SULLIVAN & CROMWELL LLP

June 12, 2013

SIGA Technologies, Inc. v. Pharmathene, Inc.

Delaware Supreme Court Reaffirms that Express Obligation to Negotiate Agreement in Good Faith Is Enforceable and Holds Expectation Damages Are Available as Remedy

SUMMARY

In an opinion issued on May 24, 2013,[1] the Delaware Supreme Court reaffirmed that an express contractual obligation to negotiate an agreement in good faith is enforceable and held that expectation damages[2] are available for breach of that obligation if the court is reasonably certain that the contracting parties would have reached an agreement but for the defendant's bad faith, assuming the damages can be ascertained with reasonable certainty. The case serves as a useful reminder that care should be taken in drafting term sheets or other preliminary documents and that obligations to negotiate in good faith should be taken seriously. In particular, if parties to a preliminary agreement agree to negotiate the final agreement in good faith but intend the material terms agreed to be merely preliminary in nature, to avoid potential damages awards appropriate disclaimer language to that effect should be included.

BACKGROUND

On March 10, 2006, SIGA Technologies, Inc. ("SIGA") and PharmAthene, Inc. ("PharmAthene") signed a merger letter of intent that included a license agreement term sheet (the "LATS") for a SIGA antiviral drug ("ST-246"). The LATS, although not exhaustive, included key material provisions such as a worldwide exclusive license, upfront cash payments, funding guarantees, cash milestone payments, the makeup of a research and development committee and sublicensing rights. The LATS also included a footer that stated "Non Binding Terms."

To cover SIGA's liquidity problems while merger negotiations were ongoing, PharmAthene entered into a Bridge Loan Agreement with SIGA to fund expenses relating to the merger, the development of ST-246

and overhead. The Bridge Loan Agreement was governed by New York law and contained a provision obligating the parties to negotiate in good faith a license agreement "in accordance with the terms" set forth in the LATS if the merger were terminated. On June 8, 2006, SIGA and PharmAthene entered into a Merger Agreement, governed by Delaware law, that contained the same provision as in the LATS requiring the parties to negotiate a license agreement in good faith "in accordance with the terms" if the Merger Agreement were terminated.

SIGA's liquidity position improved shortly thereafter, with the receipt of NIH grants for ST-246 development, and SIGA terminated the Merger Agreement once the drop-dead date passed.

Shortly thereafter, PharmAthene sent a proposed license agreement, patterned on the LATS, to SIGA's outside counsel. SIGA responded to the draft by asking both for a partnership approach and for revisions to the LATS's economic terms to reflect the drug's clinical progress. SIGA sent PharmAthene a draft LLC Agreement that included terms far more SIGA-friendly than those in the LATS, including among other things a different profit split between the companies, upfront payments of $100 million (instead of the $6 million specified in the LATS), milestone payments of $235 million (instead of the $10 million specified in the LATS), significantly increased royalty payments and greater SIGA control over the drug's development and distribution.

Once SIGA made clear that it intended to renegotiate the LATS "without preconditions" or there was "nothing more to talk about," PharmAthene filed suit in the Delaware Court of Chancery, asserting claims under theories of breach of contract, promissory estoppel and unjust enrichment. Having denied both SIGA's motion to dismiss and its motion for partial summary judgment, and after an 11-day trial, Vice-Chancellor Parsons, applying Delaware law, found (1) SIGA was liable for breach of its obligation under both the Bridge Loan Agreement and the Merger Agreement to negotiate in good faith a definitive license agreement in accordance with the LATS terms, (2) SIGA was also liable under the doctrine of promissory estoppel and (3) the appropriate remedy was an equitable payment stream that approximated the terms of the license agreement the parties would have reached had they negotiated in good faith.[3] SIGA appealed the decision.

THE SUPREME COURT OF DELAWARE'S DECISION

The Supreme Court of Delaware ruled that an express contractual obligation to negotiate in good faith is enforceable under Delaware law and affirmed the Court of Chancery's holding that SIGA acted in bad faith when it negotiated the ST-254 license agreement in breach of its obligations under the Merger Agreement and the Bridge Loan Agreement. Moreover, the Court held that contract expectation damages are an appropriate remedy when parties have preliminarily agreed to the major terms of an agreement (a so-called Type II contract)[4] and have agreed to negotiate its conclusion in good faith, and the record shows that the parties would have reached agreement but for bad faith. However, the Court reversed the Court of Chancery's finding that promissory estoppel applied, reversing the damages

awarded and remanding the case for reconsideration of the appropriate damages because it was not clear the extent to which the damages award had been based upon a theory of promissory estoppel.

A. Application of Delaware Law

A threshold question for the Court, which it reviewed *de novo*, was whether the governing law of the Bridge Loan Agreement (New York) or the Merger Agreement (Delaware) governed the question at issue. The Court affirmed the Court of Chancery's decision to apply Delaware law because the Merger Agreement occurred later in time, encompassed a broader scope of the parties' relationship and was the agreement whose termination triggered the obligation to negotiate in good faith.[5]

B. Breach of SIGA's Contractual Obligation to Negotiate in Good Faith

Reviewing the issue *de novo*, the Court reaffirmed that express obligations to negotiate in good faith are binding upon the contracting parties,[6] affirming the Court of Chancery's holding that SIGA breached its contractual obligation to negotiate in good faith in attempting to negotiate a license agreement that contained terms "drastically different" than those in the LATS.[7]

In reaching its conclusion, the Court held that the record supported the Court of Chancery's finding that the parties had a duty to negotiate toward a license agreement with "economic terms substantially similar" to the LATS,[8] as opposed to using the LATS as a "jumping off point."[9] The Court noted the Vice-Chancellor's findings that the incorporation of the LATS into the Bridge Loan and Merger Agreements was evidence of the parties' intent to negotiate toward a license agreement with substantially similar economic terms in the event the merger was not closed; that the parties would not have negotiated the LATS's terms to the same extent if they intended it merely as a basic structure of a licensing agreement; and that the bridge loan would not have been made if there was not a reasonable expectation by PharmAthene that it would control ST-246 through a merger or in accordance with the LATS's terms.[10] The Court dismissed SIGA's concern that a "substantially similar" requirement would introduce uncertainty and litigation risk in future negotiations, noting that liability attaches only when the newly proposed terms are substantially dissimilar to the preliminary agreement and they are proposed in bad faith.[11]

C. Expectation Damages as Proper Remedy for Breach of Obligation to Negotiate in Good Faith

The Court next addressed *de novo* the proper contractual remedy for breach of an express contractual obligation to negotiate in good faith, holding as a matter of first impression that expectation damages are a proper remedy where a Delaware court finds as fact that the parties would have reached an agreement had they negotiated in good faith, assuming the damages can be ascertained with reasonable certainty. In reaching its conclusion, the Court looked to the analysis of other state and federal courts in determining the remedies applicable to breaches of Type II preliminary agreements—where major terms have been agreed but other terms remain to be negotiated.[12] Noting the lack of consensus in the courts regarding whether expectation damages are an appropriate remedy, the Court distinguished the instant case by

highlighting the Court of Chancery's finding that the parties would have agreed to a license agreement on the economic terms set forth in the LATS and, therefore, the damages could be measured with reasonable certainty, a prerequisite for expectation damages. However, because the Court of Chancery's damages award may have been based on a promissory estoppel theory of liability, which the Court said was inapplicable where a fully integrated, enforceable contract governs the promise at issue, the damages award was reversed and the case was remanded for reconsideration of the appropriate expectation damages award.

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ENDNOTES

[1] *SIGA Techs., Inc.* v. *PharmAthene, Inc.*, C.A. No. 2627 (Del. May 24, 2013) (hereafter "SIGA Technologies").

[2] Under Delaware law, expectation damages are based on the reasonable expectations of the parties *ex ante* and are measured by the amount of money that would put the non-breaching party in the same position as if the breaching party had performed the contract. *Duncan* v. *TheraTx, Inc.*, 775 A.2d 1019, 1022 (Del. 2001). Expectation damages would include, in addition to direct damages, any incidental or consequential damages. In contrast, reliance damages seek to restore the non-breaching party to the *status quo ante* by compensating only for its actually incurred costs and expenses. *Titan Inv. Fund II, LP* v. *Freedom Mortg. Corp.*, C.A. No. 2627, slip op. at 32 (Del. Dec. 5, 2012).

[3] *PharmAthene, Inc.* v. *SIGA Techs., Inc.*, C.A. No. 2627-VCP, slip op. at 2-3 (Del. Ch. Sept. 22, 2011).

[4] The Court borrowed the concept of "Type I" and "Type II" agreements from federal courts interpreting New York law. In a Type I agreement, the "parties agree on all the points that require negotiation (including whether to be bound) but agree to memorialize their agreement in a more formal document." *SIGA Technologies* at 33 n.82 (citing *Adjustrite Sys., Inc.* v. *GAB Bus. Servs., Inc.*, 145 F.3d 543, 548 (2d Cir. 1998)). In a Type II agreement, the "parties agree on certain major terms, but leave other terms open for further negotiation." *Id.* at 33 (citing *Adjustrite Systems* at 548). In contrast to the fully binding nature of Type I agreements, Type II agreements bind the parties "to negotiate the open issues in good faith" but do not commit the parties to reaching a final contract. *Id.* at 33-34 (citing *Teachers Ins. & Annuity Ass'n of Am.* v. *Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y. 1987)).

[5] Because the plaintiffs alleged that the only meaningful difference SIGA articulated between Delaware and New York law concerned damages for PharmAthene's unjust enrichment claims, and the Court held that SIGA is not liable under a quasi-contractual theory, the Court applied Delaware law without deciding whether the choice-of-law provisions or the "most significant relationship" test applicable to unjust enrichment cases governs the choice of law analysis on these claims. *SIGA Technologies* at 18-21.

[6] *Id.* at 22 & 25. For similar holdings referenced by the Court, see, e.g., *Titan Investment Fund II, LP* v. *Freedom Mortgage Corp.*, 58 A.3d 984 (Del. 2012) (ORDER) (affirming holding that defendant breached its obligation, arising from the term sheet and letter agreement, to negotiate in good faith); *RGC Int'l Investors, LDC* v. *Greka Energy Corp.*, C.A. No. 17674, slip op. at 37 (Del. Ch. Aug. 22, 2001) (concluding that "[a]t the very least, after signing the [t]erm [s]heet, neither party could in good faith insist on specific terms that directly contradicted a specific provision found in the [t]erm [s]heet"), *overruled on other grounds by Scion Breckenridge Managing Member, LLC* v. *ASB Allegiance Real Estate Fund*, C.A. No. 5843 (Del. May 9, 2013).

The Court distinguished *VS & A Commc'ns Partners, L.P.* v. *Palmer Broad. Ltd. P'ship*, C.A. No. 12521, slip op. at 17 (Del. Ch. Nov. 16, 1992), in which the court applied New York law in concluding that "obligations to negotiate are said to be invalid or unenforceable where material aspects of the contract remain open," by noting that *VS & A Communications* did not involve an express good-faith obligation to negotiate anything but one provision, had disclaimer language to the effect that it "merely represents our present understanding with respect to the intended transaction described herein, and is not binding upon and creates no rights, express or implied in favor of any party," and under Delaware law the intention of the parties controls the creation of a good-faith duty to negotiate under a preliminary agreement. *SIGA Technologies* at 22-23 & 24 n.51 (citing *VS & A Communications* at 9).

[7] *SIGA Technologies* at 28.

[8] *Id.* at 26-27.

[9] *Id.* at 27 n.63.

[10] The Court also noted that the Merger Agreement contained a best efforts obligation with respect to the "transactions contemplated" by the Agreement, and that that obligation survived termination of the Merger Agreement. *Id.* at 11.

[11] *Id.* at 28 (noting further that "bad faith is not simply bad judgment or negligence, but rather it implies the conscious doing of a wrong because of dishonest purpose or moral obliquity").

[12] *Id.* at 33-36 (citing *Goodstein Constr. Corp.* v. *City of New York*, 604 N.E.2d 1356, 1360 (N.Y. 1992) (holding that New York law limits damages to reliance damages for breach of an agreement to negotiate, without distinguishing between Type I and Type II agreements); *Fairbrook Leasing, Inc.* v. *Mesaba Aviation, Inc.*, 519 F.3d 421, 429 (8th Cir. 2008) (applying New York law, the court questioned in dicta whether *Goodstein* would preclude expectation damages in cases where a court could determine the agreement that would have been reached); *Venture Assocs. Corp.* v. *Zenith Data Systems Corp.*, 96 F.3d 275 (7th Cir. 1996) (noting the availability of consequential damages under Illinois law if the plaintiff proves that but for the defendant's bad faith the parties would have entered into a final contract)).

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