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Chancery Addresses "Commercially Reasonable Efforts" Clauses in the Context of an Earnout Dispute

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In *Shareholder Representative Services LLC v. Alexion Pharmaceuticals, Inc.*, the Delaware Court of Chancery addressed an earnout dispute, holding that a buyer violated its contract with the seller by failing to use "commercially reasonable efforts" to meet the contractual milestones that would entitle the seller to a hefty earnout payment. The court addressed the differences between inward- and outward-facing "commercially reasonable efforts" clauses, and clarified the standards and evidence relevant when analyzing challenges to a buyer's efforts to achieve earnout-related milestones pursuant to such clauses.

Background

In 2018, Alexion Pharmaceuticals acquired Syntimmune, a pharmaceutical company developing a monoclonal antibody named SYNT001, later renamed ALXN1830. Under the parties' merger agreement, Alexion would pay Syntimmune's former shareholders up to $800 million upon satisfying eight contractual milestones relating to ALXN1830's development. Alexion was obligated to use commercially reasonable efforts to meet the contractual milestones.

Alexion and Syntimmune agreed to an "outward-facing standard" for the merger agreement's efforts clause, requiring reference to the efforts of similarly situated pharmaceutical companies. Specifically, the parties defined "commercially reasonable efforts" as "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," taking into account "relevant scientific[,] technical[,] and commercial factors typically considered by biopharmaceutical companies similar in size and scope to [Alexion] in connection with such similar products."

The efforts clause did not require Alexion to "act in a manner which would otherwise be contrary to prudent business judgment," nor would Alexion's failure to meet a contractual milestone function as "dispositive evidence that" Alexion "did not in fact utilize" commercially reasonable efforts. Further, while the agreement gave Alexion "sole discretion with regard to all matters relating to the operation of the Company," that discretion was limited by Alexion's obligation to employ commercially reasonable efforts in developing ALXN1830.

Although Syntimmune had promising results from its first clinical study of ALXN1830 and had opened two more trials prior to the acquisition, Alexion experienced difficulty developing ALXN1830 and deprioritized the program not long after the merger, while competitors' programs continued to advance. Following Alexion's acquisition by another pharmaceutical company, it terminated the ALXN1830 program in December 2021 to focus on launching

10 other products by 2023.

Shareholder Representative Services, LLC (SRS), representing former Syntimmune stockholders, sued Alexion for breach of the merger agreement.

Analysis

The Delaware Court of Chancery held in a post-trial opinion that the defendant-buyer failed to comply with its contractual efforts obligations and, in the process, clarified the standards and evidence relevant in assessing contractual efforts clauses.

The court noted that, in this case, the merger agreement contained an outward-facing efforts clause that "cabin[ed] Alexion's exercise of discretion with an objective standard," requiring a "hypothetical company" approach. More specifically, the court would assess Alexion's efforts to develop ALXN1830 against the efforts of a "hypothetical typical company of Alexion's size, working on a molecule like ALXN1830 at a similar stage of development, considering the factors such a company would typically consider, up until the point of being contrary to prudent business judgment." Comparable industry standards, rather than Alexion's subjective intent, would be determinative in deciding whether Alexion understood commercially reasonable efforts to develop ALXN1830.

Comparing Alexion's efforts to develop ALXN1830 against those of a hypothetical company, the court held that Alexion's efforts were not commercially reasonable. Among other things, the court determined that a hypothetical reasonable company would not have deprioritized ALXN1830, where Alexion's competitors were all advancing their competing programs. The court further found that it was unreasonable for Alexion to terminate the ALXN1830 program altogether, where the company terminated the program before obtaining definitive results concerning the product's safety, and where ALXN1830 remained commercially viable. Instead, the court held that Alexion terminated the ALXN1830 program (and so failed to meet the vast majority of the merger agreement's contractual milestones) to pursue $500 million in recurring merger synergies promised to Alexion by the acquiring pharmaceutical company. Because Alexion's decisions to deprioritize and terminate the ALXN1830 program were driven by "idiosyncratic corporate initiative[s]," rather than the considerations that would motivate a hypothetical similarly situated company, the court concluded that Alexion breached the parties' efforts clause.

Conclusion

The court's decision highlights the importance of crafting efforts clauses to plainly delineate the efforts expected from the buyer in achieving earnout milestones. Buyers and sellers should be mindful that Delaware courts will interpret and enforce contractual efforts clauses according to their plain terms and should therefore pay close attention when drafting such provisions to carefully define the parties' respective rights and obligations. Accordingly, whether parties agree to outward-facing efforts language, as in this case, or instead agree to more subjective, inward-facing language will play a significant role in how a court analyzes a buyer's conduct with respect to a contractual efforts clause.

This decision is an important reminder for buyers to pay close attention to their earnout obligations, as they may be on the hook for substantial damages if they fail to follow a contractual efforts clause. Including an earnout component in an acquisition transaction can be attractive, but parties should carefully assess the details of such

provisions before finalizing a transaction.

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