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Delaware Supreme Court Holds that a Covenant to Negotiate in Good Faith Is Enforceable and That a Plaintiff May Receive Its Expectation Damages for Breach of the Covenant

By Roger R. Crane

As many of you know, we serve as litigation counsel for PharmAthene, which recently received a favorable Delaware Supreme Court decision in *SIGA Technologies, Inc. v. PharmAthene, Inc.*, 2013 WL 2303303 (Del. Supr., May 24, 2013). This decision has generated a fair amount of buzz in the M&A community regarding good faith negotiations of LOIs and other preliminary agreements.

While the lawsuit, which started in December 2006, has us headed back to the Chancery Court on the issue of appropriate expectancy damages, we thought it would be helpful to share some of the issues resolved by the Court and some key take-aways for corporate lawyers to keep in mind:

The case involved a term sheet for a license that had a "non-binding" footer on both pages. The term sheet was subsequently attached to a bridge loan agreement and a merger agreement. Both agreements required the parties to negotiate in good faith a license for an early-stage drug in accordance with the terms of the term sheet. After a trial, the Court of Chancery held that this created an enforceable obligation and awarded PharmAthene 50% of the net profits for the sale of the drug for 10 years from the first sale. On appeal, the Supreme Court:

1. affirmed the Vice Chancellor's finding that there was an obligation to negotiate in good faith a license substantially similar to the terms of the term sheet;
2. affirmed the finding that SIGA acted in bad faith by insisting on significantly different terms;
3. reaffirmed its recent decision holding that an express obligation to negotiate in good faith is enforceable under Delaware law; and
4. held for the first time that under the circumstances of this case a party can recover its expectancy damages for breach of such a covenant.

The Key Take-Aways

In light of the Court's holdings, it is critical that if parties do not wish to be bound to terms in the course of a negotiation that they:

1. do not agree to negotiate in good faith; and
2. make it explicitly clear that there is no intention to be bound to any terms until execution of a formal agreement.

Background

In late 2005 and early 2006, SIGA and PharmAthene negotiated the terms of the LATS. Each draft, including the final version, had a footer that said "non binding" at the bottom of both pages and the

final version was never signed. After the final version the parties began merger discussions. However, SIGA needed an immediate infusion of money. So on March 20, 2006 the parties entered into a Bridge Loan Agreement.

The Bridge Loan Agreement designated New York as the governing law and specifically contemplated that the parties might not ultimately agree on a merger or license. However, it obligated the parties to negotiate in good faith a license agreement in accordance with the terms of the LATS if the merger did not occur. On June 8, 2006, the parties entered into the Merger Agreement which contained similar "good faith" language. The Merger Agreement provided that it was governed by Delaware law. The Merger Agreement had a termination date of September 30, 2006.

The drug that was the subject of the LATS was a potential smallpox antiviral treatment. Shortly after signing the Merger Agreement, SIGA received a $5.4 million grant for the drug's development from the National Institutes of Health and in September another $16.5 million. In addition, the drug had a successful human safety test and had positive results in a primate test. The Court affirmed the Vice Chancellor's finding that at this point SIGA had seller's remorse.

SIGA refused to extend the merger termination date. PharmAthene then sent SIGA a draft license agreement that incorporated the terms of the LATS. SIGA responded with a 102-page draft LLC agreement that varied dramatically from the economic terms of the LATS. For instance, the upfront payment from PharmAthene increased from $6 million to $100 million and the milestone payments increased from $10 million to $235 million.

SIGA issued an ultimatum on December 12, 2006 that unless PharmAthene was prepared to negotiate "without preconditions" regarding the LATS's binding nature, the parties had nothing more to talk about. On December 20, 2006, PharmAthene filed suit in Chancery Court.

After an 11-day trial the Vice Chancellor determined that: "(1) Delaware law applied, (2) SIGA was liable for breach of its obligation (under the Bridge Loan and Merger Agreements) to negotiate in good faith a definitive license agreement in accordance with the LATS's terms, (3) SIGA was also liable under the doctrine of promissory estoppel, and (4) the proper remedy was an equitable payment stream approximating the terms of the license agreement to which he found the parties would ultimately have agreed. The Vice Chancellor also awarded attorneys' fees and costs . . ."[1]

The Supreme Court's Decision

The Court Applied Delaware Law

The Court first had to address what was the applicable law. The Court found that the Delaware law provision in the Merger Agreement governed because it occurred later in time than the Bridge Loan Agreement and "encompassed the activity that lay at the heart" of the case.[2]

The Court Finds SIGA Breached Its Obligation to Negotiate in Good Faith

The Court found that the record supported the Vice Chancellor's factual conclusion that notwithstanding the non-binding footers, the "incorporation of the LATS into the Bridge Loan and Merger Agreements reflect[ed] an intent on the part of both parties to negotiate toward a license

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1 Id. at *6.

2 Id. at *7.

agreement with economic terms substantially similar to the terms of the LATS if the merger was not consummated."[3]

SIGA argued that requiring parties to propose terms "substantially similar" to those in a term sheet introduces some uncertainty and litigation risk into negotiations.[4] The Court rejected the argument. It concluded that this wasn't a concern because a trial judge would, like the Vice Chancellor, have to find that the terms proposed were substantially dissimilar and that the party proposed them in bad faith. It noted that bad faith is not simply bad judgment but "the conscious doing of a wrong because of dishonest purpose or moral obliquity."[5] The Court found that the Vice Chancellor "correctly concluded" that SIGA took its negotiating position in bad faith.

Promissory Estoppel

The Court reversed the Vice Chancellor's finding of liability based on promissory estoppel. The Court held that promissory estoppel does not apply "where a fully integrated, enforceable contract governs the promise at issue." Since the promise to negotiate in good faith was embodied in both the Bridge Loan and Merger Agreements there was a claim for breach of contract, not promissory estoppel.[6]

Expectation Damages

The Court looked to federal court decisions interpreting New York law which have recognized two types of binding preliminary agreements, Type I and Type II. In a Type II preliminary agreement, the parties agree on certain major terms but leave other terms for negotiation. The Court said a Type II agreement "does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith . . ."[7]

The Court noted then that the Vice Chancellor made two key factual findings supported by the record: "(1) 'the parties memorialized the basic terms of a transaction in . . . the LATS, and expressly agreed in the Bridge Loan and Merger Agreements that they would negotiate in good faith a final transaction in accordance with those terms' . . . and (2) 'but for SIGA's bad faith negotiations, the parties would have consummated a license agreement.'" The Court found that these factual conclusions supported a finding that the parties entered into a Type II preliminary agreement and "neither party could propose terms inconsistent with that agreement."[8]

The Court then concluded that where the parties have entered a Type II agreement and the trial judge finds that the parties would have reached an agreement but for defendant's bad faith negotiations, the plaintiff is entitled to recover expectation damages.[9]

The Court noted that since this was the first time that it had recognized the enforceability of a Type II preliminary agreement and that breach of such a preliminary agreement permits a plaintiff to recover

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3 Id. at *9.
4 Id.
5 Id.
6 Id. at *10.
7 Id. at *11.
8 Id. at *12.
9 Id.

expectation damages, it was remanding to the Vice Chancellor for reconsideration of damages consistent with its opinion.[10]

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[10] Id.