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Delaware Supreme Court Clarifies Implied Covenant of Good Faith and Fair Dealing

Recently in *Johnson & Johnson et al. v. Fortis Advisors, LLC*, the Delaware Supreme Court reversed, in part, the Delaware Court of Chancery's ruling that a buyer breached the implied covenant of good faith and fair dealing (the "implied covenant") by failing to satisfy its efforts obligations with respect to regulatory approvals needed to achieve an earnout milestone. The opinion by Justice Abigail M. LeGrow clarifies the narrow limits of the implied covenant and reinforces the primacy of the express contractual agreement between parties.

Background

Johnson & Johnson arose in the context of J&J's acquisition of Auris Health, Inc. The merger included up to \$2.35 billion in earnout payments contingent on J&J's using "commercially reasonable efforts" to achieve regulatory and sales milestones for Auris's robotic-assisted surgical devices (RASDs). Each regulatory milestone was expressly conditioned on a specific means of U.S. Food & Drug Administration (FDA) regulatory clearance—the "510(k) pathway"—which was the least onerous means of clearance. After closing, a change at the FDA closed the 510(k) pathway for the Auris RASD, and J&J declined to pursue the alternate, more onerous pathway for regulatory clearance—the "De Novo pathway." No milestones were achieved and thus no earnout payments were made. The plaintiff, a representative of the former Auris stockholders, sued on several theories.

In a [post-trial opinion](#), the Delaware Court of Chancery held that J&J breached the implied covenant by not seeking the DeNovo pathway to achieve the first earnout milestone when the 510(k) pathway was closed by the FDA. On appeal, the Delaware Supreme Court reversed that holding, finding that there was no genuine contractual gap for the implied covenant to fill as the merger agreement repeatedly and expressly conditioned the regulatory earnout milestones on the 510(k) pathway and, therefore, allocated to Auris stockholders the risk that regulatory developments might affect the regulatory pathway, timing or cost of approval. Thus, J&J did not breach its obligations to use "commercially reasonable efforts" under the terms of the merger agreement for the first earnout milestone. The Supreme Court affirmed the Court of Chancery's other holdings, including with respect to breaches of efforts obligations for the other milestones.

Takeaways

The main takeaway from the decision is the court's clarification of the limited availability of the implied covenant to address contractual claims. The Supreme Court clarified that the implied covenant primarily operates in one of two ways—first, relevant here, as a gap-filling mechanism to address unforeseen developments, and second, not relevant here, when a contract allocates discretionary authority and the court must apply the implied covenant to ensure that discretionary authority is applied consistent with the agreed bargain. As to the first scenario, the court stated that the covenant as gap-filler is a "limited and extraordinary remedy" that only applies when there is a "genuine contractual gap about a truly unanticipated development and only then to vindicate the parties' shared expectations at signing." Importantly, the court stressed that a post-closing development sought to be filled by the implied covenant must not only be one that the parties failed to consider, but it must be one that the parties could not have anticipated. If a development, even if unlikely, could have been anticipated, the implied

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covenant “cannot be invoked to provide protections that ‘easily could have been drafted’ at the bargaining table.” Here, the risk that the FDA would require the De Novo pathway for the first milestone instead of the 510(k) pathway was “both foreseeable and addressed in the parties’ carefully negotiated agreement.” Thus, the opinion reinforces the narrowness of any remedies that can be sought based on the implied covenant if the circumstances are expressly addressed in an agreement.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Andre G. Bouchard

+1-302-655-4413

abouchard@paulweiss.com

Chelsea N. Darnell

+1-212-373-3104

cdarnell@paulweiss.com

Frances F. Mi

+1-212-373-3185

fmi@paulweiss.com

Cullen L. Sinclair

+1-212-373-3483

csinclair@paulweiss.com

Michael Vogel

+1-212-373-3137

mvogel@paulweiss.com

Legal consultant Cara G. Fay contributed to this Client Memorandum.