Commercially Reasonable Efforts – how an Expert can help

Introduction – Framing the Question

Imagine this scenario:

1. Early stage company Smallco develops an exciting new technology, which it uses to create the prototype of its first product – Brakethroo!
2. A large company in the same field, Bigco, becomes aware of Brakethroo, and realizes that if the product works as hoped, it could be a valuable addition to Bigco's product range.
3. Bigco offers to buy the technology and product from the shareholders of Smallco.[1]
4. The merger and acquisition (M&A) agreement specifies an up-front payment, and one or more payments dependent on achievement of milestones.
5. Bigco agrees to use "commercially reasonable efforts"[2] to achieve the milestones.
6. Smallco and Bigco sign the agreement, the shareholders of Smallco get an immediate payout and look forward to further milestone payments.

Time goes on. Bigco discovers real problems with turning the Brakethroo prototype into a real marketable product. The technology has some fundamental flaws but despite that Bigco continues to pour money into the project in the hopes that Brakethroo will eventually be successful. Alas, after committing millions of dollars, thousands of hours, and management time, by the time Bigco is able to get Brakethroo to work, the market has moved on, competitors have launched second generation products better than Brakethroo, other projects are competing internally for resources, and it is unable to continue to pour resources into Brakethroo, and cancels the project.

The shareholders of Smallco are furious! They believe in Brakethroo and think that if only Bigco had done a better job, then Brakethroo would have been successful, and they would have enjoyed several million dollars of milestone payments. They decide to sue[3] Bigco on the basis that Bigco did not use "commercially reasonable efforts" to commercialize Brakethroo, and therefore they should be awarded damages equivalent to the milestone payments they have missed. Both parties hire big law firms to argue the case at trial.

The big law firms gather all the information, conduct discovery, depose people from Smallco and Bigco, and get ready for trial. The case really hinges on whether Bigco used "commercially reasonable efforts" and that is where an expert is often called in.

This scenario has played out many times, and in many industries.

Why are M&A Agreements set up like this?

Acquisition of an early stage company by a large acquiring company is done on the hope (but not the promise) of a positive outcome for both parties that the product and technology acquired will meet the commercial objectives. The likelihood of success goes up over time as more risks are retired, and earlier in a product's life cycle the greater the risk that it will not be successful. Therefore M&A agreements are

1 It could be an asset purchase, or a complete acquisition of all of Smallco's shares. The principles are the same.
2 Another equivalent term is "reasonable commercial efforts"
3 Merger agreements may specify dispute resolution by mediation, arbitration, or by lawsuit – the principles are the same

often set up so that the risk and rewards are shared proportionally by both parties, and the proportions are driven in part by the development stage of the product.

The seller gives up the potential reward of being the only party that profits from the commercial success of the product in return for immediate payment at the time of acquisition and the possibility of future milestone payments; Furthermore, the seller enjoys a lower risk because it doesn't have to completely finance and develop the product to commercial success. The buyer gives up the potential reward of being the only party that profits from the commercial success of an internally developed product, in return for lower risk of an already-developed product, and lower time risk (i.e.: faster to market).

In general, the earlier in a product's life cycle, the lower the up-front payment and the more reward is deferred and linked to achievement of milestones. Later in a product's lifecycle, the payment may be all up-front, with no deferred payment on achievement of milestones. One common structure is up-front payments coupled with some sort of (time limited) royalty payments based on sales in the hands of the acquiring company.

What does the law say?

Unfortunately, the law is unclear. "Commercially reasonable efforts is a term incapable of a precise definition and will vary depending on the context in which it is used. It is based upon a standard of reasonableness, which is a subjective test of what a reasonable person would do in the individual circumstance, taking all factors into account. Commercially reasonable efforts refer to efforts which use a standard of reasonableness defined by what a similar person would do as judged by the standards of the applicable business community. The test for commercially reasonable efforts is less stringent than that imposed by the 'best efforts' clauses contained in some agreements. A business may give reasonable consideration to its own interests, exercising discretion within its good faith business, judgment, in devising a strategy for achieving its ultimate goal."[4]

In 2017, the Delaware Supreme Court analyzed the term "commercially reasonable efforts", *for the first time,* and the inescapable conclusion is that the legal meaning of the phrase "commercially reasonable efforts" does not enjoy clarity in the law.[5] In other words, the term "commercially reasonable efforts" is a subjective term, unless there is specific language in the contract to narrow the definition. Unfortunately, few contracts specifically define the terms.

Most M&A agreements specify the governing law of the contract – often Delaware since many companies are incorporated in Delaware. Unfortunately, different states have different case law on interpretation of "commercially reasonable efforts" which merely serves to muddy the water. For example, Texas courts will enforce an efforts clause only if the underlying business contract contains objective guidelines or criteria against which a party's efforts can be measured.[6] A California Court of Appeals has held that a promise to use best efforts is a more exacting standard than a promise to use good faith. New York courts have held that both best efforts and reasonable efforts impose an obligation to act with good faith in light of one's own capabilities, allowing the promising parties the

4 See https://definitions.uslegal.com/c/commercially-reasonable-efforts/

5 See https://www.delawarelitigation.com/2017/03/articles/delaware-supreme-court-updates/supreme-court-defines-commercially-reasonable-efforts/

6 See https://www.fedseclaw.com/2017/08/articles/corporate-governance/the-impact-of-efforts-clauses-in-transactional-documents/

right to give reasonable consideration to their own interests, and permit the promising parties to rely on their good faith business judgment.

Any dispute which hinges on the meaning of the term will require the law firms to research the case law for the jurisdiction in which the case is brought, and contemporary thinking of the courts of that state.

Commercially Reasonable Efforts – what it is

When a developer agrees to use "commercially reasonable efforts" to develop a conceptual product, the developer is agreeing to use the same efforts that would be used by a similarly situated company in that industry, at the time in question, taking into account the economic condition of the developer, its place in the industry, and its business judgment. Thus commercially reasonable efforts include both an objective component (i.e., what is usual or common in the industry) and a subjective component (i.e., what is reasonable for this particular company in these particular circumstances at this particular time).

The courts have adopted a similar approach when interpreting contracts that require a party to use commercially reasonable efforts. The courts generally examine what is the usual industry practice, or what a reasonable business would have done under similar circumstances. Then, the courts may also consider the internal business considerations of the party, including the party's profitability, financial resources, and expertise. The courts have shown respect for the business discretion of a contracting party and do not require a party to act against its own business interests in furtherance of a promise to use commercially reasonable efforts. A party has not failed to use commercially reasonable efforts just because hindsight demonstrates that it could have produced a better result if it did something different.

Some lawyers consider a hierarchy of efforts:[7]

Reasonable efforts: One or more reasonable actions reasonably calculated to achieve a stated objective, *but with no one expecting that all possibilities will be exhausted*.

Commercially reasonable efforts: Those reasonable efforts that reasonable business people would expect to be made under the specific circumstances, but not necessarily *all* such efforts.

Best efforts: *All reasonable* efforts — as a Canadian court said, "leaving no stone unturned in seeking to achieve the stated objective."[8]

Hell or high water: *Just get it done*, no matter the cost, and whether or not a particular effort would be regarded as unreasonable.

industry practice for commercially reasonable efforts includes a continuous assessment of the project, including whether continuation of the device is a reasonable business decision given the status, experience to date, likelihood of success, the remaining costs, and the likely return on investment. In other words, what may be "commercially reasonable efforts" at the beginning of a project may change over time as circumstances change.

7 Definitions adapted from https://www.oncontracts.com/williams-energy-transfer/
8 Atmospheric Diving Systems Inc. v. International Hard Suits Inc., 89 B.C.L.R. (2d) 356 (1994).

Commercially Reasonable Efforts – what it is not

There may be multiple courses of action that are commercially reasonable, and it is exceedingly rare that there will be only one reasonable choice among several alternatives.

"Commercially reasonable efforts" does not mean "best efforts" or "reasonable efforts" or even "good faith efforts." Commercially reasonable does not mean perfect, and commercially reasonable efforts do not guarantee success, and nor does the term require the obliged party to use "all efforts" to achieve the goal.[9]

Courts have held that the obligation to use best efforts, reasonable efforts or commercially reasonable efforts does not mean the acting party must be successful or take extraordinary measures to satisfy its obligations.[10] Courts have held that these terms do not require a party to:

- Take every conceivable effort
- Take unreasonable actions
- Sacrifice its own economic and business interests
- Incur substantial losses to perform its contractual obligations

Derivative Products

Many M&A agreements specify milestone payments and/or royalties not only for the original product that precipitated the agreement, but also any products "derived from" the original product. This is particularly true in the case of royalties to be paid from sales of any products based on the patents underpinning the original product.[11] For example, royalty payments might be owed on the basis of sales of the original product and also subsequent generation products. This approach seeks to ensure that the seller gets rewarded for the success of all of its efforts, not just from the first product.

To continue the scenario above, imagine if Bigco realizes that Brakethroo is not a commercially viable product, but Bigco still needs a product in its portfolio. Bigco becomes aware of another company (Midco) with a second generation product (Nexgen) that is better than Brakethroo, uses more modern technology, and is more competitive. Bigco buys Midco to get access to Nexgen, and ends up being very successful. But the shareholders of Smallco argue that Nexgen is a derivative product of Brakethroo, on the basis that Brakethroo was the first product in the category, and Nexgen uses some of the ideas described in the patents which are the basis of Brakethroo.

The intellectual property argument is an interesting one, because it often reveals fundamental misunderstandings about the purpose and function of a patent in the minds of the developers of Brakethroo. The purpose of a patent is to *inform the public*, in return for which the inventor enjoys a temporary monopoly on exploiting the invention.[12] One common mistake of many inventors is to assume that everything in the description of the patent is protected. Of course that is not true, the only things and ideas that are protected are those in the granted claims.

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9 For an interesting discussion on how to use these terms in drafting a contract, see http://ericlambert.net/blog/2018/02/05/best-efforts-commercially-reasonable-efforts-good-faith-efforts-differ-use-effectively/

10 https://www.fedseclaw.com/2017/08/articles/corporate-governance/the-impact-of-efforts-clauses-in-transactional-documents/

11 Often, royalty payments incurred on sales of products based on a patent are due only for the life of the patent.

12 Patents can be ruled as invalid for a number of reasons, including failure to adequately inform the public, but that is a longer discussion outside the scope of this paper.

A “second generation” product is only a derivative of a first generation product if it uses at least some of the platform elements of the first generation product. For example, Windows 10 is a derivative product of Windows 8, which is itself a derivative product of Windows 7, and so on. Apple OS X may have similar characteristics of Windows 10 (e.g.: use of windows, a mouse, recycle bin) but it is clearly not a derivative product of Windows since it was developed independently by a different company. The mere fact that two products have similar (or even identical) attributes is not proof that one is a derivative of the other.

In the scenario described above, if the shareholders of Smallco are to be successful, they must prove that Nexgen infringes the Brakethroo patent (a “simple” IP matter), and furthermore that Nexgen is *derived from* Brakthroo. The defense of Bigco is to show that Midco independently developed thNexgen, and that Nexgen does not infringe the patents supporting Brakethroo.

How an expert can help

In the absence of legal clarity, the interpretation of “commercially reasonable efforts” comes down to the “reasonable person test.”[13] Note that a reasonable person in this type of case is not an ordinary person or an average member of society, but a person who has knowledge and experience of the type of circumstances at issue in the dispute. For example, if the dispute is over a M&A agreement between two medical device companies, then the “reasonable person” in this case is a person who has knowledge and experience of M&A transactions in the medical device industry, and has knowledge and experience of the steps that a company could have made in order to meet the standard of “commercially reasonable effort.” That may mean engaging an expert who meets those requirements.

Summary

Many M&A agreements oblige the buyer to use “commercially reasonable efforts” to develop the seller’s product or technology in order to achieve certain milestones that trigger payments to the seller. Few agreements specifically define the terms, which can lead to complicated disputes if the milestones are not met, and the payments are not made.

The law lacks clarity, and therefore many disputes about “commercially reasonable efforts” end up requiring an expert to opine of the meaning of the term in the particular circumstances of the dispute. An expert with experience in this sort of dispute can be very helpful, and if the expert has domain experience in the particular industry of the buyer and seller, then that is even better.

13 See for example https://en.wikipedia.org/wiki/Reasonable_person