Breach of Earnout: Damages

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January 21, 2026

Earnout milestones are benchmarks set in M&A purchase agreements that, if met, can lead to additional payments to the sellers once achieved. However, no one can predict the future, and when parties agree to earnout milestones, there is no way to know for sure whether those milestones will be achieved. So, what happens when there is a dispute about these milestones? One important question that will be asked is: What are the possible damages?

While some might think the damages are the entire amount of the earnout, a recent Delaware decision[1] provided helpful insight as to how damages *could* be calculated when a buyer breaches the earnout provision, including whether an award of attorney's fees is warranted based on the contract language and how to calculate prejudgment interest. Below are practical takeaways from the Delaware decision that parties should keep in mind while drafting earnout provisions, and when assessing possible monetary recovery in connection with an earnout breach.

1. How Damages are Calculated

While most sellers will want to recover all earnout amounts set out in the purchase agreement, the court in the *Fortis Advisors, LLC* decision took another approach. Despite finding that the buyer breached the earnout provision, instead of awarding the entire earnout amount that could have been achieved by the sellers, the Court awarded a "blended percentage" of the success rate estimated by the seller and the buyer *at the time of closing*. This calculation was possible because both the seller and the buyer had each hired third-party financial advisors *before* closing to provide an estimate of the probability of success on reaching each of the earnout milestones. The damages expert hired by the seller in the *Fortis Advisors, LLC* matter then calculated a blended percentage that averaged the parties' probability of success on each of the earnout milestones, which the court adopted. Two practice tips that stem from this: (i) consider whether it is worthwhile for the parties to hire a third-party advisor to assess the odds of success in reaching each of the earnout milestones before closing; and (ii) sellers should keep detailed records of post-closing events that would tend to prove the earnout milestone was or reasonably would be reached, along with any actions from the buyer that may have diminished their ability to do so.

2. Attorney's Fees Provision

In the *Fortis Advisors, LLC* decision, the seller argued it was entitled to recover its attorney's fees based on a Loss/Indemnity provision in the purchase agreement. The Court denied this argument because no portion of the purchase agreement (including in the Loss/Indemnity provision) stated or contemplated an award of attorney's fees in connection with a litigation between the parties based on a parties' breach of the agreement. A key takeaway from this is that if a party would like to be reimbursed for their attorney fees and costs incurred in enforcing any provision of the agreement, including the earnout provision, it should be explicitly stated in

the purchase agreement.

3. Interest

After the Court in the *Fortis Advisors, LLC* decision found that the buyer had breached the earnout provision, it calculated pre-judgement interest based on the interest calculation *provided in the purchase agreement*. The parties had agreed that the prime rate of interest reported in The Wall Street Journal would be assessed on any earnout payment paid more than ten (10) days after the buyer notified the seller that the milestone had been reached. Based on this provision, the seller's damages expert calculated the pre-judgment interest on a compounding, quarterly basis. Since the purchase agreement did not state whether it was simple or compounded interest, the decision was left up to the Court, which calculated compound interest based on the seller's expert calculation. The practical takeaway here is for the parties to state in the agreement whether they intend interest to be compounded or simple.

In summary, damages related to a breach of an earnout provision are largely determined before the transaction is completed. The *Fortis Advisors LLC* decision exemplifies that the work both parties complete (or omit) before closing can significantly affect a damages calculation later on.

If you have any further questions, please contact Paige Zacharakis.

[1] *Fortis Advisors, LLC v. Johnson & Johnson, et al.*, Case No. 2020-0881-LLW, 2024 WL 4048060 (Del. Ch. Sept. 4, 2024).