LEGAL UPDATES

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Delaware Chancery Court Decisions Outline Important Drafting Points for Earnout Terms in M&A Transactions

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Overview

Earnout provisions give sellers of a company rights to additional consideration if the acquired business achieves certain financial goals or specified milestones post-closing. Earnouts are often used to bridge pricing gaps in deal negotiations when the future value of the target is uncertain or hard to measure, such as startups or research and development companies. They allow the parties to condition the payment of a portion of the purchase price on the occurrence of milestone events, such as achieving EBITDA targets or obtaining regulatory approvals for products under development.

Earnout provisions have grown in popularity in recent years. They can be found in about 30% of recent private M&A transactions. They have been used in more than 50% of all recent SPAC mergers and in more than 60% of recent private life sciences deals. (*See 2019 Private Target Mergers & Acquisitions Deal Points Study, M&A Market Trends Subcommittee, Mergers & Acquisitions Committee, American Bar Association Business Law Section*). The increased use of earnouts has resulted in heightened litigation, which has provided drafting guidance to practitioners.

Last year, two decisions in the Delaware Chancery court—*Pacira Biosciences, Inc. et al. v. Fortis Advisors LLC et al., 2021 WL 4949179 (Del. Ch. Oct. 25, 2021*) and *S'holder Rep. Servs. LLC v. Shire US Holdings, Inc., 2020 WL 6018738 (Del. Ch. Oct. 12, 2020)*—have altered the standard reliance on earnout provisions and provide insight as to how they may be interpreted in the future. In both *Pacira* and *Shire*, the court refused to recognize any implied covenants or restrictions on the parties, and instead based its interpretation on the plain meaning of the express language of the agreements.

Pacira v. Fortis

In *Pacira*, Pacira BioSciences, Inc. had acquired MyoScience, Inc. for $120 million cash up front and a potential earnout payment of up to $100 million. MyoScience manufactured Iovera, a medication device that delivers doses of extreme cold to targeted nerves for pain management. The earnout payments to MyoScience would become due if certain new and specific Medicaid and Medicare reimbursement codes for Isovera were issued. Such reimbursement codes are critical to the ability of a particular medical product to be covered by Medicaid and Medicare. After completion of the merger, it became doubtful that new reimbursements codes would be issued and therefore doubtful that the earnout payments would be triggered. As a result, three former MyoScience executives – the CEO, head of marketing and lead scientist – who had sold their shares in the merger acted in concert to ensure that the minimum threshold of new reimbursement codes would be issued so as to achieve the milestone. The sellers proceeded to contact and make demands of personnel at Pacira to influence and direct them to ensure Pacira obtained the new reimbursement codes.

Eventually, new reimbursement codes that arguably satisfied the milestone objectives were issued, but Pacira refused to pay, arguing that even if the new codes satisfied the milestone objectives, the sellers breached their contractual obligations in the merger agreement by (i) sharing confidential information with each other regarding Pacira's internal discussions about the drug, (ii) retaining MyoScience's former outside counsel for Medicare/Medicaid issues to help them strategize and influence the achievement of the milestone and (iii) generally taking actions that interfered with Pacria's control of the business post-closing.

In support of their claim, Pacira relied on two sections of the earnout provision: (i) one stated that "the sole and exclusive right" of the sellers would be to receive the earnout payments if the milestone was reached and (ii) the other one provided that Pacira would have the right to operate the business as it chooses, in its sole discretion. Pacira argued that these provisions, taken together, require that the seller shareholders "refrain from interfering" in Pacira's internal affairs and operations, and that the sellers violated the agreement by interfering with internal operations to ensure payment of the earnout.

The Delaware court rejected Pacira's argument. It found that the provisions referenced by Pacira did not impose any affirmative obligations on the sellers to refrain from acting to ensure achievement of the milestone. In its opinion, the Court emphasized that there was no reference to any "obligation" of the sellers. Thus, the agreement was unambiguous in not imposing such obligations and that if Pacira had desired to impose them, they should have bargained for them and included them in the agreement. The *Pacira* ruling shows that courts will not impose any implied contractual obligations with respect to earnouts when it is clear that the parties had thoroughly negotiated the earnout and would have expressly included such obligations had they been agreed to.

Shareholder Representative Services v. Shire

In a similar fact pattern to *Pacira*, Shire Pharmaceuticals acquired FerroKin Biosciences, Inc., a company developing the experimental drug Deferitazole to treat excess iron levels in cancer patients. The merger agreement called for a payment of $95 million up front and up to $225 million in potential earnout payments. The milestones pertained to the starting of certain Phase III trials for the drug and stated that payment would become due unless (i) the drug in fact failed to commence Phase III trials **and** (ii) the failure to commence the trials 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 obtain regulatory approval for a drug."

After the closing, Shire continued development of the drug but began to experience significant cost overruns and delays. The Shire leadership exchanged communications doubting the ultimate success of the drug, citing delays, excessive costs, safety risks and the determination that an over-the-counter version of the drug was likely to become available soon. Around the same time, the FDA ordered a temporary halt to further trials of Deferitazole due to health and safety concerns – an event that constituted a Fundamental Circumstance. Phase III trials never commenced, and Shire notified the sellers that the earnout consideration would not be paid. The issue then turned on (i) whether such failure was "as a result" of a Fundamental Circumstance, in which case no earnout was due, or (ii) whether the failure had been caused by other factors, in which case the sellers were entitled to the contingent payments, regardless of the failure to commence Phase III trials.

In the opinion, the Delaware Court rejected Shire's argument and ordered them to pay the earnout consideration to the sellers. The Court held that while the FDA restriction on further testing constituted a Fundamental Circumstance, the failure to commence the Phase III trials was not a result of the FDA order. The court cited the communications within Shire's leadership doubting the viability of the drug and found that Shire failed to bring the drug to Phase III trials due to routine drug development delays and financially motivated business decisions, and that such failure had not been caused by any FDA action. In reaching its decision, the Court interpreted "as a result of" to mean that a Fundamental Circumstance must be the **only** reason causing the failure to reach Phase III trials for the earnout to fail. Since other factors had also contributed to the milestone not being achieved, Shire was ordered to pay. The Court emphasized the parties should have clarified the meaning of "as a result of" and whether they intended this to mean "solely as a result of X," "primarily as a result of X," "as a result of X among other factors," or any other potential meaning.

Takeaways and drafting tips

In examining *Pacira* and *Shire*, the main takeaway is that earnout provisions need to explicitly account for situations where the objectives of the buyer and seller may not align regarding attainment of the milestones triggering payments. While in most cases the buyer and seller will have a common interest in achieving the milestones, that is not always the case. The buyer's actions will be driven by business and operational considerations such as cost containment and profitability, whereas the seller's sole objective is getting paid. Definitive agreements should flesh out, to the greatest extent possible, the rights and restrictions of the parties that will govern during the earnout period.

Both cases represent a change to the standard interpretation of earnout provisions in that parties should not continue to depend on implied covenants or obligations or potentially ambiguous provisions when it comes to earnouts. Parties should rely only on the plain language of the express terms of the contract and carefully describe milestone events to avoid ambiguity or room for interpretation. Sell-side counsel will want to impose post-closing obligations on buyers such as a general good faith and reasonable efforts standard, in addition to specific covenants that will protect the earnout. Conversely, based on *Pacira*, buy-side counsel will want to apply restrictions on the sellers to prevent them from interfering with the business after the closing. Basic acknowledgments that the buyer will have sole control of the company after the closing may not be enough to (i) prevent interference from the sellers or (ii) prevent claims that the buyer's actions triggered the earnout payments through its business decisions.

Pacira and *Shire* highlight the importance of hiring legal and industry experts who have an in-depth understanding of the products, trade and applicable regulations when negotiating earnouts. As we saw in *Shire*, whether a multimillion-dollar milestone payment would be paid turned on the interpretation of the seemingly simple phase "as a result of," which was not defined with sufficient specificity. The two cases underline the importance of thorough business discussions among sophisticated counsel, sellers and operators to minimize risks associated with potentially varying interpretations of earnout provisions.

Contact us

Husch Blackwell continues to monitor the relevant caselaw affecting earnouts and its implications for our clients. Should you have any questions, please do not hesitate to contact Remy Fesquet, Kirstin Salzman, Brian Wetzstein or your Husch Blackwell attorney.