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The Importance of Drafting Precise Earnout Provisions in M&A Transactions

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In spring 2019, Pacira Biosciences, Inc. (Pacira) acquired MyoScience, Inc. (MyoScience)[1] . At the time of the merger, MyoScience only had one product, called "iovera," which is a handheld device used primarily for pain relief[2] . The parties agreed on an upfront purchase price of $120 million, and thereafter, former MyoScience stockholders and option-holders were entitled to up to $100 million in contingent earnout payments[3] . $50 million of the contingent earnout payments were tied to the Centers for Medicare and Medicaid Services (CMS) reimbursement rates[4] .

Reimbursement rates are set using procedural code numbers defined and updated by the American Medical Association (AMA)[5] . CMS sets how much Medicare and Medicaid will reimburse healthcare providers for each coded procedure, but this amount varies based on the care setting and locality and can vary significantly[6] . In May 2018, prior to the merger, the AMA announced a new procedure code, 64xx1, that would later be finalized. MyoScience hoped the new procedure code would increase the reimbursement rates for procedures using iovera, and therefore, increase the value of the product[7] .

Given the uncertainty in reimbursement rates and therefore the value of iovera, the deal was structured so that $50 million of contingent earnout payments were tied to reimbursement rates for iovera based on the following milestones: (1) a payment of $20 million if the CMS reimbursement rate reached $600 per procedure in an office setting, (2) a payment of $20 million if the CMS reimbursement rate reached $800 per procedure in ambulatory surgery centers, and (3) a payment of $10 million if the reimbursement rate reached $1,400 per procedure in the out-patient hospital setting[8] .

CMS issued the final 2020 reimbursement rates in November 2019, and Pacira determined that based on such rates, only the milestone for the hospital out-patient setting had been met[9] . In May 2020, Fortis Advisors, LLC (Fortis), the representative of MyoScience's stockholders, sent a letter to Pacira asserting that the reimbursement milestones for office settings and ambulatory surgery centers had also been met because additional codes had been used that yielded reimbursement rates exceeding the payment threshold for such milestones[10] . Pacira and the plaintiffs filed suit for declaratory judgment, and Fortis and the defendants filed a countersuit for breach of contract[11] .

The Court's Contract Interpretation

The Delaware Court of Chancery found the case to be a contract interpretation issue based on two issues: (1) whether specific locality-adjusted rates, which would have triggered the earnout milestones, should have been used in determining if such milestones were met, and (2) whether the earnout milestones could be triggered by additional procedure codes other than 64xx1, the temporary code that the AMA was finalizing at the time of the merger[12] .

For the first issue, Fortis argued that the earnout milestones were triggered based on both locality-adjusted and national reimbursement rates, whereas Pacira argued that only the national reimbursement rate could trigger the earnout milestones[13] . The Court found the language of the merger agreement to be ambiguous regarding whether the earnout milestones were measured by national or locality-adjusted rates, so the court turned to extrinsic evidence to determine the intent of the parties[14] . The Court found that the extrinsic evidence overwhelmingly indicated that the parties' intent at the time of the merger agreement was for national reimbursement rates to serve as the metric for the earnout milestones[15] . Among other extrinsic evidence, the Court found that the parties discussed national reimbursement rates throughout their negotiations, but never discussed the locality-adjusted rates. Additionally, after the merger, the parties only discussed national reimbursement rates[16] .

For the second issue, Pacira argued that only procedural code 64xx1 can trigger the earnout milestones, whereas Fortis argued that the milestones were not limited to only procedural code 64xx1[17] . The Court turned to the plain language of the merger agreement, under which 64xx1 and "different" codes were treated separately[17] . Code 64xx1 only requires that reimbursement be effective for that code which, to the Court, made sense given that at the time of the merger, 64xx1 referred to a forthcoming code that was not yet effective[18] . Whereas "different" codes must be both effective and describe procedures for which iovera is actually used[19] . Fortis was able to show that the different codes were effective but was unable to prove actual use of iovera for such other procedural codes[20] . Thus the court sided with Pacira.

Key Takeaways

As this case makes clear, earnout provisions require precise drafting to avoid ambiguity between the buyer and seller. While in many cases, the buyer and seller both benefit from achieving such milestones, the parties must align on how those milestones are measured. And where the measurement of those milestones could be open to interpretation, such as here, it's important for both sides to recognize and resolve any such ambiguity in the earnout provisions. Courts, as in

Pacira, will look to the plain language of earnout provisions when determining if or when milestones have been met. Those earnout provisions need to be carefully drafted to make milestones clear so the parties, and the courts, know when earnout milestones are met.

Additionally, *Pacira* demonstrates that courts may look to extrinsic evidence when interpreting ambiguous earnout provisions. Extrinsic evidence can be a deciding factor for the courts in such circumstances, and parties should be aware that their communications and negotiations may be used by the courts to determine the parties' intent.

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Footnotes

[1] *Pacira Biosciences, Inc. et al. v. Fortis Advisors, LLC*, C.A. No. 2020-0694-PAF (Del. Ch. Jan. 21, 2025).

[2] *Id*. at 2.

[3] *Id*. at 11.

[4] *Id*.

[5] *Id*. at 3

[6] *Id*.

[7] *Id*. at 7.

[8] *Id*. 12-13.

[9] *Id*. at 15.

[10] *Id*. at 16.

[11] *Id*. at 17.

[12] *Id*. at 19.

[13] *Id*. at 18.

[14] *Id*. at 28.

[15] *Id*.

[16] *Id.* at 29-30.

[17] *Id.* at 33.

[18] *Id.* at 38.

[19] *Id.* at 36.

[20] *Id.* at 38.

[21] *Id.* at 41.

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