SEPTEMBER/OCTOBER 2026

ADVOCATE'S EDGE



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Delaware Supreme Court offers guidance on earnout provisions

In mergers and acquisitions (M&As), buyers and sellers often have different expectations regarding the target company's financial performance. To reconcile these differing expectations, parties often use earnout provisions that condition a portion of the purchase price on the target's achievement of certain post-closing milestones. (See "Using earnouts to allocate risk" at page 3.)

In a recent case — *Johnson & Johnson v. Fortis Advisors LLC* — the Delaware Supreme Court provides valuable guidance on drafting earnout provisions in M&A agreements.

Anatomy of the dispute

The defendant, a global health care company, acquired the plaintiff, a developer of robotic-assisted surgical devices (RASDs). Under the agreement, the defendant paid $3.4 billion up front and agreed to pay up to an additional $2.35 billion to the plaintiff's former shareholders if its RASDs met certain regulatory and net sales milestones. The agreement contained a "commercially reasonable efforts" clause. It required the defendant to "pursue the regulatory milestones with efforts consistent with its usual practice for 'priority medical device products' of comparable potential."

The regulatory milestones were expressly conditioned on obtaining "510(k) premarket notification" for specified devices and surgical uses. Under the U.S. Food, Drug, and Cosmetic Act, Section 510(k) provides a streamlined pathway to U.S. Food and Drug Administration (FDA) clearance. It requires an applicant to demonstrate that a new device is substantially equivalent to a legally marketed "predicate device." When no suitable predicate device exists, the applicant may instead seek FDA authorization through the more time-consuming and burdensome "de novo" classification process.

For one of the plaintiff's products, the parties anticipated that 510(k) clearance would be obtained for a "stripped-down" RASD intended for general surgery, using a device previously marketed by the plaintiff as the predicate. Subsequently, the new device would serve as the predicate for 510(k) clearance of the device's future iterations designed to perform more complex surgeries. The initial milestone called for payment of a $400 million earnout upon the device's 510(k) clearance. Four future 510(k) milestones paid $150 million each, totaling $1 billion in regulatory earnout payments.

Before the first milestone could be achieved, an FDA policy change closed the 510(k) pathway for the new device, and the defendant declined to pursue the more difficult de novo pathway. As a result, none of the milestones were reached, and the



Using earnouts to allocate risk

Business value is often based on expected financial performance. But given the risks of achieving that performance, buyers and sellers in M&A transactions may have dramatically different views regarding the target company's prospects. Sellers typically push for a higher valuation to help ensure they're compensated fairly if the business meets expectations. Buyers, on the other hand, will seek a lower valuation to mitigate the risk that the target will underperform.

Earnouts can be an effective tool for bridging this valuation gap. An earnout is a contractual arrangement under which a portion of the purchase price is contingent on achievement of specified milestones, such as a certain level of earnings or regulatory approval of a drug or medical device, as in *Johnson & Johnson* (see main article). Essentially, these provisions allocate some of the target company's financial risk to the seller. If the target performs well, the seller will be compensated; if it doesn't, the buyer won't overpay.

defendant made no earnout payments. The plaintiff's former shareholders sued the defendant on several grounds, including breach of contract and breach of the implied covenant of good faith and fair dealing. (The case also involved a claim, not discussed here, that the defendant fraudulently induced the plaintiff to accept a contingent payment rather than up-front consideration for another product.)

Lower court awards significant damages

The Delaware Chancery Court rejected the defendant's claim that the FDA's change excused its contractual obligation to work toward achieving the milestones. The court held that the implied covenant of good faith and fair dealing required the defendant to pursue de novo clearance for the first milestone. Then it could pursue 510(k) clearance for the other milestones.

The court calculated damages for each earnout payment by multiplying the earnout amount by the parties' pre-merger estimates of the probability of achieving the corresponding regulatory milestone (75% for the first milestone and 80% for the others). The judgment totaled more than $1 billion, including contract and fraud damages plus prejudgment interest.

Appellate court partially reverses course

The Delaware Supreme Court reversed the Chancery Court's ruling on the implied covenant issue, finding that the defendant wasn't liable for the first earnout payment. Because the agreement explicitly conditioned that payment on 510(k) clearance, the court concluded that the defendant had no contractual obligation to pay the first earnout once the FDA eliminated that pathway. The risk that the FDA would make such a policy change was foreseeable, and the parties allocated that risk to the plaintiff by explicitly limiting the milestone to 510(k) clearance.

However, the state supreme court affirmed the lower court's judgment for the remaining earnout payments. It held that the defendant remained obligated to use commercially reasonable efforts to pursue 510(k) clearance for the remaining milestones. This included seeking de novo authorization for the first milestone, which the evidence showed could have been accomplished within the agreement's timeline. The court also upheld the lower court's damages methodology.

Precision matters

Johnson & Johnson illustrates the importance of detailing earnout milestones and the parties' post-closing obligations in M&A agreements. Courts will generally enforce the parties' risk allocations — even when unexpected (yet reasonably foreseeable) regulatory developments occur. Buyers and sellers should carefully consider how future developments may affect the achievement of milestones and clearly address those risks in their M&A agreements. ■

Business value vs. spousal support: Watch out for double-dipping

When a married couple divorces after building a successful business, it's common for one spouse to retain ownership of the business and for the other to receive a large cash equalization payment, essentially buying out that spouse's interest. Is traditional spousal support (alimony) appropriate for a spouse who receives an equalization payment? The answer depends on case facts and legal precedent.

A recent Iowa Supreme Court decision — *In re Marriage of Owen and Brinker* — addressed this question. In this case, the court found that spousal support wasn't appropriate because the owner-spouse's future income potential was tied to the business. It held that relying on that future income to both value the business and justify spousal support amounts to double-dipping.

Case background

The couple in this case married in 2003. Two years earlier, the husband had started a business that designs and manufactures fabric-covered steel-framed buildings used in agricultural and commercial industries. The wife, a practicing CPA at the time of the marriage, eventually joined the business and worked there until the couple divorced in 2022.

> The income approach, by definition, "values a business based on an estimate of the company's future earnings."

The trial court awarded the husband approximately $7.5 million in assets (including the business) and awarded the wife approximately $1.5 million in assets. To split the difference, the court ordered



the husband to make a cash equalization payment of approximately $3 million. The wife also sought $13,500 per month in spousal support, which the court denied.

The court of appeals modified the dissolution decree to include $3,500 per month in spousal support. The reasoning was 1) the wife's income from the cash equalization payment will be "subject to the rising and falling tides of market performance," and 2) the significant gap between the spouses' earning capacities "is difficult to reconcile without an award of spousal support."

Iowa Supreme Court decision

The state supreme court rejected the inclusion of spousal support and affirmed the trial court's dissolution decree. On appeal, the wife argued that she was an "equal partner" in building the business and it was "inequitable for [the husband] to receive

the income-producing assets while she received only cash." But this reasoning, the state supreme court explained, ignores the fact that the business's value was derived from its future earnings.

Both parties' experts used a combination of income- and market-based approaches to value the business. The income approach, by definition, "values a business based on an estimate of the company's future earnings." Although the court didn't discuss the market approach, pricing multiples applied under that approach also may be based on metrics of future earnings, such as revenue, cash flow or earnings.

The appeals court, in ordering spousal support, focused on the gap between the parties' expected incomes. But the state supreme court found several flaws with this reasoning. For one thing, it misconstrued the purpose of spousal support. The purpose isn't to equalize the parties' incomes but "to allow the receiving party to maintain her previous lifestyle to the extent possible within the paying spouse's ability to pay." In this case, the wife's expected salary as a CPA plus the investment interest on the $3 million equalization payment was more than adequate to maintain her previous lifestyle.

The award of spousal support also ignored the risks associated with operating a closely held business. The appeals court was wrong to provide the wife a "buffer for poor market years" when the husband enjoyed no such buffer. Essentially, the award provided the wife with guaranteed income regardless of the profitability of the business and other assets awarded to the husband. Finally, even if income inequality were a factor, the gap between the parties' incomes in this case was essentially erased by the husband's interest payments on the loan used to fund the equalization payment.

Lessons learned

The *Owen* decision illustrates the importance of carefully coordinating business valuation and spousal support analyses. Because a business's value typically reflects its future earning potential, courts may be reluctant to rely on those same earnings to justify ongoing support, which can result in an inequitable double recovery. ■

Defend the price tag with a fairness opinion

Fairness opinions are essential in today's merger and acquisition market. Higher financing costs than those seen during the pandemic-era deal boom, ongoing economic uncertainty and heightened shareholder scrutiny have increased the stakes for major transactions. A fairness opinion can help safeguard a transaction against future legal challenges.

Understanding the benefits

Simply put, a fairness opinion addresses whether a transaction appears "fair" from a financial point of view. Fairness opinions help demonstrate that decision-makers fulfilled their fiduciary duties to the company and its stakeholders. However, fairness opinions don't address legal or structural fairness, nor do they constitute an endorsement or a guarantee of a particular transaction.

When preparing a fairness opinion, a financial expert usually estimates a range of values for a proposed transaction. Theoretically, the ceiling of this range represents the highest price a prudent buyer would be willing to pay; the floor is the lowest price a prudent seller would accept. The analysis



typically presumes that neither party has been forced to buy or sell and that both parties have reasonable access to relevant financial data.

Another proxy for the lower end of the range is the amount that dissenting shareholders could reasonably expect to obtain in a statutory appraisal action. Legal counsel can help the fairness opinion provider define the appropriate standard of value.

Assessing current market conditions

A fairness opinion is valid only on a particular date. A transaction may be fair one day but unfair the next because of changing market conditions, interest rates, competitive pressures or product obsolescence.

Generally, fairness opinions are prepared as close to the transaction or proxy date as possible. Opinions dated too early or not updated for changing conditions may not withstand scrutiny — especially when markets are volatile. In today's environment, where valuations can shift quickly and financing terms may change during negotiations, timing remains critical. Obtaining a fairness opinion before a transaction is approved can show that decision-makers carefully evaluated the deal using current market data.

Thinking beyond public companies

Most people associate fairness opinions with public companies undergoing high-profile management buyouts, hostile takeovers or going private transactions. But fairness opinions have become increasingly popular among private businesses with complex deal structures, related-party transactions and vocal minority shareholders.

Fairness opinions aren't legally mandated, but they can help facilitate mergers, acquisitions, spin-offs, stock repurchases and divestitures. Businesses reorganizing out of court or under Chapter 11 may also obtain fairness opinions on behalf of creditors and other stakeholders.

Seeking outside expertise

Courts generally view fairness opinions as less objective if they're prepared by company insiders, business brokers or others involved in negotiating the deal. Instead, independent third parties — such as credentialed business valuation professionals — are usually hired to avoid potential conflicts of interest and withstand scrutiny if stakeholders later challenge a transaction.

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Ultimately, a fairness opinion is only as reliable as the assumptions, data and analyses that support it. When prepared by an independent valuation expert, a fairness opinion can provide valuable insight, enhance transparency and help demonstrate that decision-makers fulfilled their fiduciary responsibilities if a transaction is later challenged. ■

Recent report reveals fraud trends and ways to prevent losses

Businesses consistently lose about 5% of revenue to fraud, according to *Occupational Fraud 2026: A Report to the Nations*. Here are some key takeaways from the latest version of this biennial global survey from the Association of Certified Fraud Examiners (ACFE).

Emerging trends

One noteworthy development over the last 30 years is the growing prevalence of corruption schemes, such as those involving conflicts of interest or bribery. In 1996, only 10% of reported incidents involved corruption, compared to 45% in 2026. Another key change is who perpetrates fraud:

- 41% of incidents involved employees in 2026 (down from 58% in 1996),
- 41% of incidents involved managers in 2026 (up from 30% in 1996), and
- 16% of incidents involved owners and executives (up from 12% in 1996).

In addition, although the gender divide remains, it has narrowed significantly. Women continue to account for approximately one-quarter of fraud schemes, but the median loss from fraud by women has more than doubled from roughly $48,000 in 1996 to $90,000 in 2026. The median loss from schemes perpetrated by men decreased from about $185,000 in 1996 to $125,000 in 2026.

Spotlight on tips

Because tips remain the leading method of fraud detection today, formal reporting mechanisms are essential. Survey respondents with hotlines for reporting misconduct experienced a median loss of $100,000 with a median duration of 11 months. By comparison, those *without* formal reporting mechanisms suffered a median loss of $150,000 with a median duration of 17 months.

More than half of the tips (55%) came from employees, but nearly one-third (32%) came from outside parties, such as customers and vendors. To facilitate tips, a business should set up a hotline, provide training, and promote hotline use among employees and supply chain partners. It's also noteworthy that online and email reporting mechanisms are significantly more common today than telephone hotlines.



Antifraud controls

Businesses don't have to wait to receive tips to fortify their defenses against fraud. The best way to minimize losses and the duration of fraud schemes is to implement *active* antifraud controls.

The ACFE report highlighted four controls as the most effective in reducing fraud losses: 1) management review, 2) data monitoring and analysis, 3) formal codes of conduct, and 4) surprise audits. Each of these measures helped reduce the median fraud loss by 50% or more.

Opportunities for improvement

Some antifraud controls — such as codes of conduct and management review — have been widely adopted. But less than half of respondents conduct surprise audits or perform data monitoring and analysis. A forensic accountant can evaluate a business's antifraud controls, identify potential weaknesses and recommend practical ways to lower fraud risks. ■

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