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# Earn-out Risk Prevention and Dispute Resolution: A Study of M&A Transactions in the Life Sciences Industry

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Earn-outs are a commonly used payment mechanism in overseas and cross-border M&A transactions. Through earn-outs, transacting parties can set flexible metrics to adjust the buyer's payment obligation and thereby allocate the risks and benefits between the buyer and seller. Compared to valuation adjustment mechanisms ("**VAMs**") — a one-time payment receivable upon fulfilling certain conditions — that are commonly used in domestic transactions in China, earn-outs allow for conditional, incremental payments and have their own advantages and applicable circumstances. In recent years, earn-outs have become increasingly adopted in domestic M&A (especially for deals in the life sciences industry).

However, earn-outs are also one of the most contentious provisions in M&A deals. The most common disputes arise from whether certain metrics have been satisfied and whether the obligation to manage and operate the business has been fulfilled. This article introduces the application of earn-outs in life sciences M&A transactions as well as typical cases based on our practical observations and research, which we hope serves as a useful reference for contract drafting and dispute resolution relating to earn-outs.

## Application of earn-outs in the life sciences industry

### I Why earn-outs are favored

Earn-outs refer to a payment mechanism where the buyer, apart from paying the baseline price, is obligated to make additional payments to the seller contingent upon the satisfaction of certain post-closing conditions. In Chinese, earn-outs are sometimes also referred to as "或有支付机制[1]", the literal meaning of which can be interpreted as the seller needs to "earn" more consideration with its own efforts.

The primary purpose of this mechanism is to temporarily reconcile the transacting parties' disagreements on valuation[2]. While negotiating the transaction, buyers and sellers are prone be divergent on the value of the target company and related factors that may affect valuation (such as the

[1] Yahao Cheng (The Shanghai Stock Exchange Capital Market Research Institute), A study on Earn-outs in Mergers and Acquisitions, 7 Shang Zheng Yan Bao, No. 007 (2017), 4.

[2] Heiko Daniel Ziehms, M&A Disputes and Completion Mechanisms 184 (2018).

competition environment, national policies, the target's assets or business volatility, etc.). If the parties cannot reach an agreement on valuation, the transaction will be deadlocked and thus unable to be closed. Under this circumstance, earn-outs function as a bridge between the parties that allow them to each take a step forward and reach a temporary consensus on pricing.

The use of earn-outs is particularly common in the life sciences industry. According to a private study, 163 out of 227 selected M&A deals adopted earn-outs in the U.S. life sciences industry between 2008 and 2019[3]. Among the selected public M&A deals in the United States from 2017 to 2019, 83% of them had earn-outs, with 77% in medical devices, 50% in diagnostic research, and only 18% in other industries[4].

The extensive use of earn-outs in the life sciences industry is mainly attributable to the features of the industry. Taking the R&D of innovative drugs as an example, it takes substantial time and resources to take a drug from development to its eventual commercialization. Large companies can hardly spare efforts on developing multiple products, while small companies with innovative capabilities are often unable to support the entire R&D cycle due to their limited resources. As a result, the R&D of many innovative drugs must be completed by merging small companies into larger ones in order to integrate their limited resources. A product often needs to go through several years or even more than a decade of R&D and clinical trials, and then obtain various regulatory approvals before achieving commercialization. Failure at even one step has the potential to derail an entire product. According to a study in the United States, the R&D of innovative drugs costs about USD 800 million on average, and it takes an average of 12 years from the beginning of R&D to obtaining market approval—some may take as long as 15 years[5]. Due to long development cycles, large investments and high risks, investors are generally reluctant (and often cannot) make a large one-time payment and then bear the risk of no return for a long period of time. In particular, the core assets of targets in the life sciences industry are often intellectual property rights and R&D personnel related to a certain drug. Such assets are generally impossible to value and difficult to realize when the R&D of a drug product lags or fails. If a VAM is adopted for financing, it is usually difficult for investors to actually receive payments even if the VAM conditions are met. In contrast, earn-outs provide a solution that is more in line with the business logic of the industry.

## II Setting earn-out metrics

The metrics to determine payment obligations under an earn-out can be divided into two major types: financial metrics and non-financial metrics[6]. Earn-out provisions in the life sciences industry are often designed as a combination of metrics based on the R&D process. Because M&A often occurs in the middle of the R&D process, non-financial metrics such as R&D progress and regulatory approvals are often set as milestone events in the early stages of the transaction, and then financial metrics are

[3] 2019 SRS Acquiom Life Sciences M&A Study (September 2019), *available at* https://www.srsacquiom.com/resources/2019-life-sciences-study/.

[4] *Id*.

[5] Joseph A. DiMasi, Ronald W. Hansen & Henry G. Grabowski, The Price of Innovation: New Estimates of Drug Development Costs, 22 J. HEALTH ECON. 2 (Mar. 2003), 151-185.

[6] Ziehms, at 185.

adopted for after the drug obtains market approval. For example, in the merger between MEI Pharma and S*BIO, the parties first set milestone events based on the progress of three phases of clinical trials and regulatory approvals from several authorities, and then measured the buyer's payment obligations based on net sales in certain countries after commercialization[7].

Regardless of the metrics adopted, the core concern is to have clear, objective, and measurable criteria for determining whether the metrics have been achieved. In particular, care must be given to avoid granting one party too much power of interpretation over whether the metrics have been achieved, such as using as a metric the completion of preclinical preparations for the target's first product. If the investor does not agree that preclinical preparations have been completed, the company may seek third-party experts to certify that such preparations should be deemed completed due to having met objective industry standards and being in conformity with the purpose of the contract. However, this approach to judging metrics is not as clear and objective as setting clearer standards in the contract.

### 1. Non-financial metrics

Non-financial metrics include various indicators such as market share, regulatory approvals, product launches, and R&D progress[8]. Non-financial metrics are more widely used in the pharmaceutical industry, among which clinical trial results and regulatory approvals are the most common[9]. In particular, regulatory approvals may need to be filed with regulatory authorities in one or more countries, such as with the U.S. Food and Drug Administration (FDA), the European Medicines Agency (EMA), and the Chinese National Medical Product Administration. The development of a product may also require various approvals. Under China's regulatory regime, for example, the process from R&D to commercialization involves layers of regulation such as clinical trial approvals, marketing authorization, pharmaceutical production licenses, pharmaceutical distribution licenses, and post-commercialization monitoring.

### 2. Financial metrics

Common financial metrics include sales revenue, net profit[10], cash flow, EBIT, EBITDA[11], etc. In order to reduce the risk of future disputes, it is also necessary to specify applicable accounting standards while setting financial metrics, such as an accounting treatment in line with accounting practices or Generally Accepted Accounting Principles (GAAP). If GAAP is agreed upon, the effective date of relevant principles should also be specified. In practice, disputes often arise due to unclear terms on accounting, such as whether expenses can be amortized or capitalized, how inventory is calculated, what accounting standards apply, and how they are applied[12]. In *LaPoint v.*

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[7] *See*: https://www.sec.gov/Archives/edgar/data/1262104/000119312512344221/d392723dex21.htm.

[8] Ziehms, at 192.

[9] Luca Gambini, Pros and Cons of Earn-out Constructs in Life Sciences Merger and Acquisition Transactions, 9 Bocconi Legal Papers 111, 116 (2017).

[10] *See*: http://www.szse.cn/disclosure/listed/bulletinDetail/index.html?a330b11f-eec5-4c3e-96af-0b3f3fde3ac0.

[11] *See*: http://www.szse.cn/disclosure/listed/bulletinDetail/index.html?b47b32ad-4e1d-4e21-8f92-5bc90719ad48.

[12] Kevin R. Shannon & Michael K. Reilly, Post-Closing Earnouts in M&A Transactions: Avoiding Common Disputes (Winter 2011), *available at* https://www.potteranderson.com/media/publication/150_KRS_20MKR_20Post-Closing_20Earnouts_20in_20M_A_20Transactions_20Deal_20Points_20Winter_202011.pdf.

*AmerisourceBergen*, the parties disputed how to calculate the EBITA of the target company, in particular, whether the EBITA had to be reduced as a consequence of reduced R&D expenses and whether GAAP applied[13]. In the case [2019] Yue Min Zhong No. 529, the appellant contended that the net profit in the company's annual report was calculated on the accrual basis, rather than cash basis, which was different from the "net profit" of the appellee's profit target stipulated in their agreement. Thus, the annual report could not be used as the basis for determining whether the appellee had achieved its profit target. In this regard, the Guangdong High People's Court held that the publicly released annual report of the company, a listed company, was publicly credible. The annual report could be the basis for investors to evaluate the company's shares. Additionally, the parties did not explicitly agree that the profit data disclosed by the company to investors did not qualify to determine whether the "net profit" target in the agreement was completed. For the foregoing reasons, the Guangdong High People's Court held that the first-instance court correctly adopted the profit data in the annual report as the basis for determining whether the appellee had achieved the target.

## III Post-closing management under earn-outs

In addition to the agreed-upon financial metrics, an earn-out clause often specifies the standards for post-closing management obligations of the party that controls the target company. Because achievement of financial metrics is dependent on the controlling party's ability to operate the business, the non-controlling party often requires that there be no change in management, reserves voting rights on major decisions, or sets standard management obligations binding on the other party. The controlling party may be liable for breach of its management or other obligations that results in a failure to achieve milestones. Common standards used in transactions include "commercially reasonable efforts," "best efforts," "diligent efforts," "acting in good faith," etc.[14] The most commonly used criterion is "commercially reasonable efforts," which is used as an example in the following discussion[15].

Sometimes, parties specifically define in the contract what constitutes "commercially reasonable efforts." A common approach is an "outward facing definition," which refers to industry standards and the efforts that other companies would use, such as efforts that would be devoted by comparable companies in the medical device industry with equivalent resources and technology exercising their business judgment under similar circumstances[16]. This definition is more favorable to the seller because it allows the seller to refer to objective industry standards rather than the subjective standards of the buyer[17]. Another approach is an "inward facing definition," which refers to the buyer's past standards, e.g., the buyer has obligations to operate with efforts it has put into the corresponding stage of a similar product with similar market potential[18]. This criterion is more favorable to the buyer. A

[13] *LaPoint v. AmerisourceBergen Corp.*, C. A. No. 327-CC (Del. Ch. 2007).

[14] *Neurvana Medical, LLC v. Balt USA, LLC et al.*, C.A. No. 2019-0034-KSJM (Del. Ch. 2020).

[15] Kristian A. Werling & Richard B. Smith, "Commercially Reasonable Efforts" Diligence Obligations in Life Science M&A (Mergers and Acquisitions), Nat. L. Rev. (May 29, 2014), *available at* https://www.natlawreview.com/article/commercially-reasonable-efforts-diligence-obligations-life-science-ma-mergers-and-ac.

[16] Balt, C.A. No. 2019-0034-KSJM (Del. Ch. 2020).

[17] *Id.*

[18] *Banas v. Volcano Corp.*, 47 F. Supp. 3d 941, 946 (N.D. Cal. Civ. R. 2014).

further option is to leave the definition open, leaving it to the discretion of an adjudicator to decide on the merits of each case[19].

## Comparing earn-outs with VAMs

Earn-outs are essentially a type of valuation adjustment mechanism. The apparent difference between earn-outs and the commonly used type of VAM, "a one-time payment followed by a put option," is that earn-outs usually bring in "incremental payments subject to conditions." VAMs in some transactions in China are essentially earn-outs, for example, in the case (2015) Lin Shang Chu Zi No. 113, the parties agreed to pay a third installment of the share purchase price if the after-tax net profit in the commitment period reached a specified target. Reverse earn-outs also exist in overseas M&A, which are similar to VAMs used in China, i.e., the buyer initially pays a lump sum as the purchase price and, if the agreed conditions are not fulfilled, the seller would be obligated to return a certain amount of the price[20]. In the case (2020) Hu 01 Min Zhong No. 6979, the parties agreed that Party B would pay the consideration in four installments. Party B would pay an initial payment of 30% of the total price, and at the end of each fiscal year, pay 20%, 20%, and 30% of the total price, respectively, if the company's actual amount of net profit in such fiscal year achieved a target, within ten working days after an accounting firm commissioned by Party A issued a special audit report on the target company. If the target company's actual net profit was less than the target net profit, Party C (the former shareholder) would compensate Party B for the balance in cash at the end of each fiscal year during the commitment period. We understand that it is also common in China to agree on both an earn-out clause and a VAM. Courts have tacitly recognized this mechanism comprises two arrangements. We have also handled cases involving earn-out arrangements in domestic arbitral proceedings.

Terms and application of earn-outs and VAMs are different so as to adapt to different transactions with a variety of market environments, characteristics, and needs of parties.

Compared to VAMs, earn-outs are a buyer-friendly arrangement where the buyer is in a relatively advantageous position as to whether and how much additional consideration to pay after closing. In contrast, promises are easier to be made but harder to be fulfilled under a VAM, where the buyer has already paid all the consideration in advance and is in a relatively weaker position. Even in circumstances where that the seller's compensation obligation is triggered (usually when the target company encounters business difficulties), it is more difficult for the buyer to actually receive the compensation. Besides, if it is the target company that bears compensation obligations, its repurchase of shares will be subject to the restrictions of the company's capital reduction process. Securing compensation often remains difficult despite that, in most cases, the share repurchase price is greater than the initial payment price to compensate for risk exposure.

As opposed to VAMs, earn-outs are often used for projects with multiple relatively clear, objective, and easily measurable milestones, high levels of financing, and long commercialization and payback periods,

[19] Werling & Smith, *supra* n.11.

[20] Troy Ungerman, Tax considerations for earn-outs and reverse earn-outs (September 15, 2016), *available at* https://www.deallawwire.com/2016/09/15/tax-considerations-for-earn-outs-and-reverse-earn-outs/.

such as for new drugs and the development of other technologies (the use of VAMs in these fields that require long-term investment can sometimes encourage companies to blindly pursue short-term performance at the cost of long-term growth). This explains why earn-out mechanisms are more commonly used in relation to non-financial metrics. On the other side, VAMs are more common when the company's products or technologies are already primed for commercialization and are in urgent need of funds to expand production and market reach, with a relatively short payback period (and using earn-outs at that time may not be favorable for the seller).

Fields such as innovative drugs, chips, semiconductors, new energy, new materials and intelligent manufacturing, involve extensive use of intellectual property, large investments, long return periods, and high uncertainty regarding short-term growth prospects. These fields represent the future and are increasingly favored by capital. Therefore, it is foreseeable that earn-outs will become more and more popular in M&A transactions.

## Disputes regarding earn-outs in life sciences M&A

Despite earn-outs' various advantages and frequent use in life sciences M&A, earn-out clauses often lead to disputes. A defective earn-out clause may fail to function as intended as an allocator of risks and benefits. Rather, it may merely serve as a hidden cause for future disputes. Two reasons might explain this situation.

First, contract drafting has its limitations. The development of drug and medical devices in the life sciences industry is highly uncertain. The longer R&D takes, the more likely circumstances change, thus the higher the risk for disputes[21]. The parties can hardly foresee all possible circumstances in the future while drafting the contract, which makes it difficult for parties to define absolutely clear criteria for milestone events. Therefore, the parties often have disputes regarding whether milestone events have been achieved.

Second, earn-outs are likely to cause moral hazard issues[22]. After closing, whether milestone events can be achieved largely depends on the controlling party's management ability and integrity. If the buyer obtains control after closing, the buyer may take measures to avoid making additional payments to the seller, such as sloppy management, dishonesty, or change of R&D directions etc. If the seller retains control, it may disregard the long-term development of the target or even engage in fraud in order to achieve the milestone events[23]. Thus, the parties may have disputes about whether the controlling party has devoted reasonable efforts to manage the business or has intentionally prevented/forced the milestone events to be achieved. We have commonly seen these two situations in representing our clients.

There are two primary types of disputes involving earn-outs—first, whether a milestone event has been

[21] Ziehms, at 193.

[22] Albert H. Choi & Albert C. BeVier, Facilitating Mergers and Acquisitions with Earnouts and Purchase Price Adjustments (August 12, 2014), *available at* https://corpgov.law.harvard.edu/2014/08/12/facilitating-mergers-and-acquisitions-with-earnouts-and-purchase-price-adjustments/.

[23] Reb Wheeler, Life Sciences M&A Transactions (May 26, 2020), *available at* https://www.lexisnexis.com/supp/LargeLaw/no-index/coronavirus/life-sciences/life-sciences-life-sciences-ma-transactions.pdf.

achieved; second, whether the controlling party has fulfilled its post-closing obligation to manage the business[24]. The following paragraphs analyze some merger cases in the life sciences industry and provide hints for risk prevention and dispute resolution regarding earn-out provisions.

## I Disputes over the achievement of milestone events

### 1. *SRS v. Gilead Sciences* — when the contract is unclear[25]

Before the merger, the target, C, was a biotech company that held a portfolio of compounds including CAL-101, a potential treatment for hematologic cancer. The buyer, G, is a biopharmaceutical company that develops and commercializes drugs for the treatment of life-threatening diseases and illnesses. The merger agreement sets forth three milestone events, two of which have been achieved, and the buyer has made the milestone payments accordingly. The third milestone provides that if CAL-101 receives regulatory approval in the United States or an EU country as a first-line drug treatment for a hematologic cancer indication, the buyer is obliged to pay an additional USD 50 million.

Later, an EU regulatory approval was granted for CAL-101 to be used as a first-line treatment for patients with chronic lymphocytic leukemia (CLL). The seller thus claimed that the third milestone had been achieved and the buyer was obliged to make the additional payment. The buyer, however, contended that the milestone had not been achieved because it can only be triggered by a disease-level approval for hematologic cancer, whereas the approval achieved is merely a sub-disease level approval.

The core of the dispute boils down to what level of disease the word “indication” refers to in the contract. Although the parties agreed that the milestone would be achieved when CAL-101 obtains regulatory approval as a treatment for hematologic cancer indication, they failed to define whether “indication” referred to hematologic cancer as a disease or a particular disease of hematologic cancer. The buyer takes the narrow view and claims that indication means a particular disease for a population of patients and thus the milestone events have been triggered. The seller, on the other hand, adopts a broad definition, i.e. “indication” means “disease” and thus the regulatory approval obtained should be a disease-level approval and claims the approval obtained is a sub-disease rather than disease level approval.

The court noted that the meaning of “indication” was ambiguous judging from the wording of the contract. Thus, the court turned to abundant extrinsic evidence to determine the meaning of “indication,” including drafting history, negotiation process, email correspondences and witness statements, etc. The above evidence indicated that the parties were always discussing regulatory approval of CAL-101 for hematologic cancer as a disease. The court thus determined that the parties intended the approval to be a disease-level regulatory approval rather than a sub-disease level approval. In addition, the approval required by the third milestone should be comparable to that of the first two milestones. Therefore, the narrow approval obtained for the drug did not trigger the buyer’s payment obligation under the third milestone.

[24] Shannon & Reilly, *supra* n.6.

[25] *S’holder Representative Servs. LLC v. Gilead Scis., Inc.*, No. 10537-CB (Del. Ch. 2017).

**2. *Fortis Advisors v. Shire* — when the contract is clear**[26]

In this case, an Irish pharmaceutical company, S, merged with the target, C, to develop a drug called Lifetegrast for dry-eye disease. The parties agreed on an earn-out provision with several milestones to allocate risks and interests, the first two of which are as follows:

- The first milestone: if the drug achieves certain endpoint in the OPUS-2 study, the buyer shall pay an additional USD 175 million;
- The second milestone: premised on the achievement of the first milestone, if the drug obtains certain regulatory approval, the buyer shall pay an additional USD 250 million.

The drug failed to achieve the endpoint in the OPUS-2 study. However, S chose to continue the third-phase clinical trial and used statistics from the OPUS-2 study along with statistics from other studies to submit for regulatory approval, which was eventually granted by the relevant regulatory authority. Although the drug was launched successfully afterwards, the buyer refused to pay on the ground that the first and the second milestones were not met.

The seller sued the buyer, requesting payment of USD 425 million as consideration for the first two milestones. The seller claimed that whether the endpoint had been achieved should not be limited to statistics in the OPUS-2 study under the first milestone and such endpoint had been achieved in other studies. Moreover, the drug had not obtained regulatory approval. The buyer argued that whether the milestones had been met should be understood according to the plain meaning of the contract and the first milestone explicitly limited the source of statistics to the OPUS-2 study.

In this case, the court strictly followed the wording of the contract to determine the buyer's payment obligations. The court noted that the contract explicitly provided that the results in the OPUS-2 study, rather than other studies, should be used to measure whether the endpoint had been achieved. The drug apparently did not achieve such endpoint in that study and thus the first milestone was not met. Further, according to the contract, the second milestone was premised on the achievement of the first milestone and, therefore, neither milestone was met. Even if the drug obtained approval and was eventually launched, the buyer still had no additional payment obligations according to the contract.

The two cases above fully demonstrate the different attitudes that courts may adopt when faced with differing circumstances. When a contract is unclear, courts will determine the parties' true intent through extrinsic evidence and interpret the contract contextually to decide whether the milestone events have been achieved. In contrast, when the contract is clear, the buyer's payment obligation is strictly limited to the scope provided by the contract. The buyer's payment obligation may not be triggered even if the commercial purposes of both parties may have been achieved. Therefore, in the process of drafting and negotiating a contract, it is necessary on one hand to ensure that the contract is clear and definite while, on the other, it is essential to consider whether the achievement of certain milestone events constitutes a necessary condition for the realization of commercial purposes. When a milestone stipulated in the contract clearly cannot be achieved, the seller should negotiate with the

[26] *Fortis Advisors LLC v. Shire US Holdings, Inc.*, C.A. No. 12147-VCS (Del. Ch. 2017).

buyer in a timely manner to waive or change the payment terms even if the seller believes that failure to meet a milestone does not prevent the realization of commercial purpose. The seller should refrain from pushing forward the project arbitrarily in the hope that a court or arbitral tribunal might find that buyer's payment obligation has been triggered on the ground that its commercial purpose has been realized.

## II Disputes over post-closing management of the company

### 1. *Himawan v. Cephalon*[27] and *Neurvana Medical v. Balt*[28]

*Himawan* and *Balt* are two Delaware court cases with highly similar factual backgrounds and legal issues, but very different outcomes.

Both cases involved transactions that used an earn-out mechanism, set regulatory approval as a milestone event, and agreed that the buyer should use "commercially reasonable efforts" to reach the milestone. Both contracts similarly defined "commercially reasonable efforts" as those that companies in the same industry with the same resources and technology would devote to a similar product with the same market potential. Both sellers sued the buyers for failure to exercise "commercially reasonable efforts" causing the milestones not to be reached. Both buyers filed motions to dismiss.

In *Balt*, the contract provided that the buyer should use "commercially reasonable efforts" to obtain regulatory approval for the relevant medical device. When the buyer failed to obtain regulatory approval, the seller argued that the buyer's delay in application and refusal to assist did not reach the contractual standard and constituted a breach of contract. The court rejected the seller's claim, noting that the seller's allegations only focused on the buyer's failure to notify the seller in a timely manner and its breach of promises made during the cooperation process, but did not provide any evidence that the seller might have breached its obligation to use "commercially reasonable efforts" as agreed in the contract. Specifically, the seller failed to find companies in the medical device industry with the same resources and technology as the buyer, failed to prove how other companies would have used reasonable business judgment to manage their business, and failed to find comparable products with the same market potential and at a similar stage of research and development as the product in the case. Therefore, in the absence of a comparable product, the seller's claim lacked a factual basis.

In *Himawan*, the buyer abandoned certain R&D directions for the product and did not submit the corresponding regulatory approval application. The seller claimed that the buyer had not exercised "commercially reasonable efforts" as required by the contract. In this case, the court did not uphold the buyer's motion to dismiss. The court held that the seller had at least cited companies with equivalent resources and technology that were developing similar drugs for the disease in that case and noted that the buyer's failure to do what others had done could constitute a breach of contract. Although such facts were not yet sufficient to support the seller's substantive claims, it could reasonably be inferred at the pretrial motion stage that the buyer may have failed to perform its

[27] *Himawan v. Cephalon, Inc.*, C.A. No. 2018-0075-SG (Del. Ch. 2018).

[28] *Neurvana Medical, LLC v. Balt USA, LLC et al.*, C.A. No. 2019-0034-KSJM (Del. Ch. 2020).

contractual obligations.

Comparing the two cases above indicates that in disputes regarding business management obligations, the party claiming breach of contract needs to present sufficient evidence to prove the existence of a breach. In particular, if the contract stipulates a reference for the management obligation, it is necessary to find a suitable subject for comparison in accordance with the contract—a mere subjective belief of failure in exercising "commercially reasonable efforts" is not sufficient.

**2. (2018) Lu Min Chu No. 103**

Although this case involves a VAM rather than an earn-out, it reveals to some extent the attitude of Chinese courts toward management obligations. In this case, the plaintiff signed a VAM agreement with nine shareholders of the target company, agreeing on double performance compensation. The Shandong High People's Court in the first instance supported only a part of the plaintiff's claims. The court found that because the plaintiff participated in the management of business as the controlling shareholder, the plaintiff was responsible for the target's decline in performance and that supporting the double performance compensation would be an obvious violation of ex aequo et bono. Thus, the court exercised its discretion to reduce the liability of nine defendants and held them liable for only 70% of the performance compensation.

The case is still on appeal and no final judgment has been rendered. However, it can be inferred that even if the parties fail to reach an agreement on the standard of management and operation obligations, it is possible for Chinese courts to apply the fairness principle to adjust the buyer's payment obligations.

**3. Company J arbitration case**[29]

In 2018, Company Z, a subsidiary of Company J, signed a Share Purchase Agreement (SPA) with Ma, Liu, Wang, and a partnership to acquire shares of Company H. The relevant industry and commerce registration procedure was completed on August 29, 2018, after which Company Z officially owned 60% shares of Company H and became a major shareholder. According to the SPA, Ma and Liu promised that the net profit of Company H would not be less than RMB 100 million, 140 million, and 196 million in 2018, 2019, and 2020, respectively. Company Z would make three installments to Ma totaling 50% of the consideration for the transfer of shares, subject to Company H's actual business performance. Meanwhile, if H failed to achieve its business metrics, Ma and Liu would compensate Company Z. Later, Company Z engaged lawyers to initiate an arbitral proceeding at the Beijing Arbitration Commission, requesting Ma and Liu to perform the SPA and accept a special audit by an accounting firm with securities and futures qualifications. In April 2020, Company J announced that it had lost control of Company H and that the annual report audit work group had been obstructed by Ma and Liu since March 16, 2020 while stationed in Company H to conduct 2019 audit work.

On December 22, 2020, according to the Announcement of Receipt of Interim Award of Beijing Arbitration Commission[30], the arbitral tribunal found that if the accounting firm was unable to complete auditing of Company H within six months, the tribunal would consider accepting the Consulting Report

[29] *See*: http://www.szse.cn/disclosure/listed/bulletinDetail/index.html?2a85bfa7-aaed-41ad-ab14-982f35ed1aff.

[30] *See*: http://www.szse.cn/disclosure/listed/bulletinDetail/index.html?64324ba1-7b01-4161-9d30-880bf926f893.

submitted by Company Z to determine the Company H's performance in 2019 and hold Ma and Liu liable for performance compensation of RMB 133,852,645.67. On January 9, 2021, according to the Announcement on Change of Date of Subsidiary's Arbitration Hearing, the second hearing was held on January 17, 2021 Beijing time and the result has not yet been disclosed[31]. It can be anticipated that, under the earn-out, even if the parties did not agree on how to determine the target's performance, there is a certain chance that the tribunal may support the buyer's claims.

## Practice Notes

Based on the analysis above, we present below advice on the application of earn-out mechanisms from the perspective of drafting and dispute resolution.

1. **Carefully balance clarity and flexibility when setting milestones.** The definition of a milestone event is highly dependent on the specific facts of each transaction. On one hand, to mitigate the risks of future disputes, a contract should set clear and concise milestone events to the extent possible (preferably linked to the documents or results generally produced by similar types of transactions); on the other hand, consideration should also be given to the features of the transaction itself as well as rapid changes in the market and regulatory environment, maintaining a certain level of flexibility. For the seller, if a milestone event is defined as a narrow technical metric unnecessary for the achievement of commercial purpose, the seller may not be able to obtain relevant payments even if the buyer achieves the commercial purpose. Conversely, for the buyer, the achievement of a technical metric does not guarantee commercial interests. If the seller is forced to achieve such unnecessary metrics, the project may not proceed as envisioned and thereby harm the interests of both parties. Therefore, contract drafters should take into account all possible commercial, technical, and legal risks to set forth reasonable metrics.

2. **Reasonably allocate the buyer's and seller's control rights and clarify management obligations.** To prevent moral hazard, the contract may provide that the party without control rights can appoint certain directors, supervisors, and employees to advise on and supervise the business management, exercise voting or veto rights on important decisions, and have information right on account book and other important information. The contract can also stipulate that if the managing party causes the milestone events to be unachievable, that party should provide certain compensation. Moreover, when using industry standards or past practices to define management obligations, it is necessary to consider whether there is a comparable subject matter and the difficulty of proof in case of disputes.

3. **Choose an appropriate governing law, dispute resolution mechanism, and institution.** As the aforementioned cases indicate, whether milestone events have been achieved may eventually rest upon contract interpretation. Even if a clause seems clear when drafted, it may still need to be interpreted as circumstances change. Thus, when it comes to contract interpretation, conducting legal research in advance and choosing appropriate governing laws appears to be extremely important, especially in cross-border M&A. The governing law should at least be one with which the parties are familiar. In regard to dispute resolution mechanisms, parties should take into account different

[31] *See*: http://www.szse.cn/disclosure/listed/bulletinDetail/index.html?64324ba1-7b01-4161-9d30-880bf926f893.

features of litigation and arbitration and choose an appropriate arbitration institution if they agree to resolve disputes through arbitration.

4. **Negotiate with the counterparty in a timely manner when disputes arise.** If the contract becomes unclear or does not provide for certain circumstances due to the change of objective conditions, a party should first negotiate with the counterparty instead of arbitrarily entering into litigation or arbitral proceedings, especially when the existing contract is unfavorable to the party. If a buyer has achieved its commercial purposes, the seller may attempt to urge the buyer to waive or change the payment conditions. If commercial purposes have not been achieved, the parties may negotiate to redefine milestone events.

5. **Preserve evidence formed during negotiation and performance of the contract.** Winning an earn-out dispute case largely depends on strong evidence. When a contract is vague or unclear, courts may rely on extrinsic evidence such as negotiation history and drafts of contracts to determine the true intent of the parties. In addition, parties need to collect and preserve evidence after closing but before contingent consideration is fully paid in case of potential disputes. For sellers, attention should be paid to the buyer's misconduct, such as negligence in R&D or lack of good faith; buyers may need to retain evidence to prove that they have devoted sufficient financing, labor, and resources to fulfill its management obligation.

## *Important Announcement*

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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