M&A Insights: Earn-Outs, New HSR and Investment Rules, and Fraud Liability

December 10th , 2024

GIBSON DUNN

MCLE Information

The information in this presentation has been prepared for general informational purposes only. It is not provided in the course of an attorney-client relationship and is not intended to create, and receipt does not constitute, an attorney-client relationship or legal advice or to substitute for obtaining legal advice from an attorney licensed in the appropriate jurisdiction.

- This presentation has been approved for **0.75 General credit.**
- Participants must submit the form by **Tuesday, December 17th** in order to receive CLE credit.

CLE Form Link:
https://gibsondunn.qualtrics.com/jfe/form/SV_eWAv2rdGiLJhuBw

Most participants should anticipate receiving their certificate of attendance in 4-6 weeks following the webcast.

All questions regarding MCLE Information should be directed to **CLE@gibsondunn.com**.

Today’s Panelists

Branden Berns

Branden C. Berns is a partner in the San Francisco office of Gibson, Dunn & Crutcher, where he practices in the firm's Corporate Transactions Practice Group, focusing on representing leading life sciences companies and investors. Mr. Berns advises clients in connection with a variety of financing transactions, including initial public offerings, secondary equity offerings and venture and growth equity financings, as well as complex corporate transactions, including mergers and acquisitions, asset sales, spin-offs, joint ventures, PIPEs and leveraged buyouts.

Michael Farhang

Michael M. Farhang is a former federal prosecutor and a partner in the Los Angeles office of Gibson, Dunn & Crutcher. He is a member of the firm's White Collar Defense and Investigations and Securities Litigation Practice Groups. Michael is an experienced litigator and trial attorney who has earned recoveries totaling nearly $70 million for private equity and corporate clients pursuing fraud, contract, and M&A-related claims. He specializes in private M&A litigation matters, including rep and warranty, earnout, and working capital disputes, as well as the defense of companies, directors, and executives in DOJ and SEC investigations and in shareholder class actions, derivative suits and other commercial litigation.

Andrew Cline

Andrew Cline is Counsel in Gibson, Dunn & Crutcher's Washington, D.C. office. He currently practices in the firm's Antitrust Practice Group.

Michelle Weinbaum

Michelle Weinbaum is of counsel in the Washington, D.C. office of Gibson, Dunn & Crutcher LLP where she is a member of the firm’s National Security and International Trade practices. Michelle advises clients on cross-border transactions and national security compliance matters including reviews before the Committee on Foreign Investment in the United States (CFIUS), the Defense Counterintelligence and Security Agency (DCSA), and Team Telecom, as well as export controls (ITAR/EAR), sanctions, foreign direct investment, and government contracts matters.

Ryan Foley

Ryan Foley is Of Counsel in the Washington, D.C. office of Gibson, Dunn & Crutcher and a member of the firm’s Antitrust and Competition Practice Group. Ryan counsels clients on all aspects of antitrust law, with a focus on complex transactions. He has extensive experience representing clients in all phases of merger review before the U.S. Department of Justice Antitrust Division, Federal Trade Commission, and other competition authorities globally. He has expertise across a broad range of industries, including pharmaceuticals, technology, media, consumer products, and energy.

Agenda

01	Introduction
02	Earn-Outs
03	New HSR Rules
04	Outbound Investments
05	Fraud Liability

Earn-Outs

Himawan v. Cephalon Overview

Case Overview

- **Parties:** Jeff Himawan, Josh Targoff, Stephen Tullman (Plaintiffs) vs. Cephalon, Inc. and Teva Pharmaceuticals USA, Inc. (Defendants)
- **Court:** Delaware Court of Chancery
- **Date:** April 30, 2024

Background and Key Events

- **2010:** Cephalon acquired Ception Therapeutics, which had an antibody, Reslizumab (RSZ), for treating eosinophilic esophagitis (EoE) and eosinophilic asthma (EA)
- **Merger Agreement:** Included $250 million upfront and up to $400 million in milestone payments for FDA and European approval of RSZ for EoE and EA
- **2010-2011:** Cephalon made multiple attempts to gain FDA approval for RSZ for EoE, all of which were rejected
- **2011:** Cephalon terminated the EoE program due to lack of clinical benefit and feasibility
- **2011:** Teva acquired Cephalon and focused on developing RSZ for EA, which was eventually approved by the FDA

Legal Issue

- **Plaintiffs' Claim**: Cephalon and Teva failed to use "commercially reasonable efforts" to develop and commercialize RSZ for EoE, breaching the Merger Agreement

Court's Decision

- **Holding**: The court found that Cephalon and Teva did not breach the Merger Agreement. Their efforts were deemed commercially reasonable given the circumstances and challenges faced in developing RSZ for EoE

Himawan v. Cephalon Lessons Learned

Lessons Learned for Buyers

- ***Address Individual Drugs or Indications on Their Own Merits***
  The court found it "notable that Defendants did undertake approval of RSZ for EA, where the preliminary test results were more favorable than for EoE, that they were successful in doing so, and the milestone payment were made to Plaintiffs. The different circumstances regarding EoE led to a different result." Where a milestone contemplates multiple products or product candidates, or a product or product candidate in multiple indications, a buyer must assess the merits of each individually.
- ***Hiring a Consultant to Conduct a Rigorous or Analytical Review***
  The case demonstrates that it may be helpful but is not necessary for a buyer to conduct a rigorous and analytical review to substantiate its decision as commercially reasonable when declining to pursue a program.

Lessons Learned for Buyers and Sellers

- ***Court Found It "Unworkable" to Compare Efforts to Real World Competitors***
  It was suggested to the court that one way to interpret the CRE Clause was to compare the efforts of similarly-situated pharma companies and their actions in the real world to the actions undertaken by the defendants. ***The court found this method unworkable***. The court noted that no exemplar companies operate under the actual conditions faced by the Defendants, who also differ from one another in their circumstances. Rather, the requirement was an objective standard meant to be imposed on the buyer as it found itself situated. Specifically, the buyer must "exercise . . . such efforts and commitment of such resources [as] a company with substantially the same resources and expertise as" the buyer.
- ***Commercially Reasonable Efforts Does Not Require Acting Against Own Self-Interest***
  The plaintiffs argued that the court's interpretation of the CRE Clause offers sellers minimal protection, as it only prevents the buyer from acting against its own self-interest. The court responded that this interpretation aligns with the parties' agreement, that Cephalon was not required to take actions beyond what was commercially reasonable, and the plaintiffs received the protection they negotiated for, that Cephalon would act in a commercially reasonable manner.

Fortis v. Medtronic Overview

Case Overview

- **Parties**: Fortis Advisors LLC (Plaintiff) vs. Medtronic Minimed, Inc. (Defendant)
- **Court**: Delaware Court of Chancery
- **Date**: July 29, 2024

Background and Key Events

- **2014**: Medtronic acquired Companion Medical, Inc., which developed "smart insulin pen" products called InPen and InCap.
- **Merger Agreement**: Included over $300 million in closing consideration and contingent milestone payments, including a $100 million First Milestone based on sales targets.
- **Milestone Period:** November 1, 2020, to October 28, 2022.
- **First Milestone:** Required sales of at least 85,000 units of InPen at an average price of $400 each during any four consecutive quarters within the Milestone Period.
- **Allegations:** Fortis claimed Medtronic took actions to frustrate achievement of the First Milestone, such as requiring non-compete agreements, delaying marketing programs, and not pursuing InCap clearance.

Legal Issue

- **Plaintiffs' Claim**: Medtronic breached the Merger Agreement by acting with primary purpose of defeating the First Milestone and failing to authorize release of escrow funds.

Court's Decision

- **Holding**: The court granted Medtronic's motion to dismiss the claims related to the First Milestone. The court found Fortis did not sufficiently allege Medtronic acted with the primary purpose of frustrating the First Milestone.

Fortis v. Medtronic Lessons Learned

Lessons Learned for Buyers and Sellers

- ***Courts Will Respect Buyer-friendly or Seller-friendly Language***
  The court notes that Fortis faces a heavy burden due to the buyer-friendly terms of the Merger Agreement, which grants Medtronic sole discretion to take actions that might frustrate the First Milestone, provided those actions have another primary purpose. Fortis's allegations include Medtronic's deferral of new salespeople, a $12 million marketing program, and pursuit of InCap clearance and sales. However, the court finds these allegations insufficient, including because Fortis fails to provide direct or circumstantial evidence of Medtronic's primary purpose behind these actions, such as unique treatment of Companion products or suspicious timing of actions.
- ***An Omission Is Not an Action***
  If the operative language states that a party shall not take any action in bad faith, then the court will not treat an omission as an act.

2.11(f) states:

> The parties hereto acknowledge that, following the Closing, it is the intention of the parties that the development, marketing, commercial exploitation and sale of the Milestone Products shall be exercised by Buyer, the Surviving Corporation or their Affiliates and transferees *in accordance with its or their own business judgment and in its or their sole and absolute discretion, which may have an impact on the payment of the Milestone Consideration*. The parties hereto further acknowledge and agree that achievement of the Milestones is uncertain. Neither Buyer nor the Surviving Corporation makes any representation or warranty, express or implied, whatsoever, with respect to the achievability of the Milestones, and the Company, on behalf of itself and the Former Holders, acknowledges that there can be no assurances that the Milestones are achievable.[22]

Importantly to this litigation, the next sentence of Section 2.11(f) qualifies that language, saying: "Notwithstanding the foregoing, until the end of the Milestone Period, *Buyer shall not take any action intended for the primary purpose of frustrating the payment of Milestone Consideration* hereunder."[24] Section 2.11(f) concludes:

> For clarity, other than the Ancillary Agreements, the parties hereto agree that this Agreement is intended to define the full extent of the legally enforceable undertakings of the parties hereto, and that no promise or representation, written or oral, which is not set forth explicitly in this Agreement or such Ancillary Agreement is intended by any party to be legally binding. The Company and the Former Holders acknowledge that in deciding to enter into or adopt this Agreement and to consummate the Merger none of them has relied upon any statements or representations, written or oral, other than those explicitly set forth herein.

At bottom, and as Fortis acknowledges,[25] Section 2.11(f) immunizes Medtronic from any milestone-related claims aside from a claim that Medtronic acted "for the primary purpose of frustrating the payment of Milestone Consideration."[26]

WT Representative v. Philips Holdings USA Overview

Case Overview

- **Parties**: WT Representative LLC (Plaintiff) vs. Philips Holdings USA Inc. (Defendant)
- **Court**: Delaware Court of Chancery
- **Date**: August 16, 2024

Background and Key Events

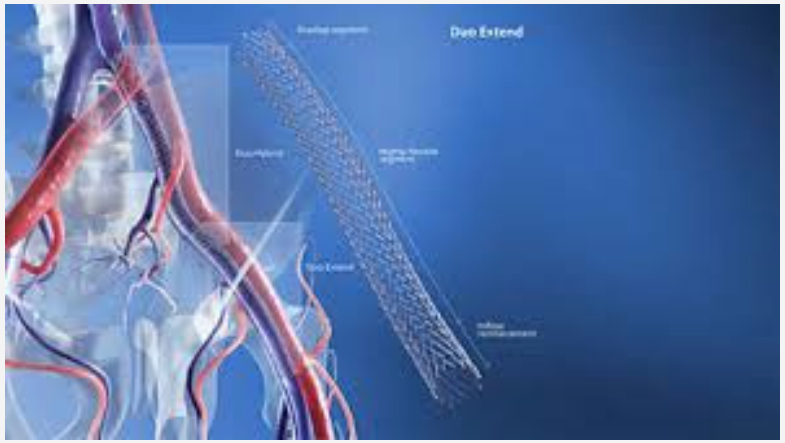
- **2021**: Philips acquired Vesper Medical, Inc., which developed the DUO Venous Stent System for treating deep venous obstructions.
- **Merger Agreement**: Included a potential milestone payment contingent on achieving FDA Authorization for the DUO Venous Stent System.
- **FDA Approval Process:** Vesper initially included 10mm stents in its FDA filing but later removed them based on clinician feedback. Philips continued the approval process without the 10mm stents.
- **FDA Authorization:** The FDA approved in late 2023, but did not include 10mm stents.
- **Dispute:** Philips informed WT Representative that the milestone payment was not triggered because the FDA approval did not include the 10mm stents.

Legal Issue

- **Plaintiffs' Claim**: WT Representative alleged Philips breached the Merger Agreement by failing to make the milestone pmt, not using CRE to achieve FDA Authorization, and acting in bad faith to avoid the pmt.

Court's Decision

- **Holding**: The court denied Philips' motion to dismiss the claims related to the failure to make the milestone payment and acting in bad faith but granted the motion to dismiss the claim regarding the failure to use commercially reasonable efforts. The court found that WT Representative's interpretation of the Merger Agreement was reasonable and that the bad faith claim was adequately pled.



WT Representative v. Philips Holdings USA Lessons Learned

Lessons Learned for the Buyers and Sellers

- ***Avoiding Achievement of a Milestone on a Seeming Technicality Could Be "Bad Faith"***
  The court analyzed the "bad faith" argument by examining whether Philips acted with the primary purpose of avoiding or minimizing the milestone payment. The court noted that the Merger Agreement required Philips not to take any action in bad faith with the primary purpose of avoiding the milestone payment. WT Representative alleged that Philips acted in bad faith by failing to include the 10mm stents in the clinical trial and PMA application, despite knowing that FDA approval of these stents was necessary to trigger the milestone payment. The court found that it was reasonably conceivable that Philips' decision not to pursue FDA approval for the 10mm stents, while aware of the milestone requirements, could qualify as bad faith. This decision allowed the bad faith claim to survive the motion to dismiss.

The "DUO-EXTEND Stent" is defined as:

> the Company's self-expanding venous stent intended to improve luminal diameter in symptomatic venous outflow obstructions, which integrates with the DUO-HYBRID Stent to treat longer lesions in the following sizes: 10mm x 40mm, 10mm x 60mm, 10mm x 80mm, 10mm x 100mm, 10mm x 120mm, 10mm x 140mm, 12mm x 40mm, 12mm x 60mm, 12mm x 80mm, 12mm x 100mm, 12mm x 120mm, 12mm x 140mm, 14mm x 40mm, 14mm x 60mm, 14mm x 80mm, 14mm x 100mm, 14mm x 120mm, 14mm x 140mm, 16mm x 40mm, 16mm x 60mm, 16mm x 80mm, 16mm x 100mm, 16mm x 120mm, 16mm x 140mm.[25]

"Duo-HYBRID Stent" means:

> the Company's self-expanding venous stent intended to improve luminal diameter in symptomatic venous outflow obstructions in the following sizes: 12mm x 60mm, 12mm x 80mm, 12mm x 100mm, 12mm x 120mm, 12mm x 140mm, 12mm x 160mm, 14mm x 60mm, 14mm x 80mm, 14mm x 100mm, 14mm x 120mm, 14mm x 140mm, 14mm x 160mm, 16mm x 60mm, 16mm x 80mm, 16mm x 100mm, 16mm x 120mm, 16mm x 140mm, 16mm x 160mm, 18mm x 60mm, 18mm x 80mm, 18mm x 100mm, 18mm x 120mm, 18mm x 140mm, 18mm x 160mm.[26]

> FDA Authorization Milestone is defined means "the receipt by a member of the Parent Group of FDA Authorization for each of the DUO Venous Stent First Generation System and the DUO Venous Stent Second Generation System."

> The DUO Venous Stent First Generation System means "the DUO-HYBRID Stent, the DUO-EXTEND Stent and a pin and pull manual delivery system."

> The DUO Venous Stent Second Generation System means "the DUO-HYBRID Stent, the DUO-EXTEND Stent and the DUO Triaxial/Handle Stent Delivery System."

New HSR Rules

Overview of Final Rule

On October 10, 2024, the FTC announced significant revisions to the HSR premerger notification requirements

- The rule is a scaled-back version of the proposed rule submitted for public comment in June 2023.

- The rule is scheduled to go into effect on **February 10, 2025** (barring a freeze by the incoming administration)

- The rule **changes the content of the filing information and documents submitted**; it does not change the types of transactions that are notifiable or who must file

- Revives potential for "early termination" ("ET") of HSR waiting period, although we expect FTC to be very cautious about granting ET

Key Changes

New categories of deal-specific and ordinary course documents:

- Adds mandatory inclusion of certain **ordinary course "Plans and Reports"** regarding the **parties' overlaps**
- Expands current scope of required 4(c) documents to include any created by or for a **"supervisory deal team lead"** who does not otherwise qualify as a director or officer

Enhanced disclosure requirements, including for current or potential overlaps

- All filing parties will be required to provide narratives outlining current or future/planned overlaps
- Acquirers must also provide detailed narratives describing the transaction

New details about the affiliations of officers and directors, particularly those in overlapping industries

- **Identification of board and corporate affiliations** held by officers and directors where there may be competitive overlaps (non-profit religious or political organizations are exempt).

Expanded reporting obligations about the parties' prior acquisitions

- Both acquirers *and* acquired parties are **required to report prior acquisitions from the past five years**
- Expands the scope of asset acquisitions that are required to be reported to closer align with the existing reporting requirement for share deals

Other Notable Changes

Disclosure of vertical supplier relationships

- Filers must identify any supplier relationships between the acquiring and acquired parties, as well as with known competitors to either party

Targeted Disclosure of Minority Holdings

- Filers must now list only minority holdings that have competitive overlaps with the transaction; providing a comprehensive list of all minority holdings is no longer sufficient

Filing on a Letter of Intent

- Submissions made under a letter of intent (prior to finalizing an agreement) must include documents detailing the transaction structure, scope of acquisition, purchase price calculations, estimated closing timeline, employee retention policies, post-closing governance, and any material transaction expenses

Foreign Subsidies and Defense/Intelligence Contracts

- Filers must identify and describe certain subsidies from foreign entities or governments of concern
- Filers must also identify products produced in countries of concern subject to countervailing duties
- Parties must also identify proposals and awarded contracts with the U.S. Department of Defense and Intelligence community for overlaps ($100 million or more)

What Was Not Added?

Draft 4(c)/4(d) Document Requirement

- No requirement for filers to submit draft 4(c) / 4(d) drafts
- Note that all versions sent to board members count as final

Labor Market Information

- No requirement to include labor market information in HSR filings, limiting the data required from companies regarding employment impacts

Litigation Hold Obligations

- Proposed litigation hold obligations at the filing stage were not incorporated

Additional Documents/Narratives

- Deal timeline; and
- Organization charts

Outbound Investments

Outbound Investment Restrictions

- The U.S. Department of the Treasury published its final rules to implement President Biden's Executive Order on: "*Addressing United States Investments in Certain National Security Technologies and Products in Countries of Concern*."
  - These rules are set to go into effect on January 2, 2025.
  - The rules will prohibit some transactions outright and require transaction parties to make post-closing notifications with respect to others.
  - Willful violations of the rule can result in criminal penalties and/or imprisonment, and other violations may result in civil monetary penalties.

- The rules restrict U.S. persons' investments in companies that engage in "covered activities" in "countries of concern" (i.e., China, Hong Kong, and Macau). The covered activities relate to:
  - Quantum computing
  - Semiconductors and microelectronics
  - Artificial Intelligence systems

- Treasury established a new website for Outbound Investment and held the first Outbound Investment conference on Monday, December 9th.
  - Treasury plans to provide more information on how to facilitate compliance, including how to file notifications.

- European countries are considering their own Outbound Investment regimes.

How Industry is Preparing

Financial Investors.

- U.S. and non-U.S. investment firms and fund managers/advisors have been updating their diligence processes to address outbound investment restrictions *and* have been considering new terms to include in their Limited Partnership agreements and side letters.
- For non-U.S. investment firms, some may exclude U.S. limited partners from certain investments.
- Investors (particularly large limited partners) are considering how to update their diligence processes to account for this new legal regime and are also considering what contractual assurances to demand from general partners/investment advisors.

Strategic Investors.

- Companies with global operations are reviewing both their approach to new acquisitions and investments as well as their own activities in covered areas, including by:
  - Updating processes to ascertain whether technology and products will fall under either the prohibited or notifiable categories.
  - Updating procedures to ensure that U.S. persons are not "knowingly directing" prohibited or notifiable transactions.

Other interested parties.

- Lenders and insurers have begun asking diligence questions relating to outbound investment restrictions.

Fraud Liability

Fraud Liability in M&A Transactions: General Principles

- Rep and Warranty Claims – key distinctions between contract/indemnification and common law fraud claims:
  - Contract/indemnification – intent and reliance not required; Delaware is a pro-sandbagging state. Contractual limitations (caps, deductibles, survivals, may apply)
  - Fraud – misrepresentation must be intentional/knowing or reckless under DE law, and counterparty's reliance is required. Contractual limitations (exclusive remedies, caps, deductibles, survivals etc.) do not limit fraud claims. *Online Healthnow, Inc. v. CIP OCL Investments*, (Del. Ch. 2021)
  - Fraud carveouts – can eliminate liability for some claims that would be permitted under common law fraud, e.g., recklessness. *Express Scripts v. Bracket Holding Corp. (Del. 2021)*
  - Seller liability for company reps. *See Abry Partners*, *Prairie Capital.* Some additional pleading theories (like aiding and abetting or agency liability) may be applicable.

Fraud Liability in M&A Transactions: Recent Cases

- Anti-Reliance Disclaimers – may provide protection against fraud claims based on misrepresentations occurring outside of the purchase agreement's reps and warranties. *See Abry Partners*, *Prairie Capital.*
  - Integration clauses are not sufficient, but the disclaimer must be clear as to the buyer's reliance. *Labyrinth, Inc. v. Ulrich (*Del Ch. 2024) (Zurn, V.C.)
  - Disclaimers can bar fraud claims and fraudulent inducement claims. - *Trifecta Multimedia Holdings v. WCG Clinical Services* (Del. Ch. June 2024 (Laster, V.C.). Anti-reliance disclaimers are required to bar claims for extracontractual misreps *and* promissory fraud or fraudulent inducement claims.

Fraud Liability in M&A Transactions: Recent Cases

- Advancement and Indemnification in Fraud Cases.
  - By-law provisions entitling directors and officers to advancement and indemnification in the event of claims may result in successful claims by D&O sellers for advancement against buyers in the context of a fraud litigation. *Hyatt v. Al Jazeera Am. Holdings* (Del. Ch. 2016); *Rhodes v. Biomerieux* (Del. Ch. 2024).
  - Waivers of by-law or other rights to D&O advancement and indemnification in the context of a purchase agreement are not effective without a specific release by the concerned D&O in their individual capacity and not simply as a signatory to the agreement in their corporate capacity as a company representative. *Javice v. JP Morgan* (Del. Ch. 2023) (McCormick, C.)

GIBSON DUNN