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Legal Updates

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1. Practical Insights: Copyright Chain of Title Review

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Adaptations based on novels, film and television, animations, games, and other works (often referred to in the industry as "**IP**"[1]) with clout are a major source of content for the content industry. According to data released by Endata, IP dramas accounted for 65-70% of the top 50 drama series from 2018 to 2020, consistently occupying the mainstream market[2]. IP has become a core asset of the film and television industry and even the entire content industry.

However, in practice, IP usually changes hands multiple times. Every time when an IP changes hands, the possibility that defects exist in the rights to the IP increases. Therefore, in order to avoid the project being hindered or even caught in infringement disputes due to the defects in the target IP, investors should request the IP transferor or licensor to provide a complete chain of title from the original right holder to that party before investing in an IP project. Investors should review the rights and the restrictions on the rights to the IP through all relevant transfer and license documents, including all certificates, license/transfer agreements, authorization letters, confirmation letters, etc. In this article, we use IP licensing as an example to analyze and summarize the basic methods, common risks, and corresponding solutions of the copyright chain of title review. But the above analysis and summaries are also applicable to the case of IP transfer.

Summary

The basic method for conducting a copyright chain of title review is to organize all documents that the licensor provides into a table in chronological order, listing the licensed content, licensed rights, authorized means, exclusivity, license period, licensed territory, authorized language(s), whether the license is sublicensable, and whether any other restrictions are imposed, etc. Each key term in the upstream and downstream documents should be carefully compared to identify the legal and commercial issues involved.

As for the risks that are inherent in the IP transfer/license process, it is impossible to comprehensively summarize because the focus tends to vary from industry to industry and from project to project. Based on our practical experience, we recommend investors to review the chain of title from three perspectives — (1) whether the licensor is entitled to grant the license, (2) whether the granted rights cover all the commercial development needs of the project, and (3) whether the granted rights are subject to restrictions. From these three perspectives, we briefly summarize the common risks in the IP transfer/license process in the following table. In the second part of this article, we proceed to analyze each common risk in detail and propose corresponding solutions.

[1] Herein, IP does not refer to legal concept of intellectual property, but collectively refers to works (such as literature, film and television, animation, games, etc.) that have internet traffic and fan base.

[2] See Endata, 2020 Chinese Drama Series Market Research Report.

Review Perspectives	Common Risks
Whether the licensor is entitled to grant the license	■ Whether the author of Internet literature has the right to directly license the work; ■ Whether the IP is co-owned and thus requires the license from the co-owners; ■ Whether the IP is a derivative work and thus requires license from each level of upstream right holders; ■ Existence of gaps in the chain of title due to mixed use of affiliates; ■ Existence of conflicting prior licenses (i.e., concurrent licensing); ■ Existence of sublicense rights.
Whether the rights granted by the licensor cover all the commercial development needs of the project	■ Whether the rights granted by the licensor cover all the commercial development needs of the project; ■ Whether the rights granted by the licensor can help to achieve the expected competitive advantages.
Whether the rights granted by the licensor are subject to restrictions	■ Whether the license period is clear and definite; ■ Existence of a right reversion mechanism; ■ Existence of additional limitations.

Title defects are usually difficult to avoid if the chain of title is relatively long. When title defects are found, the most common practice adopted by each party in the chain of title is to "patch up" the defects by directly negotiating with the original owner of the IP (such as the authors of literary works). However, logical gaps and risks may be inherent in this "patch up" method of reaching directly to the original owner and skipping over intermediate licensees. In the third part of this article, we propose more careful and prudent methods for investors to rectify the defects.

Summary of risks

I Whether the licensor is entitled to grant the license

Whether the licensor is entitled to grant the license is vital to an IP transaction. The transaction may be subject to significant risks if the licensor's rights to the target IP are defective or the chain of title is incomplete.

- **Common Risk 1: Whether the author of Internet literature has the right to directly license the work**

Internet literature has always been an important source of content for the content industry[3]. If the target IP is ordinary literature, the most commonly adopted industry practice is for investors to deal directly with the author. However, for Internet literature that is serialized on major Internet literature

[3] The Scriptwriter Education Committee of the China Film Industry Association and the China Film Scriptwriter Research Institute of the Beijing Film Academy, *the Report on the Evaluation of the Potential for Adapting IP TV dramas from Internet Literature from 2019 to 2020*. According to the report, among a total of the 309 hit TV dramas in 2018 and 2019, 65 were adapted from Internet literature IP, accounting for about 21% of the total; and among the top 100 hit TV dramas, this percentage is as high as 42%.

platforms (such as qidian.com, jjwxc.net, xxsy.net, etc.), according to the platforms' general rules and practices, it is highly possible that authors have signed agreements with the platforms concerning works first published on the platform (especially works that are marked as signed or VIP). Authors may grant certain right to the platforms through such agreements, such as the rights of alteration, distribution, revenue share, and derivative development, which may deprive the authors of the right to license the work to other third parties[4]. Specifically, agreements between China Literature and the author can be divided into the following three types[5]:

	Commercial Development Rights[6]	Revenue Share	Other Priority Rights[7]
Basic Agreement	No	No	No
General License Agreement	Yes	Yes	Potentially
In-depth Cooperation Agreement	To be determined through negotiations.		

It is evident that significant uncertainty exists in practice as to whether the author of an Internet literary work has the right to directly grant the license. Therefore, investors should carefully review the terms and agreements of the relevant Internet literature platforms. If such agreements are only accessible to partial users, investors could consider to search through public channels (such as relevant news reports and judicial cases). In addition, investors should request the licensor to provide evidence that the author has the right to directly grant the license, such as a confirmation letter issued by the Internet literature platform or the agreement entered into between the licensor and the Internet literature platform.

■ Common Risk 2: Whether the IP is co-owned and thus requires license from the co-owners

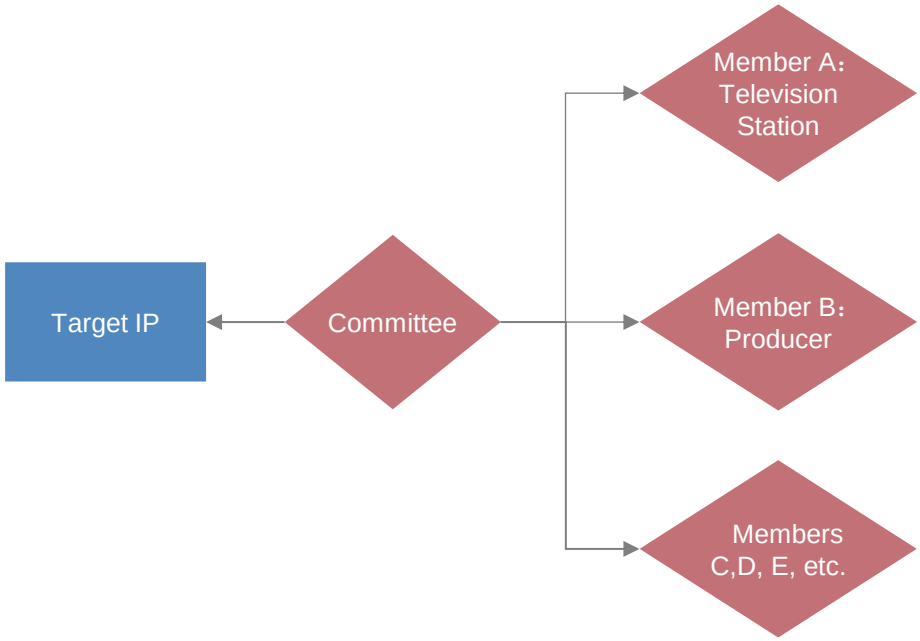
Work may be co-owned by multiple right holders, especially in the case of audiovisual works, such as films and TV series, that involve large investments and complicated production processes. For example, in practice, copyrights of Japanese animations are generally co-owned by a committee comprising members of television stations, producers, and so on. The illustration is as follows.

[4] For example, in the Case (2018) Su Min Zhong No.130, the author of a tomb-robbing novel series exclusively licensed the copyright of the first part of the novel series (except for the author's personal rights) to a certain Internet literature platform on April 28, 2006, and transferred all the rights of the first and second parts of the novel series (except for the author's personal rights) on January 18, 2007.

[5] China Literature, *the New Management of China Literature launched "Single Optional New Contract"*, https://mp.weixin.qq.com/s/EjLHA9A _ EI3cVOrPP9clg.

[6] Commercial development rights here refer to the rights of commercial development, such as the right of adaptation to the work published by the author on the Internet literature platform other than the rights of reproduction and information network dissemination.

[7] Other priority rights refer to the Internet literature platforms' priority rights to obtain the transfer/license of other works created by an author under the same conditions.



The co-owners of the target IP may agree that the target IP to be disposed of only if a consensus is reached among the co-owners, or may agree that certain rights of the target IP are exclusively owned by a specific member. For example, in the case of Yi Zhong Min Zhong Zi [2012] No.2518[8], the copyright of the film at issue was co-owned by Company A, Company B, and Company C, but only Company A held the rights to broadcast on television and transmit online domestically and overseas. Despite such agreement, Company B licensed the exclusive right to transmit the work online to Company D, and Company D sublicensed to the defendant. Company A then sued the defendant, arguing that the defendant's dissemination of the film constituted infringement. Ultimately, the court ruled that Company B neither had the right to transmit the work online nor was it entitled to license this right to others. Thus, the defendant could not acquire from Company D the right of information network dissemination by signing a license agreement with Company D. In fact, the defendant was at fault for failing to exercise due diligence by strictly examining whether the licensed right was defective when it signed the license agreement and was therefore required to bear the corresponding legal consequences.

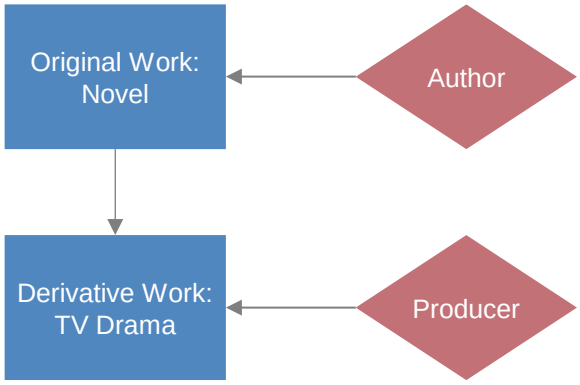
Thus, if IP is co-owned by multiple copyright owners, only examining whether the upstream right holder has the right to grant the license by the appearance of the work's attribution, etc. cannot rule out the risk. Investors should also comprehensively examine the original agreement or relevant authorization letters between the upstream right holders and their co-owners. If an investor deals with only one of the co-owners, a key issue is to examine whether the co-owner is entitled to grant the relevant license on behalf of all co-owners.

- **Common Risk 3: Whether the IP is a derivative work and thus requires license from each level of upstream right holders**

If the target IP is a derivative work such as an adaptation, it may involve multiple layers and different

[8] See the Civil Judgment (Yi Zhong Min Zhong Zi [2012] No.2518) rendered by Beijing No. 1 Intermediate People's Court.

types of upstream rights. For example, TV dramas adapted from an original novel may concurrently involve rights relating to the original novel and rights relating to the adapted TV drama. The illustration is as follows.



In such cases, investors should obtain licenses from all levels of right holders, in particular the copyright holder of the original work[9]. In judicial practice, if a license does not explicitly involve the license from the original work, the licensor is generally not obligated to obtain and grant such license. For example, in the case of Hu Er Zhong Min Wu (Zhi) Chu Zi [2010] No.158[10], the defendant licensed to the plaintiff the right to develop games related to a tomb-robbing novel based upon cartoon figures of the novel. After the plaintiff adapted and developed the game in accordance with the agreement, the plaintiff was sued for infringement by right holders who enjoyed the copyright of the novel and the right to adapt online games. The plaintiff alleged that the defendant had an obligation to obtain authorization from the copyright holder of the original novel when it licensed the plaintiff to develop the above game. However, the court did not support the plaintiff's claims, holding that the defendant had no such obligation to obtain authorization from the copyright holder of the original novel, because the parties did not stipulate in the agreement on terms relating to the original work license.

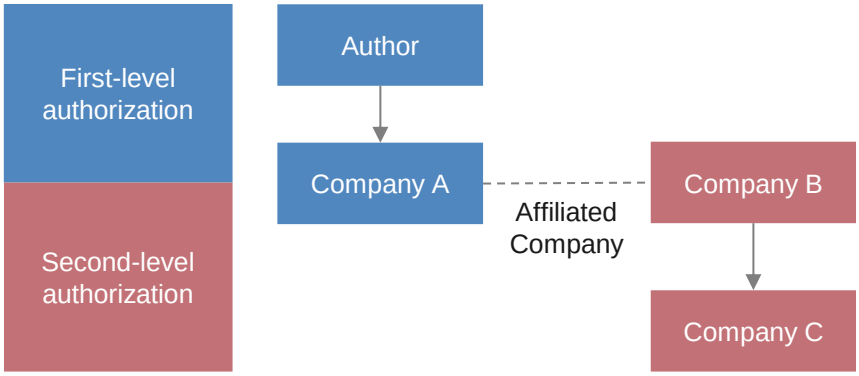
Thus, it can be seen that in the case of the target IP is a derivative work, investors should examine whether licenses have been obtained from all levels of upstream right holders, especially the copyright holder of the original work. If not, it is recommended to specify in the agreement which party is obligated to obtain the relevant rights.

- **Common Risk 4: Existence of gaps in the chain of title due to mixed use of affiliates**

In practice, one of the most common defects that investors easily overlook is the gaps of the chain of title caused by using different entities within a group company to manage and operate IP. That is, the **licensee** of the IP is Company A, while the **licensor** of the IP is Company B—an affiliated company of Company A. The illustration is as follows.

[9] In particular, when reproducing the films and TV dramas (especially the overseas ones), even if such films and TV dramas are original, attention should be paid to whether the ownership of the script still rests with the screenwriter or his studio and, if so, attention should be paid to whether authorization or confirmation has been obtained therefor.

[10] See the Civil Judgment (Hu Er Zhong Min Wu (Zhi) Chu Zi [2010] No.158) of Shanghai No. 2 Intermediate People's Court.



Objectively speaking, the risk of such defect is not high because Company A and Company B are affiliated companies. However, if Company A subsequently refuses to acknowledge Company B's act of authorization, there is a risk that Company B's authorization and all subsequent downstream authorizations may be invalid. Take a trademark dispute case as an example. A licensee signed a trademark transfer contract with a Taiwan company, a subsidiary of a group company, which stipulated the transfer of various trademarks including the trademark at issue. However, the trademark at issue was registered in Chinese mainland by a Shenzhen company — another subsidiary within the group. The court held that the trademark transfer contract was signed between the licensee and the Taiwan company. The Shenzhen company did not participate in the negotiation, nor did it authorize any other party to dispose of the trademark at issue and conclude the trademark transfer contract, or entrust the trademark to other parties. The Shenzhen company was therefore not bound by the trademark transfer contract and the licensee was not entitled to the trademark at issue merely because it had signed the trademark transfer contract with the Taiwan company. Similarly, in the case of Xiang 01 Min Chu [2018] No. 1146[11], the defendant claimed that it had reached a settlement agreement through mediation with a company, in which the company promised not to pursue any legal responsibility of other TV programs for which it has made pre-litigation preparations such as notarization before the effective date of the mediation or has filed but the court has not yet ruled. The defendant claimed that because the plaintiff was an affiliated company of that company, the mediation agreement should also apply to the plaintiff. However, the court held that the defendant's claim lacked a factual and legal basis, considering the contractual parties to the meditation agreement are the company and the defendant, and the company and the plaintiff are independent legal identities. Even if it was proven that the company was affiliated with the plaintiff to some extent, the evidence submitted by the defendant could not prove that the plaintiff was bound by the mediation agreement reached between the defendant and the company.

Therefore, in reviewing a copyright chain of title, investors should carefully check the consistency of identities along the chain and should reconsider if the upstream right holders and the downstream right holders are affiliates. Investors should request the licensor to provide an internal license agreement among those affiliates to ensure continuity of the copyright chain of title.

- **Common Risk 5: Existence of conflicting prior licenses (i.e., concurrent licensing)**

Concurrent licensing is a common industry practice (similar to "twice-sold property"). For example, in

[11] See the Civil Judgment ([2018] Xiang 01 Min Chu No.1146) rendered by the Changsha Intermediate People's Court.

a dispute involving a popular song, the songwriter licensed the song to different parties in a paid or unpaid manner several times, causing chaos in the chain of title.

In the case of concurrent licensing, Chinese judicial practice usually protects prior rights over the rights of later bona-fide third parties[12]. That is, if a copyright has been licensed to a prior licensee before it is licensed to a later one, the rights obtained by the later licensee would become invalid to the extent of the conflict, or the rights obtained by the later licensee cannot be exclusive to the extent of the conflict (in determining the scope of conflict of concurrent licenses, factors to be considered include the nature, scope, and content of the license). For example, if the licensor has exclusively licensed to a third party the right of information network dissemination of the target IP before it licenses the same to the investor, the investor cannot obtain that right even if the licensor expressly licenses to the investor in an agreement a full bundle of rights to the target IP (including the right of information network dissemination).

Under such circumstances, a bona-fide third party may fail to obtain licensed rights in accordance with the license agreement even if it has paid substantial royalties, thereby suffering heavy losses. In order to control the risk of concurrent licensing, it is insufficient to merely require corresponding representations and warranties. Investors should confirm clearly with the licensor whether there are any prior licenses and request the licensor to disclose all downstream licenses. We also recommend investors to conduct news report research and industry surveys for all prior licenses that may exist. For important transactions, investors may also withhold a reasonable percentage of the final payment for a certain period of time, or require the licensor to provide certain guarantees to further reduce the risk of concurrent licensing.

- **Common Risk 6: Existence of sublicense rights**

In the target IP license process, it is important for investors to confirm whether all upstream right holders have the right to sublicense. Generally, upstream licensors reserve rights they do not expressly grant. If the chain of title document does not expressly state that the licensed party has the right to sublicense, the target IP cannot be sublicensed to the downstream. Notably, risks also exist if an upstream licensor does not possess a right to sublicense but invites an investor to jointly exercise certain licensed rights in a cooperative manner. For example, in the case of Jing 0102 Min Chu [2016] No. 14029[13], the court held that because the agreement at issue in the case expressly provided that no party was permitted to transfer any of its rights and obligations without the written consent of the other party, the defendant was deemed to be in breach for signing a joint distribution agreement with a third party because it constituted the transfer of distribution rights to a third party.

[12] Paragraph 2, Article 3.10 of the Guidelines of the Beijing Higher People's Court for the Trial of Copyright Infringement Cases provides: "Where a copyright owner repeatedly transfers or licenses the same right, the assignee or licensee shall be deemed as having obtained the copyright or the exclusive license as long as the order of precedence can be ascertained, unless there is evidence to the contrary." In addition, see the Civil Judgment (Yue Gao Fa Min San Zhong Zi [2008] No.371) rendered by the Guangdong Higher People's Court and the Civil Judgment (Jing 73 Min Zhong [2018] No.394) rendered by the Beijing Intellectual Property Court.

[13] See the Civil Judgment (Jing 0102 Min Chu [2016] No. 14029) rendered by the Xicheng District People's Court of Beijing.

II Whether the rights granted by the licensor cover all the commercial development needs of the project

In practice, the copyright holders generally divide their IP into different types and categories and clearly stipulate the type and quantity of the licensed content, authorized media, and authorized means. Therefore, after confirming a right holder is entitled to grant the license, investors should focus on whether the license can satisfy their commercial development needs and whether the license may affect the realization of their commercial interests.

■ Common Risk 1: Whether the rights granted by the licensor cover all the commercial development needs of the project

The Copyright Law divides copyrights into 17 rights, including the rights of reproduction, publication, adaptation, audiovisual work production, exhibition, broadcasting, and information network dissemination. The rights required for a specific project will vary based upon specific commercial needs. For example, for TV drama development projects, the key rights to obtain are the rights of adaptation and audiovisual work production; for game development projects, the right of adaption; for audiobook development projects, the rights of reproduction, adaptation, and performance.

However, in addition to the key rights mentioned above, there are also other rights that may be necessary to the project's practical development and operation. For example, after an investor develops a TV drama based on the target IP, the next step is to distribute the work, which may involve rights of information network dissemination, broadcasting, exhibition, and so on. If the license agreements do not expressively provide the right category under the Copyright Law (for example, it just provides "the right to transmit online" rather than "the right of information network dissemination"), how do investors confirm whether they have acquired all rights necessary for the project's commercial development needs?

In judicial practice, if the license of a specific right category is not expressly stated in the license agreement, investors can determine whether such rights have been licensed based on the description of the authorized means. For example, in the case of (2011) Er Zhong Min Chu Zi No. 16049[14], the plaintiff claimed the defendant infringed its right of audiovisual work production by developing a TV drama based upon the screenplay adapted from a novel, considering the transfer agreement reached between plaintiff and defendant merely stipulated the transfer of the right of adaption of the novel without mentioning transfer of the right of audiovisual work production. After a hearing, the court held that the transfer agreement contains many articles related to the finished TV drama, such as "title of the finished TV drama," "statement to be displayed on beginnings of the TV drama," "change of title of the TV drama," "ownership of copyright of the finished TV drama," and "provide two sets of CDs of the finished TV drama for memory". It could be seen from the words and expressions used in the transfer agreement that the fundamental purpose of the parties for entering into the transfer agreement was to produce a TV drama based upon a screenplay adapted from the novel. Therefore, the rights transferred by the plaintiff should include the rights of adaptation *and* of audiovisual work production.

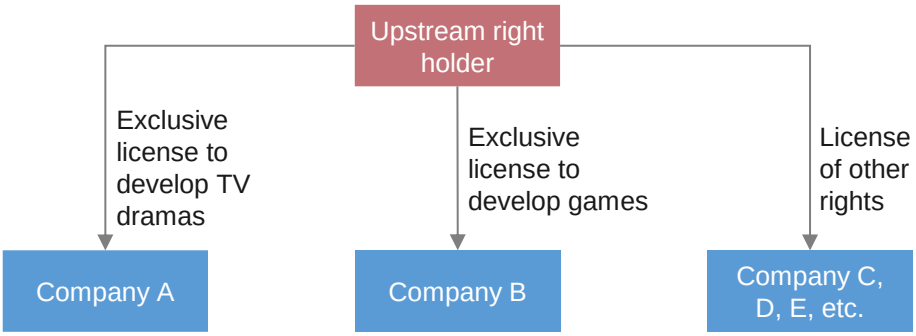
[14] See the Civil Judgment (Er Zhong Min Chu Zi [2011] No.16049) rendered by Beijing No. 2 Intermediate People's Court.

However, it should be noted that even if a right is expressly granted in a license agreement, the actual scope of the license may be limited if the right is merely licensed for a restricted authorized means. For example, in the case of Zhe 01 Min Zhong [2017] No.5396[15], the court held that the authorized means of the licensed right expressly stipulated in the agreement was for "electronic publication" (which the court considered to be commonly understood as text form). Thus, the defendant engaged in infringement by developing and distributing an audiobook (i.e., audio form) without authorization. The court based its judgment on the following grounds: written books and audiobooks are consumed differently, which face different consumer groups and have different independent markets. If the target IP has value for multiple markets, the value that is not expressly assigned or licensed for a specific market remains with the author.

Therefore, during the process of chain of title review, investors should comprehensively examine rights explicitly granted in the upstream documents, and the description of the authorized means (especially whether the agreement restricts the scope of the licensed rights to certain market segments) to determine through the interpretation of the purpose of the contract whether the rights granted by the licensor can cover the commercial development needs of the project. If, based on the above methods, investors are still not convinced that whether the rights it has obtained can cover project needs or no, we recommend to request the upstream right holder to provide supplementary documents to specify the scope of the license or to obtain other rights not expressly granted in the chain separately from the upstream rights holder.

- **Common Risk 2: Whether the rights granted by the licensor can help to achieve the expected competitive advantages**

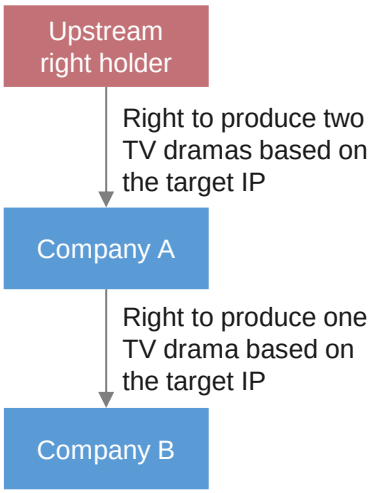
As mentioned above, right holders typically split their IP into different categories and license each category separately—such as licensing to Company A the right to **create TV dramas** based on the Target IP and to Company B the right to develop games based upon the Target IP ("**Scenario 1**"). Although target market segments vary for different right categories, investors would still achieve competitive advantages in the corresponding market segments as long as the licensed rights are on an exclusive basis. Details of Scenario 1 are illustrated as follows.



However, there is another scenario that may affect the competitive advantage analysis: Company A obtains the right to create **two** TV dramas based on the target IP from an upstream right holder, but

[15] See the Civil Judgment (Zhe 01 Min Zhong [2017] No.5396) of the Hangzhou Intermediate People's Court of Zhejiang Province.

only licenses the right to create **one** TV drama to Company B ("**Scenario 2**"). In this case, even if the TV drama development right licensed to the investor (i.e., Company B) is exclusive, its competitive advantage may still be impaired by the rights reserved to the upstream right holder (i.e., Company A) to develop another TV drama, which may constitute an exception to the exclusive license. If the upstream right holder and the investor each develop and distribute a TV drama based on the same IP at the same time, the investor's expected competitive advantage from the target IP would be diluted substantially. Therefore, in order to avoid this risk, we would recommend investors verify with the upstream right holder whether it has plans to develop another TV drama and request a confirmation letter stating that it waives its rights to develop another TV drama. The details of Scenario 2 are illustrated as follows.

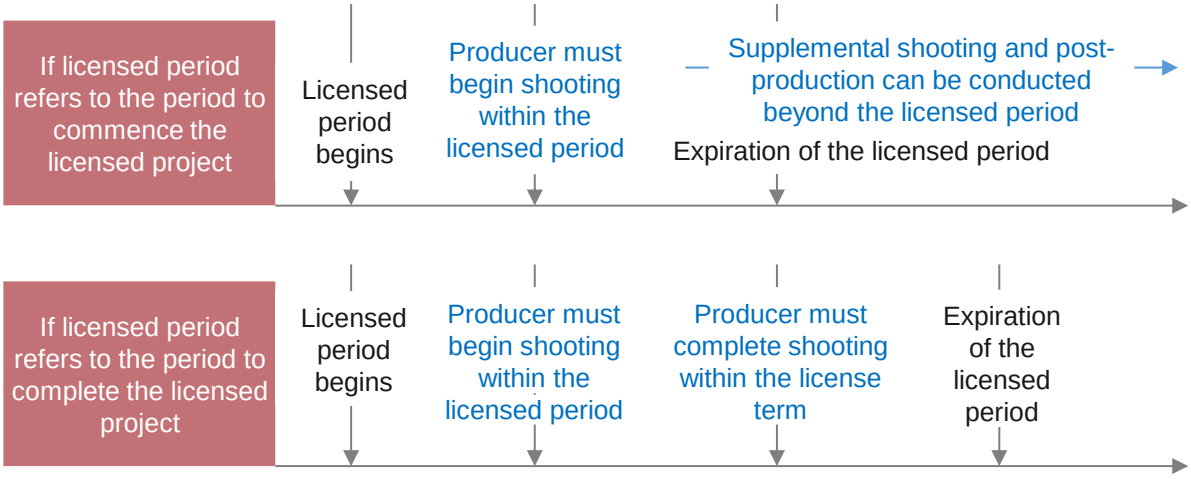


III Whether the rights granted by the licensor are subject to restrictions

After confirming that the licensor holds the relevant rights of the target IP and has the right to license, and such rights are consistent with the commercial development needs of the project, investors should further examine whether the rights are subject to any restrictions and, if so, whether the relevant restrictions are clear and explicit, so as to ensure the project proceeds smoothly and protect the commercial value of the project from being adversely affected due to title defects in such rights.

■ Common Risk 1: Whether the license term is clear and definite

Today, as IP transaction gradually matures, the author and other upstream right holders will generally restrict the licensed period of any licensed right to downstream licensees (usually three to eight years) to ensure the timely and reasonable exploitation and utilization of the target IP. However, when a licensed period is provided, opinions may conflict over the specific meaning of the period—whether it means the period for commencement of the licensed project or the completion date of the licensed project. Answering this question is of great significance for it may affect the valuation of the target IP and the design of the development cycle of the project. Take film and TV drama projects as examples, the consequences resulting from this issue are specifically illustrated as follows.



In the case of Jing 0101 Min Chu [2016] No. 6846[16], the plaintiff licensed the right of adaptation, audiovisual work production, etc. to the defendant for a licensed period ending on March 14, 2016, while failing to define the meaning of the licensed period in the agreement. Subsequently, the plaintiff sued the defendant for infringing on its rights of adaptation, audiovisual work production, and so on, based on grounds that the defendant did not begin shooting until March 12, 2016, and the subsequent shooting and post-production had exceeded the licensed period. Upon trial, the court of the first instance held that the defendant should have completed the screenplay adaptation and production of the TV drama before the expiration of the licensed period, including screenplay adaptation, shooting, and post-production. In other words, the first-instance court believed licensed period meant the term for completing all licensed projects unless otherwise agreed in the license agreement.

However, as we all know, the development cycles for film and TV drama are quite long and will usually last for several years. The development process is also very complex and may involve scriptwriting, selection of producers and casting, formal production, post-production, government approvals, and the selection of the distribution schedule, etc. All of those factors add uncertainty to the time of the development cycle. Therefore, where a license is granted with an indefinite licensed period, we recommend investors to consider the following options: (i) to request the licensor to apply for the upstream right holders to specify that the licensed period refers to the term for commencing the licensed projects (it can refer to the date when the production project officially commences in the case of film and TV drama projects); (ii) to request the licensor to apply for the upstream right holders to grant the downstream the option to extend the licensed period by making additional payments before the expiration of the licensed period, if the licensor refuses to define the licensed period in a manner satisfactory to the licensee and the licensed period is relatively short.

■ Common Risk 2: Existence of a right reversion mechanism

Licensed rights may be subject to a reversion mechanism, which give licensor the right to revert the rights granted to downstream licensees upon the occurrence of a trigger event. Trigger events include the failure to pay licensing fees, delay in payment of revenue share, failure to make commercial use

[16] See the Civil Judgment (Jing 0101 Min Chu No. 6846) rendered by Dongcheng District People's Court of Beijing. The case has now been dismissed and remanded due to the disqualification of one of the defendants.

of the target IP within a time limit, abuse of the target IP, etc. If a right of reversion exists, investors should confirm with the licensor whether any trigger event has occurred and request the licensor to provide relevant evidence, such as licensing fee payment certificates and contracts evidencing commercial development of the target IP.

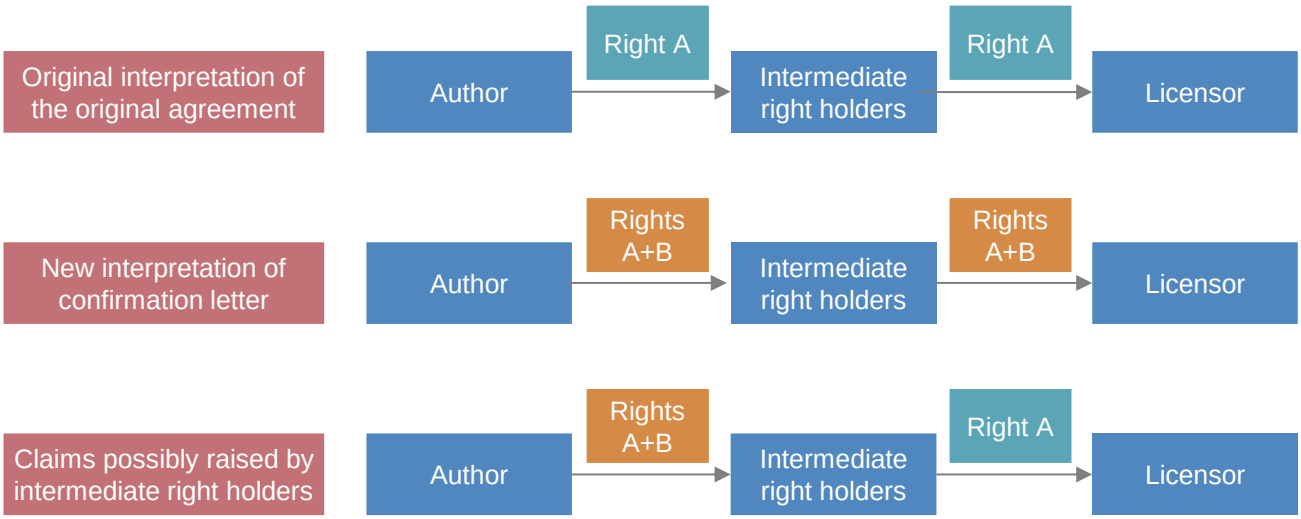
- **Common Risk 3: Existence of additional limitations**

New limitations may be imposed on the target IP with each change of hands, especially when they are licensed by upstream right holders who have development capabilities. Those upstream right holders may carry out preliminary development work based upon the target IP before they license the IP to downstream companies, and usually attach commercial restrictions on the development of target IP when granting such licenses. For example, they retain certain control over the development process (such as the right of creative supervision) and enjoy certain intellectual property rights, revenue rights and attribution rights to the final results of the development without bearing the development costs. Although these limitations are commercial and will not give rise to major legal disputes in most cases, they may still produce adverse effects on a project or even impair the commercial value of the project if not handled properly by investors.

Potential risks in common solutions proposed to resolve title defects

As mentioned above, copyright chain of title defects become relatively difficult to avoid as copyright changes hands multiple times. Generally, once a title defect is discovered, the end licensee will try to resolve the defect by directly signing a supplementary agreement with, or seeking a confirmation letter from, the most upstream right holder (such as the author). However, there are potential risks in such practice since it bypassing intermediate right holders, although it appears to be the safest choice considering the most upstream right holder generated the IP.

For example, to resolve title defects in copyright that has passed through multiple upstream right holders, an investor might request the upstream right owner to provide an confirmation letter issued by the author to confirm the expansion of the scope of licensed right at each time of the transfer/license—for example, to confirm the expansion of transmission channels from the original offline channels ("**Right A**") to both online and offline channels ("**Rights A+B**"). However, if Rights A+B is exclusively licensed by the author to intermediate licensees, neither Right A nor Right B can be further licensed to any other persons during the licensed period. Therefore, the expansion of the licensed right, as confirmed by the author's confirmation latter, would merely take effect for the author's downstream licensees with whom the author has directly signed license agreements, but would have no effect on other intermediate right holders with whom the author has not signed a license agreement. That is to say, if the upstream right holder claims that it merely licenses Right A to the investor (possibly by following the author's instructions), the scope of the investor's rights would remain ambiguous. The IP transaction process is as follows.



Therefore, in its attempt to resolve the title defect, investors should realize it is far from sufficient to merely sign a supplementary agreement with or obtain a confirmation letter from the most upstream right holder. A safe title defect solution requires investors to consider many other factors, including to examine whether the supplementary agreement or the confirmation letter will constitute concurrent licensing that would be held invalid, whether different interpretations may exist to such supplementary agreement or confirmation letter considering they are reached by bypassing the intermediate licensees. Take the above case as an example, if the investor wishes to expand the scope of licensed rights from Right A to Rights A+B., it would be advisable for the investor to seek an additional license (i.e., a separate license of Right B) directly from the most upstream right holder, or to sign supplementary agreements or confirmation letters with all upstream right holders (including various intermediate licensees).

Conclusion

The above are some of our insights on the basic methods, common risk and our proposed title defect solutions of the copyright chain of title review. There remain many other noteworthy issues in IP transfer/license in practice that we will separately explore in subsequent articles, including the design of transaction structures, drafting of transaction documents, and transaction negotiations.

2. 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[17]", 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[18]. 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 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[19]. Among the selected public M&A deals in the United States from 2017 to 2019, 83% of

[17] 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.

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

[19] 2019 SRS Acquiom Life Sciences M&A Study (September 2019), *available at*

them had earn-outs, with 77% in medical devices, 50% in diagnostic research, and only 18% in other industries[20].

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[21]. 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[22]. 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 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[23].

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,

https://www.srsacquiom.com/resources/2019-life-sciences-study/.

[20] *Id*.

[21] 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.

[22] Ziehms, at 185.

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

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[24]. Non-financial metrics are more widely used in the pharmaceutical industry, among which clinical trial results and regulatory approvals are the most common[25]. 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[26], cash flow, EBIT, EBITDA[27], 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[28]. In *LaPoint v. 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[29]. 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

[24] Ziehms, at 192.

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

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

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

[28] 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.

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

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.[30] The most commonly used criterion is "commercially reasonable efforts," which is used as an example in the following discussion[31].

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[32]. 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[33]. 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[34]. This criterion is more favorable to the buyer. A further option is to leave the definition open, leaving it to the discretion of an adjudicator to decide on the merits of each case[35].

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

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

[31] 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.

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

[33] *Id.*

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

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

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[36]. 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, 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

[36] 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/.

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[37]. 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[38]. 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[39]. 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 achieved; second, whether the controlling party has fulfilled its post-closing obligation to manage the business[40]. 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.

IV Disputes over the achievement of milestone events

1. *SRS v. Gilead Sciences* — when the contract is unclear[41]

Before the merger, the target, C, was a biotech company that held a portfolio of compounds including

[37] Ziehms, at 193.

[38] 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/.

[39] 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.

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

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

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.

2. *Fortis Advisors v. Shire* — when the contract is clear[42]

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;

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

- 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 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.

V Disputes over post-closing management of the company

1. *Himawan v. Cephalon*[43] and *Neurvana Medical v. Balt*[44]

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 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

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

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

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[45]

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[46], 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 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[47]. It can be anticipated

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

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

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

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 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.

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 Newsletter 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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