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Important Earnout/Milestone Drafting Points Arising from Recent Pacira *and* Shire *Decisions*

Earnout or milestone provisions in a merger agreement provide a framework for additional merger consideration to be paid, after the closing, if specified "milestone" events occur or specified performance targets are achieved post-closing. (We use the terms "earnout" and "milestones" interchangeably in this Briefing.) According to recent studies, earnouts are used in over 60% of private company acquisitions in the life sciences industry (where the payments usually are tied to the occurrence of specific steps in the regulatory process relating to the development and marketing of the target company's product) and in roughly 20-30% of other private company acquisitions (where the payments typically are based on the achievement of specified levels of revenue or EBITDA). In recent years, earnouts have consistently appeared each year in almost half of all de-SPAC transactions (mergers with a SPAC acquiror).

While earnouts help to bridge the gap between a buyer and seller in the upfront negotiation of the purchase price, they often lead to post-closing disputes (and litigation) over the earnout itself. Thus, it is critical that an earnout is drafted with appropriate specificity and clarity—as underscored most recently in the *Pacira* and *Shire* decisions. In both of these cases, based on the "plain meaning" of the express language in the merger agreement at issue, the Delaware Court of Chancery rejected the buyer's argument that an earnout payment was not due. These decisions indicate that merger agreement parties should consider certain changes to the standard formulation of earnout provisions, as discussed below.

Key Points

- **Based on *Pacira*, merger agreement parties should consider setting forth specific restrictions on selling stockholders' post-closing efforts to facilitate achievement of an earnout.** In *Pacira*, the buyer contended that the milestone payment was not owed, in part, because the selling stockholders, in contravention of the buyer's contractual right to control the acquired company post-closing in in sole discretion, had taken steps to seek to influence achievement of the milestone. The court found that, as no specific restrictions on the selling stockholders were set forth in the merger agreement, no obligation to refrain from seeking to influence achievement of the earnout existed. The court held that the buyer was not excused from making the milestone payment on the basis that the selling stockholders had breached a contractual obligation.

- **Based on *Shire*, when the phrase "as a result of" is used, the drafting should clarify whether it means "*exclusively* as a result of."** In *Shire*, the merger agreement provided that a milestone payment would be paid on a specified date even if the specified milestone event had not occurred by that date, but would *not* then be payable if the failure of the milestone to have occurred by that date was "as a result of" certain regulatory-related issues having arisen. The court acknowledged that such a regulatory issue had arisen, but interpreted "as a result of" to mean that the milestone payment

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would not be payable only if the regulatory issue had been the *only* reason the milestone was not achieved. The court held that the buyer was not excused from making the milestone payment as it concluded that other factors had contributed to the milestone not being achieved.

Pacira v. Fortis

Background. Pacira BioSciences, Inc. acquired MyoScience, Inc. for $120 million cash and up to $100 million in contingent post-closing milestone payments. MyoScience (operating as "Pacira CryoTech" after the closing) manufactures ivosera, a pain medication device that delivers doses of extreme cold to targeted nerves to reduce pain. The merger agreement provided that milestone payments would become payable if, after closing, new "CPT codes" for ivosera were issued that met certain levels of specificity and exceeded specified reimbursement amounts.[*] After the closing, it appeared doubtful that CMS would issue CPT codes for ivosera that would trigger the final milestone payment. Three key former employee-stockholders of MyoScience (the "Individual Defendants"—two of whom were no longer employed by the company) then coordinated with each other to seek to influence the process so that more favorable CPT codes would be issued. Although CMS issued more favorable codes, they still did not clearly achieve the milestone. Pacira did not make the milestone payment, and the Individual Defendants brought suit.

Pacira sought a declaratory judgment that the milestone payment was not owed because the CPT codes issued did not meet the parameters set forth for the milestone event. That issue is still pending before the court. This recent decision, issued October 25, 2021, addressed the selling stockholders' motion to dismiss Pacira's claim that the milestone payment was not payable because the Individual Defendants breached a contractual obligation to refrain from interfering with its right to control the company by taking steps to try to ensure achievement of the milestone. Vice Chancellor Fioravanti granted dismissal of the buyer's claim, finding that the merger agreement did not impose any restrictions on the Individual Defendants' post-closing actions.

The Merger Agreement provisions. Each Individual Defendant had agreed in his option holder transmittal letter to be bound by Section 1.15 of the merger agreement. Section 1.15 contained the milestone provisions, and provided as follows: (i) ***Pacira's Good Faith and Reasonable Efforts Obligations.*** After the closing, "Pacira shall operate Pacira CryoTech in good faith in the context of this Section 1.15 and shall use commercially reasonable efforts to achieve the Milestones." (ii) ***Individual Defendants' Sole Right.*** "The sole and exclusive right" of the Individual Defendants under Section 1.15 will be to receive the milestone payments that may become payable. (iii) ***Pacira's Right to Control Post-Closing.*** After the closing, "Pacira will have the right to operate the business of Pacira CryoTech as it chooses, in its sole discretion, except as expressly set forth in this Section 1.15; and Pacira is not under any obligation to provide any specific level of investment or financial assistance to Pacira CryoTech or to undertake any specific actions (or refrain from taking any specific actions) with respect to the operation of [Pacira CryoTech], except as expressly set forth in [this Section 1.15]." Pacira argued that, taken in combination, these provisions, directly or implicitly, required that the Individual Defendants not take any

[*] Medical providers seek Medicare and Medicaid reimbursement by reporting to the Centers for Medicare and Medicaid (CMS) the appropriate CPT code for the service or product they provided to patients. The CPT codes, including how specific they are to a particular service or product and what the reimbursement rate is, are determined by CMS after input from industry participants; and the codes are updated on an annual basis. The more specific a CPT code is to a particular product, the more likely that Medicare will provide the reimbursement. Thus, the success of a medical product is closely tied to what CPT code is available for it.

actions to seek achievement of the milestones—given that Pacira had the right to operate the company in its sole discretion and the Individual Defendants' sole right was to receive the payments if payable.

The court found that, as no specific restrictions on the Individual Defendants were set forth in the agreement, they had no obligation to refrain from trying to ensure achievement of the milestone. The court emphasized the express wording of the contract, and read the contract as a whole to determine its meaning. The court observed that there was no reference in Section 1.15 to any "obligation" of the Individual Defendants, just a reference to their "sole right"; and, moreover, that there was no reference to "obligations" of the Individual Defendants anywhere in the agreement. On that basis, the court concluded that the agreement was "unambiguous" in not imposing obligations on the Individual Defendants with respect to their post-closing actions relating to achievement of the milestone. If the parties had wanted to impose restrictions, the court stated, they easily could have expressly set them forth in the agreement. The parties not having done so, the court would not infer such restrictions from the other provisions.

We note (although the court did not address) that the Individual Defendants' post-closing actions with respect to the CPT code process were seemingly limited and benign, without any obvious conflict with Pacira's common objective to obtain more favorable CPT codes. The opinion describes the Individual Defendants' actions as having consisted of (i) contacting personnel at Pacira to try to "influence and direct" them to proceed in certain ways with CMS, and (ii) retaining MyoScience's former outside legal counsel for CMS issues to help them strategize as to how to try to influence the issuance of more favorable CPT codes (which, it turned out, later prevented Pacira from engaging that counsel when it wanted her to join its other counsel that was already engaged in the process). Query whether the court might have reached a different result if the Individual Defendants' objectives or actions had been more extensive and at cross-purposes with, or had otherwise clearly impeded, Pacira's own efforts with respect to achievement of the milestone.

Conclusion. The decision indicates that buyers should consider seeking to set forth specific restrictions relating to selling stockholders' post-closing actions with respect to influencing the process of achieving a milestone event (or earnout performance triggers). (*See* "Drafting Points" below.)

Shire v. Shareholder Representative Services

Background. In 2012, Shire Pharmaceuticals LLC acquired FerroKin Biosciences, Inc., a company that was developing the experimental drug deferitazole to treat excess iron levels in cancer patients. The merger agreement provided that Shire would make a $45 million milestone payment when it commenced Phase III trials of the drug. The agreement provided, further, that, if the trials had not commenced by December 31, 2015, the milestone payment nonetheless would be paid on that date *unless* the failure to commence the trials by that date was "as a result of" a "Fundamental Circumstance" (defined in the agreement as "a circumstance in which material safety or efficacy concerns made it impracticable to produce and sell or to obtain regulatory approval for the drug").

In 2013, as the company's drug development testing proceeded, issues arose with respect to the correct dosing for the drug as well as the drug's safety. Throughout 2013, in emails among one another, Shire executives commented on the significant unexpected expense of the program to develop the drug and expressed doubts about its ultimate success in light of the safety concerns. In 2014, the FDA ordered a temporary halt to further testing of the drug based on the safety concerns. Shire then projected that Phase III trials would be delayed to 2017 and approval of the drug to 2020 (by which time a generic form of the drug would have been released, substantially lowering the expected financial benefits of the drug to Shire). In February 2015, Shire decided to terminate development of the drug. At that time, it notified the former target stockholders that the FDA's order to halt testing had constituted a Fundamental

Circumstance and the milestone payment would not be made. The stockholders sued to enforce the milestone payment and recover related costs (which they currently estimate at about $20 million).

In a post-trial decision issued Oct. 12, 2020 by then-Vice Chancellor (now Chancellor) Kathaleen McCormick, the Court of Chancery held that, while the FDA action constituted a Fundamental Circumstance, the failure to commence the Phase III trials by December 31, 2015 was not "as a result of" the Fundamental Circumstance because the trials would not have commenced by that date in any event due to other business and financial decisions Shire had made. The court ordered that Shire pay the milestone payment. Shire appealed. At a hearing held November 3, 2021 before a three-member panel of the Delaware Supreme Court, the Chief Justice's comments indicated that he would support upholding the lower court's decision. A decision has not yet been issued by the Supreme Court.

The Court of Chancery found that, although a Fundamental Circumstance had occurred, the failure to commence the trials by December 31, 2015 was not "as a result of" the Fundamental Circumstance because other factors also contributed to the failure. Shire argued that, as the FDA's blocking further testing was a Fundamental Circumstance that occurred before December 31, 2015, Shire was excused from making the milestone payment. The former target stockholders argued that Shire's failure to initiate the Phase III testing was improper as it was based on routine timing and cost-related business decisions, made *before* the FDA's block. The Court of Chancery, in a post-trial decision, agreed with the target stockholders. Chancellor McCormick, focusing primarily on the phrase "as a result of" in the merger agreement, reasoned that the issue was not whether a Fundamental Circumstance had occurred prior to December 31, 2015 (which the court acknowledged it had), but whether the occurrence of the Fundamental Circumstance was the reason Shire failed to commence the Phase III trials by December 31, 2015. The Chancellor found that the trials would not have commenced by December 31, 2015 in any case due to Shire's decisions made before the FDA block (such as its decision to conduct more dosing and safety studies prior to proceeding with more testing). —

The Chief Justice's comments at a recent hearing supported the Court of Chancery's interpretation. At the November 3, 2021 hearing before a panel of the Delaware Supreme Court, Shire contended that enforcing the milestone payment would create an "unfair windfall" for the former target stockholders, given that the FDA had halted further testing on the drug (and that the prior delays by Shire were to ensure the efficacy and safety of the drug). Chief Justice Collins Seitz commented that there seemed to be neither a windfall nor unfairness as payment of the milestone payment under these circumstances was what the parties had provided for in their merger agreement. He noted that the focus of the milestone provisions in the agreement was certainty of payment on December 31, 2015.

Conclusion. The decision indicates that, when the phrase "as a result of" is used, the drafting should clarify whether the intended meaning is "solely as a result of." (*See* "Drafting Points" below.)

Drafting Points Arising Out of *Pacira* and *Shire:*

- **Merger agreement parties should consider carefully what rights and restrictions, if any, will apply post-closing to the buyer and/or the selling stockholders relating to efforts to achieve an earnout.** While both the buyer and the selling stockholders in most cases will have a common objective in achieving an earnout, their interests may diverge. A buyer must balance its efforts in achieving earnout triggers with its other objectives, while the selling stockholders' sole interest typically would be that the earnout is achieved. Also, if the company is *close to* achieving financial performance earnout triggers, the selling stockholders' interest in its being achieved may be much greater than the buyer's. Although generally a merger agreement will provide that the buyer will control the company post-closing, including all aspects of developing and implementing a strategy to

achieve the earnout, many agreements do not contain specific restrictions on selling stockholders to refrain from making efforts to influence the buyer, or taking other steps, in connection with facilitating achievement of the earnout. Buyers should consider seeking to include such restrictions to prevent the selling stockholders from taking actions that could conflict with, confuse, or otherwise complicate or hinder the buyer's own efforts, or more generally could interfere with the company's employees, advisors, and relationships (with regulators, customers, contractual counterparties, and so on).

- ***Define buyer's post-closing efforts to achieve the milestones.*** The buyer's right to control the acquired company post-closing, including with respect to achieving the earnout, should be expressly stated. The buyer's obligations to seek to achieve the earnout may range from a broad good faith and reasonable efforts standard (as in *Pacira*) to a detailed list of actions the buyer intends to take (subject to a right to change its mind) or will be required to take. In some circumstances, the selling stockholders may want a specified initial plan set forth as to how the earnout will be achieved (generally, subject to the buyer's right to change the plan, other than with respect to specified required actions).

- ***Define selling stockholder's efforts.*** If the selling stockholders have special knowledge or influence the buyer wants them to bring to the effort of achieving the earnout, the agreement could specify a general obligation to assist and cooperate or could set forth a detailed list of actions the stockholders will be required to take. In other circumstances, the buyer may want to have a consulting agreement with selling stockholders pursuant to which they would be required to participate with the buyer in seeking to achieve the earnout, as requested by the buyer or pursuant to a list of specific obligations that are set forth.

- ***Define restrictions on the selling stockholder's efforts.*** This was the element missing from the *Pacira* agreement (and, as discussed, the court refused to infer obligations when they had not been specifically set forth in the agreement).

    - A buyer may wish to provide that, in furtherance of its right to sole control of the target post-closing, the selling stockholders will not make any efforts to influence of seek to ensure achievement of the earnout. Alternatively, the parties might provide that any such efforts will be limited to the selling stockholders providing information or suggestions to specified personnel of the buyer and/or the target (or will be made only pursuant to some other specified process).

    - A buyer should consider specifying that the selling stockholders will not contact regulatory agencies, target company customers, employees, advisors, or other third parties, to obtain information relating to the earnout, or in any effort to persuade such persons to take or refrain from taking actions that would affect the earnout, or otherwise to seek to affect the achievement of the earnout (unless at the buyer's request or with its prior consent).

    - The need for such restrictions may be greater with respect to selling stockholders who were managers of the target company.

    - For restrictions set forth in the merger agreement to be binding on selling stockholders, generally the stockholders must either be signatories to the merger agreement or the restrictions must be incorporated by reference into the stockholder's transmittal letter.

- **Drafters should clarify the meaning of the phrase "as a result of."** It should be made clear whether "as a result of X" means "solely as a result of X," or "primarily as a result of X," or "as a result of X among other factors."

- **While an earnout provision is often thought of as a relatively easy fix to major valuation problems, merger agreement parties should be mindful that a well-crafted earnout provision involves significant challenges in terms of negotiation and drafting, and earnouts often lead to post-closing litigation.** Alternatives to the use of earnouts should be considered where appropriate; and, if an earnout is utilized, it should be carefully drafted to mitigate the risk of disputes (including by providing dispute resolution procedures). Lawyers should draft earnout provisions in conjunction with business people who have an in-depth understanding of the business, products, industry and regulatory regime at issue. Importantly, drafters must be mindful that earnouts implicate numerous *interrelated* provisions—involving, for example, the metrics for the earnout formula or parameters for the milestone event, the process for making the earnout determinations, and the buyer's and sellers' respective rights and obligations with respect to the operation of the acquired business during the earnout period (including the general level of efforts, and any specific efforts, as well as any restrictions on efforts (as discussed above), to be made by the parties in connection with seeking to achieve the earnout). In addition, earnouts create special considerations for the governing law and remedies provisions, among others.

See also our prior M&A/PE Briefings on earnouts, *The Enduring Allure and Perennial Pitfalls of Earnouts*, available at https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/; and *A Tale of Two Earnouts,* available at https://corpgov.law.harvard.edu/2018/10/02/a-tale-of-two-earnouts/.

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