ALERT MEMORANDUM

Delaware Court of Chancery Finds in Favor of Buyer in Earnout Dispute Based on Ambiguous Milestone Provision

January 28, 2025

Milestone earnout provisions in acquisition agreements attempt to bridge the valuation gap by conditioning portions of the purchase price on post-closing milestones, and are particularly common in the medical and pharmaceutical industry where the valuation of drugs and medical devices can be uncertain. On January 21, 2025, in *Pacira Biosciences, Inc. et al. v. Fortis Advisors LLC*, the Delaware Court of Chancery found in favor of a buyer in an earnout dispute based on ambiguous milestone after examining extrinsic evidence, including evidence showing that the seller and its consultant devised a new interpretation of the agreement months after both parties had acknowledged that the milestones had not been met.[1]

Background and Decision

In the spring of 2019, Pacira Biosciences acquired MyoScience, a privately held medical technology company, for $200 million, consisting of a $120 million upfront payment and $100 million in potential milestone payments.[2]

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[1] *Pacira Biosciences, Inc. et al. v. Fortis Advisors LLC*, C.A. No. 2020-0694-PAF (Del. Ch. Jan. 21, 2025).
[2] *Id.* at 11.

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At the time of the merger, MyoScience had one product: iovera, a handheld medical device used for pain relief.[3] Like many other medical devices, the value of iovera is influenced by the reimbursement rates clinicians and health care providers receive for its use.[4] Health care providers submit bills for their services using standardized procedure codes defined by the American Medical Association ("AMA"), and the Centers for Medicare and Medicaid ("CMS") set and annually update national reimbursement rates for each procedure code.[5] However, these national reimbursement rates only serve as a reference point for comparison within the industry.[6] Care providers are paid based on a calculation that adjusts the reimbursement rate based on locality to reflect the cost of care in a given area.[7] Prior to the merger, MyoScience saw a large potential market for iovera but low reimbursement rates, hindering widespread adoption.[8] In May 2018, the AMA announced a new procedure code, temporarily labeled "64xx1," which MyoScience anticipated to reimburse for iovera.[9]

To account for the uncertainty of the CMS reimbursement rate for the forthcoming procedure code, the merger agreement attached $50 million of the potential milestone payments to three CMS reimbursement-related milestones.[10] The first milestone was a payment of $20 million if the CMS reimbursement rate for iovera reached $600 per procedure in an office setting.[11] The second, a payment of $20 million if the reimbursement rate reached $800 per procedure in ambulatory service centers.[12] And lastly, a payment of $10 million if the reimbursement rate reached $1,400 per procedure in out-patient hospital settings.[13]

In November 2019, CMS issued the final 2020 national reimbursement rates.[14] Only the third milestone had been met based on the national reimbursement rate, and in May 2020, Pacira paid that milestone.[15] Later that month, the representative of the MyoScience securityholders sent Pacira a letter, asserting that the other two milestones had been met, basing its assertion on two factors that collectively resulted in billing rates exceeding the milestone thresholds: first, additional procedure codes other than 64xxl should have been taken in to account; and second, specific locality-adjusted rates (which were higher than the national rates) should have been used.[16] In August 2020, Pacira filed suit for declaratory judgment and the MyoScience securityholders quickly filed a countersuit for breach of contract.[17]

Contract Ambiguity

After a bench trial, the Court determined that the case was purely a contract interpretation issue.[18] Regarding the first factor, the Court held that the agreement clearly allowed a procedure code other than 64xx1 to trigger the thresholds, but such other procedure code must both be effective and describe procedures for which iovera was actually used.[19] The securityholders were unable to prove that another procedure code describes the procedures for which iovera was actually used.[20]

In contrast, on the second factor, the Court held that the merger agreement was ambiguous as to whether the term "CMS Reimbursement" referred to the national or locality-adjusted rate.[21] The Court looked to the "four corners of the contract" and found that there was no reference to CMS reimbursement rates

[3] *Id.* at 2.
[4] *Id.* at 7.
[5] *Id.* at 3–4.
[6] *Id.* at 5.
[7] *Id.* at 4.
[8] *Id.* at 7.
[9] *Id.* at 8.
[10] *Id.* at 11.
[11] *Id.* at 12.
[12] *Id.*
[13] *Id.* at 13.
[14] *Id.* at 14.
[15] *Id.* at 15.
[16] *Id.* at 16.
[17] *Id.* at 16–17.
[18] *Id.* at 22.
[19] *Id.* at 41–42.
[20] *Id.*
[21] *Id.* at 26.

elsewhere in the merger agreement.[22] Additionally, neither interpretation firmly displaced the other: "the words on the page of the Merger Agreement leave plenty of room for both interpretations."[23]

Extrinsic Evidence in Contract Interpretation

To properly give effect to the parties' intent, the Court turned to extrinsic evidence, including pre and post-merger communications, to determine what the parties understood "CMS Reimbursement" rate to mean at the time of drafting.[24]

The Court found that the extrinsic evidence "overwhelmingly" indicated that the parties' shared intent at the time of the drafting was for the national reimbursement rates to serve as the relevant metric.[25] Looking to pre-agreement negotiations, the Court noted that the parties discussed national reimbursement rates throughout their negotiations, but never discussed locality-adjusted rates, and no one from MyoScience even looked into locality adjusted rates during the negotiations.[26]

Additional extrinsic evidence and communications from after the merger supported that the parties shared this interpretation of the milestones.[27] Between July and November of 2019, the parties' correspondence regarding the milestones only referenced national rates.[28] When the finalized rates came out in 2019, MyoScience's former CEO lamented that they had not reached the thresholds for the first two milestones based on the national reimbursement rate.[29] Furthermore, in the early months of 2020, the former MyoScience securityholders only expressed concerns that the timeline of the payment for the third milestone was slow, not that Pacira had used the wrong metric to determine whether the milestones had been met.[30]

The Court found that the locality-adjusted reimbursement rate theory originated when a consultant devised the theory in spring 2020.[31] The Court held that, while the consultant did proffer "a reasonable interpretation" of the language, "proffering a reasonable interpretation of ambiguous language cannot, alone, carry the day."[32]

Key Takeaways

- **Identifying Key Drivers of Milestones and Meticulous Drafting:** This case highlights how important it is for parties to a transaction to develop a clear understanding of the key drivers of earnout milestones (here, the different reimbursement codes and the differences between national and local rates). It also highlights the challenges in drafting unambiguous earnout milestone language, particularly given the incentives that litigants (and their consultants) have to identify potential ambiguities and new interpretations after the fact. Like several other recent cases,[33] the case again calls attention to the importance of close collaboration between legal and science teams in drafting milestones in order to avoid costly litigation and potentially unpredictable outcomes.
- **Importance of Maintaining a Clear Record:** As earnout litigation becomes increasingly common, it is of the utmost importance that parties build a clear record regarding negotiations of these provisions. While Delaware courts generally do not look outside the four corners of an agreement, they will do so in cases of ambiguity to understand the parties' intent. In light of this risk, it is critical that parties to a transaction are appropriately informed about the technical details of earnout milestones and are sensitive to the fact that their

[22] *Id.* at 25.
[23] *Id.*
[24] *Id.* at 28.
[25] *Id.*
[26] *Id.* at 28–29.
[27] *Id.* at 29.
[28] *Id.* at 30
[29] *Id.* at 31–32.
[30] *Id.* at 31.
[31] *Id.* at 32.
[32] *Id.*
[33] *See* *Shareholder Representative Services LLC solely in its capacity as representative of the Securityholders v. Alexion Pharmaceuticals, Inc.*, C.A. No. 2020-1069-MTZ (Del. Ch. Sept. 5, 2024)

contemporaneous communications and records of their negotiations may be determinative in a court's interpretation of the parties' obligations.

- **Agreements that Limit the Relevance of Extrinsic Evidence, While Useful, May Not Limit the Use of All Extrinsic Evidence:** Myoscience and Pacira's merger agreement contained a clause providing that prior drafts, course of performance, and course of dealing could not be used to interpret the merger agreement.[34] The Court respected this provision and made clear that its decision did not rely on prior drafts or the parties' course of performance (including the fact that the MyoScience securityholders had accepted a separate undisputed milestone payment based on the national reimbursement rate).[35] However, this provision did not preclude the Court from considering other extrinsic evidence of the parties' intent, such as the negotiation history and the seller's own after-the-fact communications, which showed that the interpretation the seller advocated in the litigation was developed retrospectively by its consultants.
- **Consider Loser-Pays Provisions:** This case is consistent with the broader trend of increased litigation involving earnouts. We expect that trend to continue based on the increased prevalence of earnout provisions in life science and pharmaceutical transactions, as well as the incentives to litigate that typically exist when an earnout milestone is not met. Given that context, parties should consider carefully whether to include loser-pays provisions in transaction agreements. While the inclusion of such provisions is not without risk, it may be decrease the likelihood that non-meritorious claims will be pursued and reduce potential defense costs.

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[34] *Pacira Biosciences, Inc*., 2020-0694-PAF at 29–30, n. 95. [35] *Id.*