuring earnouts to mitigate litigation risk as much as possible.

Background

An earnout is a contractual provision for contingent consideration in a purchase agreement that is based on the post-closing operations of the acquired business. Under an earnout, the buyer agrees to pay additional consideration to the seller based on the achievement of certain financial or operational goals over a specified period. An earnout provides a means for the parties to bridge the gap between the buyer’s valuation of the target company and the seller’s valuation, which may differ due to opinions about the company’s prospects—the buyer gets to pay an agreed-upon price today without feeling like it overpaid, but the seller gets to participate in future performance growth without feeling like it left purchase price on the table. Earnouts can be structured in many ways, but they typically involve a series of performance targets, such as targets for gross revenue, net sales, EBITDA, or customer churn, that must be achieved for the seller to receive the additional consideration.

CONTINUED ON PAGE 2 ▶

While earnouts can be an effective way to align the interests of the buyer and seller, they also introduce the potential for post-closing disputes. As one Delaware court put it, an earnout “often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”¹ And earnout litigation can be complicated and expensive, with experts battling over valuation and accounting issues. Moreover, earnout disputes often are fact-intensive, which can preclude an efficient resolution of claims through motion practice.

As a result, if an earnout is going to be part of a deal, it is important for parties to carefully negotiate and draft the earnout provision to avoid future litigation.

Common Issues in Earnout Litigation

One of the primary risks associated with earnout provisions is that the parties may have different views on how to operate the post-closing business, measure the targets or calculate the payout. This disagreement can stem from ambiguity in the provisions or from the parties’ interpretations of the terms. For example, the parties may have different understandings of how the target company’s performance should be measured, leading to a dispute over whether the targets have been met.

Another potential risk arises when there is perceived bad faith or a lack of trust between the parties. Purchase agreements, like other contracts, typically include an implied covenant of good faith and fair dealing. If, for example, the buyer is perceived as acting in bad faith or using aggressive tactics to manipulate the target company’s performance to reduce an earnout payment, litigation may ensue. The case of *Clarke v. Trigo U.S., Inc.*,² pending in the U.S. District Court for the Southern District of New York, is illustrative. That case involves the purchase of Supplier Management Solutions, LLC (“SMS”). The buyer, TRIGO U.S., bought SMS for \$58.5 million in cash at closing and two earnout payments based on the growth of SMS measured by its EBITDA. The combined earnout payment could have totaled tens of

An earnout “often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”

millions of additional dollars. When SMS failed to meet the specified EBITDA, the plaintiffs blamed the buyer, alleging the buyer breached the purchase agreement and the implied covenant of good faith and fair dealing.

Another risk can rise when the economic incentives encourage one of the parties to suppress or seek to inflate an earnout payment. A poorly structured earnout provision may encourage a buyer to operate the target company in a way that suppresses its performance to reduce or avoid payouts. Conversely, if there is enough at stake, a seller may sue for a larger earnout payment regardless of whether the claim has merit. If there are tens of millions of dollars at stake, a seller may find it worthwhile to invest a few hundred thousand dollars into litigation with the hope of creating leverage to negotiate a resolution with a higher earnout payment. Take, for example, *Fortis Advisors LLC v. Johnson & Johnson*,³ pending in Delaware chancery court. That case involves \$2.35 billion in potential earnout payments. The seller claims the buyer duped it into agreeing to make the post-closing earnout payments contingent on unachievable regulatory and sales milestones.

These cases are prime examples of “tomorrow’s litigation over the outcome” and highlight the peril of using earnouts and the importance of structuring and drafting them properly.

How to Draft Earnout Provisions to Mitigate Litigation Risks

To minimize litigation risks associated with earnout provisions, parties should carefully consider the structure and drafting of the provisions. The following are some essential considerations when drafting these provisions:

- **Clear and Objective Targets:** The earnout targets must be defined clearly and objectively, with a focus on metrics that can be easily measured. Ambiguities in the language can lead to interpretation issues and disputes. Including a schedule or example of a calculation in the purchase agreement is a best practice.
- **Realistic Earnout Period and Payout Structure:** The earnout period and payout structure should be realistic and achievable. If the targets are not met, the buyer should not have to pay the full earnout amount.

- **Defined Performance Metrics:** Parties should define how performance metrics will be measured, including the accounting principles used, and whether there are any adjustments or exclusions. It is also essential to specify the frequency and manner of reporting on the target company’s performance. Again, having a sample calculation included in the purchase agreement is helpful to eliminate disagreements about measuring the performance metrics.
- **Books and Records Access:** Parties should agree, when possible, on when, how, and to what extent the seller can access relevant financial and performance information to avoid disputes and sellers’ claims that the buyer is hiding something.
- **Dispute Resolution Mechanism:** A clearly defined dispute resolution mechanism should be included in the earnout provision. The provision should identify, at a minimum, who will resolve disputes (e.g., an independent business-valuation expert), the process for raising and resolving disputes and the timeline for dispute resolution.

Final Thoughts

Earnout provisions can be an effective tool in M&A transactions, but they also come with litigation risks. Earnout litigation is common, and factual disputes often prevent a quick resolution. Moreover, because these cases tend to be fact-intensive and expert-driven, they are usually expensive, potentially costing more than the earnout at issue. Because of these risks, parties should structure and draft the provisions carefully, including defining objective targets and performance metrics, realistic payout structures, providing fair access to relevant books and records and providing dispute resolution mechanisms. It’s also essential to consider the potential litigation risks when negotiating the earnout provision so parties can ensure they are getting the best deal possible while minimizing risk.

¹ *Airborne Health v. Squid Soap*, 984 A.2d 126, 132 (Del. Ch. 2009)

² No. 22-cv-1917 (PKC), 2023 BL 79287, 2023 Us Dist Lexis 40882 (S.D.N.Y. Mar. 10, 2023).

³ No. C.A. No. 2020-0881-LWW, 2021 BL 474521, 2021 De Ch Lexis 290, 2021 WL 5893997 (Del. Ch. Dec. 13, 2021).

Understanding Subrogation in Representations and Warranties Insurance Policies



**Lauren E. Tucker
McCubbin**

Commercial Litigation
Vice Chair
Kansas City



Emily K. Gould

Associate
Nashville

Representations and warranties insurance (“RWI”) policies have in recent years become a favorite tool for buyers and sellers as they allocate post-closing risk, and the parties may even make RWI the exclusive remedy in the event of a breach.

As in all insurance policies, RWI policies give the insurer the right to pursue subrogation claims against third parties who are responsible for the insurer having to pay out under the policy. In some instances, an RWI insurer may even pursue subrogation against the seller. Additionally, RWI insurers may require the buyer to pursue claims against third parties in furtherance of the insurers’ subrogation interest. Subrogation therefore has the potential to disturb the allocation of risk agreed on between the parties. Buyers and sellers alike would be wise to understand provisions in the acquisition agreement and the RWI policy related to subrogation.

Shifting Risk with RWI

A major concern of parties to a transaction is what happens in the event of a breach of the acquisition agreement. The allocation of risk of post-closing liability is a heavily negotiated point, as the buyer wants to have a source of recovery while the seller wants to minimize its exposure after the closing. The acquisition agreement codifies the risk each party has agreed to accept and typically sets forth exclusive remedies if a breach occurs. The agreed-upon indemnification framework serves as the exclusive remedy, meaning the buyer must file an indemnification claim

instead of pursuing litigation. The aggrieved party—most often the buyer—funnels its claims through the indemnity, likely subject to specific time limitations and dollar amounts and other carve-outs. In a transaction with RWI, the RWI policy is often the exclusive remedy which shifts risk away from the parties and to a third-party insurer.

Though an RWI policy covers breaches of representations and warranties by the seller, the policy itself is an agreement between the insurer and the buyer. For covered breaches, in theory the buyer simply files a claim with the insurance company, avoiding the costs and hassles associated with litigation against the seller or other responsible parties. But this is not always the case.

While RWI insurers are in the business of accepting risk, they are also mindful of the need to shift any risk they do not wish to cover back to the parties. As with other types of insurance, certain retentions (i.e., deductibles) will need to be met and caps on liability will apply. Also, the policy will set forth a list of exclusions to coverage—based largely on issues revealed during due diligence. In addition, the RWI policy will contain conditions such as the requirement that the buyer take steps to mitigate its losses, which can potentially obligate the buyer to pursue affirmative claims against third parties who may be responsible for losses otherwise covered under the RWI policy.

Limitations with RWI

In addition to shifting risk back to the buyer through exclusions to coverage, the RWI insurer may shift risk back to the seller by asserting its subrogation rights. A transaction that utilizes RWI is generally designed to allow a seller to close the deal with “no strings attached,” that is, with no lingering post-closing liability. So, once the insurer has paid a claim out of the RWI policy, it would seem that the seller is off the hook for damages. However, in certain situations—typically involving allegations of fraud—the RWI insurance carrier may assert subrogation rights against the seller (and, in some cases, its officers and equity holders) to recover amounts paid out under the policy.

While the law, especially in Delaware, favors freedom of contract, there are limitations when it comes to intentional fraud. Parties to an M&A transaction are restricted in their ability to contract away liability for intentional fraudulent statements contained within the four corners of the acquisition agreement.¹ While the acquisition agreement may set forth exclusive remedies in the event of a breach of representations and warranties, the buyer may pursue extra remedies (e.g., the right to sue in a court of law) in the case of fraud. The parties may choose to narrow the definition of fraud in the acquisition agreement to include only intentional or deliberate fraud, or they may leave the term undefined, allowing a court to apply a state-specific common law definition of fraud (which may also capture reckless behavior).

When fraud is involved, the allocation of risk between the parties and an RWI insurer is not as certain as it might appear from the documents. Even when RWI is the exclusive remedy, a buyer still might be able to sue the seller for fraud after it receives a payout under the insurance policy. As a practical matter, so long as the buyer is made whole, it is unlikely to pursue a fraud claim. Some RWI policies require the buyer to pursue the fraud claim against the seller. Others provide that, if the buyer chooses not to pursue a fraud claim itself, the insurer may step into the shoes of the buyer and attempt to recover the amount it paid out of the policy. In either case, the buyer will be required to cooperate with the RWI insurer as it pursues its subrogation claim, which can be time-consuming and may require the buyer to incur expenses that are not covered under the RWI policy itself.

RWI policies will likely require the buyer to participate in any subrogation claim the insurer makes, which can be time consuming and expensive.

It is important for parties purchasing RWI insurance to look closely at the provisions in the policy related to the buyer’s obligation

CONTINUED ON PAGE 4 ▶

to mitigate damages, the buyer's obligation to prosecute claims against third parties on behalf of the RWI insurer, the scope of the RWI insurer's subrogation rights – both against the seller and others, and the provisions regarding who gets paid first when any subrogation recovery occurs. Each of these sections is likely negotiable, but it is important for buyers to understand whether the policy language broadens or narrows the coverage they intend to purchase. And it is also important for sellers to understand when they may be subject to indemnification claims by or on behalf of the RWI insurer through its subrogation interest.

AIG Specialty Ins. v. McColgan

A case pending in the U.S. District Court for the District of Massachusetts provides an interesting example of this RWI subrogation process. In *AIG Specialty Ins. v. McColgan*,² the RWI insurer is seeking subrogation against the defendants for the \$5 million dollar insurance claim it paid the buyer through the RWI policy. This case involves a transaction between two software companies in which the parties agreed to use RWI as the

exclusive remedy in the event of breaches of representations and warranties. A dispute arose post-closing regarding the termination of a material contract. The company being acquired represented in the acquisition agreement that it had no knowledge of or any reasonable basis to expect the termination of a material contract. "Knowledge" of the company was defined to mean actual or constructive knowledge of the company's CEO. The plaintiff insurance company, as subrogee and assignee of the buyer, offered specific facts that the defendant CEO knew that one of the company's largest customers did not intend to renew its contract. While this case is still pending, the court made clear in its denial of the defendants' motions to dismiss that an RWI insurer has broad subrogation rights in the event of a breach resulting from fraud.

Conclusion

RWI can be a powerful risk-mitigation tool providing coverage for buyers while limiting post-closing liability for sellers. However, it is important for the parties to work with experienced legal counsel both during the

underwriting process and when claims are made to understand an insurer's subrogation rights as set forth in the insurance policy and the acquisition agreement and to consider how the definition of fraud might affect an insurer's ability to collect against the seller after an insurance claim has been paid.

¹*Express Scripts, Inc. v. Bracket Holdings Corp.*, 248 A.3d 824, 830 (De. 2021) (distinguishing between freedom of contract with regard to unintentional versus intentional fraud).

¹*Express Scripts, Inc. v. Bracket Holdings Corp.*, 248 A.3d 824, 830 (De. 2021) (distinguishing between freedom of contract with regard to unintentional versus intentional fraud).

²*AIG Specialty Ins. v. McColgan*, ___ F. Supp.3d ___, 2022 WL 4096912 (D. Mass. Sept. 07, 2022).



The Impact of the Court of Chancery's Recent Clarification on Arbitration vs. Expert Determination



Robert A. Penza
Shareholder
Wilmington



Stephen J. Kraftschik
Shareholder
Wilmington

The Delaware Supreme Court recently clarified the standard of review that trial courts must apply to determinations made by an expert under a contractual expert-determination provision.¹ Under Delaware law, there is a distinction between whether an alternative dispute resolution (ADR) provision is by arbitration or expert determination.

After *Terrell v. Kiromic Biopharma, Inc.*, any legal determination made by an expert (or other non-judicial, non-arbitrator decision maker) pursuant to a contractual ADR provision will be reviewed by the court *de novo*, whereas factual determinations made by the expert typically in their area of expertise will be binding absent fraud, bad faith, or other improper conduct of the adverse party.

Background

The plaintiff/appellant, Dr. Jason Terrell, was a former consultant and director of defendant/appellee, Kiromic Biopharma, Inc., until he resigned his board seat in 2019. Dr. Terrell was compensated for his work through

three stock-option grants. The parties disputed whether the third stock-option grant extinguished the first two via the following language: “By signing this Grant Notice, you acknowledge and agree ... you have no other rights to any other options, equity awards or other securities of the Company (except securities of the Company, if any, issued to you on or prior to the date hereof, if any) ...” Kiromic maintained that this provision extinguished the first two stock-option grants, while Dr. Terrell maintained that parenthetical phrase preserved them.

The parties also disagreed whether a dispute resolution provision contained in their stock option agreement (§ 15.1) would govern their dispute about the first two stock-option grants. Section 15.1 required that disputes about the interpretation of the stock-option agreement would be submitted to a committee created by the board of directors, and that resolution by the committee would be “final and binding.”

The Court of Chancery found that § 15.1 gave the committee the right to interpret the agreement (including the preliminary determination as to whether Section 15.1 even applied) and stayed the case while the committee made its determinations. The committee determined that § 15.1 applied and delegated to the committee the authority to decide the substantive dispute. The committee then interpreted the third stock-option grant as having extinguished the first two, but it did not provide any reasoning in support of its determination. Kiromic’s counsel forwarded the committee’s legal conclusions to the Court of Chancery, which quickly dismissed Dr. Terrell’s complaint for lack of subject-matter jurisdiction without any review of the committee’s determination.

Dr. Terrell appealed, arguing the Court of Chancery erred in concluding § 15.1 was not an arbitration provision. If § 15.1 was an arbitration provision, then that would have required the Court—not the committee—to determine the scope of the provision. Also, Dr. Terrell argued it was error for the Court of Chancery to fail to review the committee’s determination before dismissing Dr. Terrell’s action for lack of subject-matter jurisdiction.

Two Types of ADR: Arbitration vs. Expert Determination

On appeal, the Supreme Court first analyzed whether § 15.1 was an arbitration provision or some other type of ADR provision (*i.e.*, an “expert determination” provision). The Supreme Court agreed with the lower court that § 15.1 was not an arbitration provision, but rather more akin to an expert determination provision.

As the Court explained, Delaware (unlike some other states) “recognizes a distinction between an arbitration and an expert determination.”² An expert determination ADR provision grants the expert decision maker authority to make binding factual determinations (most often regarding valuation), but not binding legal determinations. In contrast, an arbitration ADR provision delegates to the arbitrator “authority to decide all legal and factual issues necessary to resolve the matter,” in a role akin to that of a judge.³

The Supreme Court agreed with the Court of Chancery that § 15.1 was not an arbitration provision, resulting in the application of traditional principals of contract interpretation to determine who, in the first instance, should determine the scope of the provision. The Supreme Court upheld the Court of

CONTINUED ON PAGE 6 ▶

Chancery's interpretation of § 15.1 that the Committee should determine whether § 15.1 applies the parties' dispute, and if so, the interpretation of the option grants.

Standard of Review Applied to Expert Determinations (Factual vs. Legal Determinations)

The Supreme Court next considered the Court of Chancery's decision not to review the committee's determination that Dr. Terrell's first and second option grants had been extinguished. The Court first discussed the standard of review that would apply to expert determinations of fact and explained that type of expert determination would only be subject to review for fraud, bad faith or other improper conduct by the adverse party. The Court contrasted that more typical scenario with the somewhat unusual provision at issue in *Terrell* that delegated a legal determination to the expert decision maker (in this case the committee).

An expert determination ADR provision grants the expert decision maker authority to make binding factual determinations, but not binding legal determinations.

The Court rejected Kiromic's argument that the committee's decision, even if contrary to Delaware law, was insulated from court review because under the clear and unambiguous contract provision of § 15.1, the parties agreed exclusive authority for

interpretation of the stock-option grants was provided to the committee. Analogizing to the implied covenant of good faith and fair dealing, which applies to every contract, the Court explained that it must reject Kiromic's argument because that "would permit the Committee, a conflicted party made up of three directors owing fiduciary duties to the company, to unfairly — even in bad faith — skew its determinations in the company's favor with impunity."

Acknowledging Delaware's "admittedly scant" case law on the topic and considering authorities from other jurisdictions, the Court found that review of legal determinations by an expert were not limited to consideration of fraud or bad faith, but instead must be reviewed by the court *de novo*. The Supreme Court thus reversed and remanded to the Court of Chancery to review the committee's decision, under this standard of review.

Impact and Conclusion

Delaware's strong public policy encourages the use and enforcement of ADR provisions, including expert determinations. Following *Terrell*, expert determinations of factual issues (for example, valuation) will continue to receive deferential limited review from courts. Legal determinations made by an expert, however, will be reviewed *de novo* by a court.

The complete lack of deference given to such legal determination made by experts begs the question as to what possible benefit such a provision could provide to the contracting party controlling the expert decision maker. Companies adopting expert determination ADR provisions, therefore, should strongly consider delegating only factual (not legal)

decisions to an expert decision maker in their area of expertise in a contractual ADR provision. Otherwise, if the intent of the ADR provision was to attempt to avoid the additional cost and expense of litigation, any legal determinations by an expert, who is not in the role of an arbitrator, will be subject to *de novo* review.

¹*Terrell v. Kiromic Biopharma, Inc.*, C.A. No. 299, 2022 (Del. May 4, 2023)

²*Id.* at 13.

³The distinction between an arbitration and an expert determination is important because it often impacts who will decide the scope of the parties' contractual dispute resolution mechanism (an analysis often referred to as "substantive arbitrability"). Generally, in an arbitration, the court rather than the arbitrator will decide questions of substantive arbitrability unless there is clear and unmistakable evidence that the parties intended otherwise. In one example, courts have found that where the parties have agreed to arbitrate in accordance with the rules of the American Arbitration Association (AAA), the parties have clearly and unmistakably evidenced intent to have the arbitrator decide substantive arbitrability. In contrast, where the provision at issue is an expert determination, the court will apply normal contract interpretation principles to determine the scope of the ADR provision, and given Delaware's pro-contractarian policy, agreements that delegate the interpretation of the scope of the ADR provision to the non-judicial decision maker will be enforced.



Shareholder Spotlight — Q&A with Michael Malone



Michael Malone
Shareholder
Nashville

Q. What is biggest trend in M&A litigation right now?

A. As the economy takes a downturn, we are seeing a rise in post-closing disputes. For example, we are seeing more earnout disputes tied to business performance. We expect these types of disputes to continue to rise as businesses navigate a challenging economy.

Q. What question are you most often asked by clients?

A. Two related questions - "How long will this take" and "How much is it going to cost?" We work with our clients to make sure that a given strategy's time horizon and cost match their business goals. We often present budgets for multiple courses of action, coupled with our analysis of the strengths and weaknesses of each, allowing our clients to select from a menu of options.

Q. What do you want other people to know about the M&A Litigation team?

A. As litigators, we are ready, willing and able to pursue our clients' interests in court or any arbitration forum. But we are more than that. We are savvy business lawyers, and we work to understand our clients' business objectives and how different courses of action may be more successful at accomplishing them. Some of our proudest "victories" are matters in which we achieved our clients' objectives without having to actually file a lawsuit or arbitration—and at a fraction of the cost that would have been incurred in litigation.

Q. What do you enjoy the most about working at Polsinelli?

A. I enjoy working and collaborating with my colleagues. We have a great team across the board. They are smart, talented attorneys and they're great people. Some of my most enjoyable and rewarding experiences have involved matters where I'm working with attorneys in different practice areas. It's very gratifying to be part of a firm that can assemble a multidisciplinary team that can solve virtually any client problem.

Q. What might someone be surprised to know about you?

A. Lots of people picked up new hobbies or developed new skills in the early days of the Covid pandemic. Mine was baking gluten-free bread, pizza and bagels for my wife, who has celiac disease. I got really into it; I even started buying and experimenting with a flour imported from Italy. I've continued to dial in the recipes and methods over the last few years, and they are spot on now. I'm no chef, so this was a little surprising to my family and friends.



Mergers and Acquisitions Litigation

Members of Polsinelli's national business litigation practice work in close collaboration with Polsinelli's corporate and transactional attorneys representing buyers, sellers, officers and directors, boards and board committees, founders and other stakeholders in disputes arising from merger and acquisition transactions.

These transactions include a broad cross-section of business organizations, including, among others, Fortune 500 companies, private equity sponsors, venture capital sponsors, nonprofit organizations, manufacturers, foundations, operators and founders.

Contact

Bryan M. Westhoff

Chair, M&A Litigation Working Group

bwesthoff@polsinelli.com

312.873.2973

Polsinelli is very proud of the results we obtain for our clients, but you should know that past results do not guarantee future results; that every case is different and must be judged on its own merits; and that the choice of a lawyer is an important decision and should not be based solely upon advertisements. Copyright © 2023 Polsinelli PC. Polsinelli LLP in California.



What a law firm
should be.™