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Solving The Valuation Puzzle in Life Sciences Transactions: The Pros and Cons of the CVR

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Earnout provisions of all stripes have long populated the private company M&A landscape. But the public company equivalent, contingent value rights (CVRs), has been a much rarer bird. Over the past five years, in the thousands of announced public company M&A transactions, CVRs were a component of the transaction consideration in fewer than 1%. In 2015, only five public company transactions included a CVR and in 2014, there were only nine. Though rare, CVRs are, however, far from extinct and can be a powerful tool for bridging valuation gaps in public company M&A transactions.

CVRs come in two basic varieties: price-protection CVRs and event (or milestone)-triggered CVRs. Price-protection CVRs promise target shareholders additional consideration if the acquirer securities fail to meet certain trading price thresholds over time and are typically used where the acquirer's securities are a key component of the transaction consideration. Event-triggered CVRs, which are much more typical, promise target shareholders additional consideration if, after the transaction closes, certain events occur.

Event-triggered CVRs have most frequently appeared in life science/pharmaceutical (LS/Pharma) transactions where targets' pipeline products are seen to have great potential value but also carry significant uncertainty as to when and whether that value can be realized. This uncertainty may arise due to the complex nature of the science involved, FDA or non-U.S. regulatory approval requirements, the strength (or weakness) of patent exclusivity, or the unpredictability of future sales or profit margins. And this uncertainty around pipeline products often leads to a valuation gap between the acquirer and the target company. Event-triggered CVRs are a way to bridge that gap.

Shire Plc's November 2015 announced acquisition of Dyax Corporation is the most recent example of such a transaction. The Shire CVRs provide Dyax's shareholders with the right to receive a cash payment of $4 per share (an approximate premium of 10% of the total consideration paid at closing) if, prior to December 31, 2019, the FDA grants approval to market and sell in the United States a specific product in the Dyax pipeline. The CVR provides that Shire is required to make "Diligent Efforts" to seek and obtain such FDA approval, with "Diligent Efforts" defined as using such efforts and resources normally used by persons of comparable size within the pharmaceutical industry for the development and seeking of regulatory approval for a pharmaceutical product having similar market potential as the specified product at a similar stage of its development or product life, taking into account all relevant factors including issues of market exclusivity, product profile, other product candidates, the launch or sales of a generic or biosimilar product, the regulatory environment and the expected profitability of the applicable product.

Because event-triggered CVRs are the most common, and because they are so well-suited to LS/Pharma M&A transactions, this article will focus on the pros and cons of utilizing event-triggered CVRs in that context.

CVR Pros

CVRs provide sufficient benefits to warrant a place at the top of the M&A toolkit in LS/Pharma transactions. One of the main benefits is *flexibility*. The terms of a CVR can be crafted to fit a transaction based on the parties' business expectations and desires. Event triggers can include a large variety of external events (such as the commencement of initial patient testing), receipt of regulatory approvals (such as FDA or EMA approvals) and meeting of financial milestones (which can include not only specific thresholds but also include customized financial definitions). Some of the other principal benefits of CVRs are *certainty*, *liquidity*, and *rationality*.

Certainty

A CVR can help increase certainty in at least two ways: certainty of value and certainty of closing. With respect to certainty of value, although more art than science, using a CVR to fill a valuation gap dependent on meeting certain triggers may result in greater precision than trying to attribute current value in highly speculative circumstances. This is particularly true in LS/Pharma transactions, where early stage products may be meaningful valuation drivers. With respect to certainty of closing, using a CVR can eliminate the need to wait for certain key value events (such as FDA approvals) to take place before a transaction can be consummated.

Liquidity

Cash is king, but sometimes paper is prince. When an acquirer has limited ability to pay cash, a CVR can help complete transactions without the dilutive effect of issuing stock as part of the consideration. CVRs are, in effect, a financing mechanism which delays payment of a portion of the purchase price until the specified events are achieved. As U.S. interest rates begin to rise over the next few years and borrowing becomes relatively more expensive, this liquidity function will likely become of greater relevance. Even if the ability of an acquirer to borrow is not an issue, the current utility of cash in the hands of the acquirer may be of greater value than the potential long-term cost of a CVR.

Rationality

A target company in an LS/Pharma M&A transaction will almost always need shareholder buy-in to obtain the necessary level of tenders in a two-step transaction or the necessary merger vote in a one-step transaction. And, if a stock component is also included in the consideration, the acquirer may need to hold a shareholder vote if it intends to issue shares exceeding the 19.9% threshold. In both circumstances, the ability to tell a rational story as to how an early stage product was valued can be important. And the use of a CVR, which pays if and only if certain key value events occur, can make that story a more rational one to tell.

CVR Cons

Most deal professionals in the LS/Pharma M&A space will attest that CVRs are often considered but not often utilized. The limited historical usage of CVRs is due primarily to two meaningful perceived risks: *complexity* and *liability*.

Complexity

While, as discussed above, *flexibility* may be one of the CVRs primary benefits, that flexibility may also spawn considerable *complexity*. CVRs can include multiple layers of event triggers and numerous customized financial definitions. In addition, CVRs are sometimes (though not often) SEC registered and exchange traded. The rationale for registering a CVR is that the greater liquidity may provide a value enhancer. However, many acquirers ultimately decide that the complexity of the registration, listing, and maintenance process is too complicated (and expensive) to pursue.

Liability

As with private company earnouts, CVRs can present an acquirer with a litigation risk where CVR triggers are not met and shareholders are unhappy. Most recently, shareholders of Genzyme have brought claims against Sanofi arising from the CVR issued in Sanofi's $20 billion acquisition of Genzyme in 2011. In that transaction, the Sanofi CVR promised Genzyme shareholders an additional potential $3.4 billion in consideration in the event that Genzyme's drug Lemtrada received certain FDA approvals by March 31, 2014. Now, four years after the transaction closed, Genzyme's CVR holders have brought a claim against Sanofi alleging that, in order to avoid the $3.4 billion payment under the CVR, Sanofi has failed to exercise "Diligent Efforts," as required pursuant to the agreement, to obtain FDA approval for Lemtrada. In support of their claim, the Genzyme CVR holders have sought to introduce evidence that Sanofi has been developing its own competing drug that, if successful, would provide them with the same economic profit without the cost of the $3.4 billion payment under the CVR.

Mitigating the Cons

Although it is not possible to eliminate all the risks that a CVR may pose to an acquirer, the perfect does not have to be the enemy of the good. There are ways to structure an event-triggered CVR that may mitigate many of the disadvantages discussed above.

First, keep it simple. Employing straightforward event triggers will reduce the complexity of negotiations and will also reduce the complexity of the necessary CVR documentation. Straightforward event triggers should also reduce risks of liability. The less uncertainty as to triggers, the less fodder will be available for creative legal claims by shareholders. The Shire/Dyax CVR discussed above is a good example of a CVR that takes this approach.

Second, keep it nontransferable. Although registering and listing a CVR may theoretically enhance value, a CVR which is nontransferable reduces complexity since it eliminates the time and expense of SEC registration, exchange listing, and reporting requirements. A nontransferable CVR may also reduce liability risk since such a CVR could then be structured to not constitute a "security" for federal law purposes. If a CVR is not a "security," claims (if any) that an acquirer could be subject to would likely be limited to state law contractual claims and not federal securities law claims. State law contractual claims often have restrictions on liability (*e.g.*, no "lost profits" damages) as well as limitations on the availability of class action status for classes encompassing out-of-state parties.

Third, keep it transparent. Clear and full disclosure about the uncertainty of triggering events and the uncertainty of valuation is critical in the CVR context. Such disclosure should help substantially reduce liability risks.

Fourth, keep it collective. To the extent permissible by law, any actions regarding the enforceability of, or claims under, a CVR should require the consent of at least a majority of the CVR holders.

If individual actions by CVR holders are not permitted, and if shareholders knowingly waive their rights to bring such actions and agree to be bound by whatever decisions or settlements are entered into by the majority, the liability risk of the CVR may be reduced.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings New York lawyers:

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