Gibson Dunn’s December M&A Insights

Dec 6, 2023 12:00 PM ET

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Today's Panelists

Branden Berns

Branden Berns is a partner in the San Francisco office of Gibson, Dunn & Crutcher, where he practices in the firm's Corporate Transactions Practice Group, with a practice focused on representing leading life sciences companies and investors. Mr. Berns advises clients in connection with a variety of financing transactions, including initial public offerings, secondary equity offerings and venture and growth equity financings, as well as complex corporate transactions, including mergers and acquisitions, asset sales, spin-offs, joint ventures, PIPEs and leveraged buyouts. Mr. Berns regularly serves as principal outside counsel for publicly-traded companies and advises management and boards of directors on corporate law matters, SEC reporting and corporate governance.

Pamela Lawrence Endreny

Pamela Lawrence Endreny is a partner in the New York office of Gibson, Dunn & Crutcher. Ms. Endreny represents clients in a broad range of U.S. and international tax matters. Ms. Endreny's experience includes mergers and acquisitions, spin-offs, joint ventures, financings, restructurings and capital markets transactions. She has obtained private letter rulings from the Internal Revenue Service on tax-free spin-offs and other corporate transactions. She has been repeatedly selected for inclusion in Chambers USA: America's Leading Lawyers for Business, and was also named a Tax "MVP" by Law360. Ms. Endreny is a member of the Executive Committee of the New York State Bar Association Tax Section. She is also a member of the Tax Forum and Private Investment Fund Tax Forum.

Andrew Kaplan

Andrew Kaplan is a partner in the New York office of Gibson, Dunn & Crutcher, where his practice focuses on mergers and acquisitions, and corporate governance matters. Mr. Kaplan represents both public and private acquirors and targets in connection with mergers, acquisitions and takeovers, both negotiated and contested. Mr. Kaplan also advises corporations and their boards of directors in connection with corporate governance and compliance matters, shareholder activism, takeover preparedness and other corporate matters. He also represents various major investment banks as financial advisors in M&A transactions, and hedge funds in their M&A and investment activities. Mr. Kaplan also has represented both issuers and underwriters in a variety of securities transactions.

Lora Elizabeth MacDonald

Lora Elizabeth MacDonald is of counsel in the Washington, D.C. office of Gibson, Dunn & Crutcher. She practices in the Firm's Litigation Department, focusing on white collar criminal defense, internal investigations, and corporate compliance. Lora has extensive experience representing multinational corporations as well as individuals in connection with internal investigations related to potential violations of the U.S. Foreign Corrupt Practices Act ("FCPA") and U.S. antitrust laws. As part of her practice, she regularly interacts with attorneys at the U.S. Department of Justice and the U.S. Securities and Exchange Commission. Lora has particular experience guiding companies towards the resolution of DOJ and SEC investigations, as well as prophylactic and post-resolution corporate compliance.

How to Use CVRs to Bridge Valuation Gaps

Contingent Value Rights:

Fundamentals and Recent Developments

What are CVRs?

- Mechanism for providing additional value to target or its stockholders after closing based upon future events
- Typically called earn-outs and contingent value rights (we may use terms interchangeably).
- Earn-out is more general term and often used to describe contractual right to additional consideration
- CVR is often used to describe earn-out that takes the form of a separate, registered, tradable security issued to target stockholders that pays out additional consideration to holder based upon future events (but not always registered)

CVRs in Life Sciences

- Event/performance based CVRs are common in life sciences industry
- CVRs can be tailored to the uncertainties inherent to the development and commercialization of pharmaceutical products
- CVRs feature licensing and collaboration concepts that are familiar to life sciences industry participants

Contingent Value Rights:

Fundamentals and Recent Developments

Payment Triggers

- Payment triggers vary with stage of assets: (i) Development Stage (e.g., clinical milestones, regulatory approvals, labeling) and (ii) Commercial Stage (e.g., royalties, sales miletones, EBITDA)
- May be linked to achievement of milestones under existing collaborations
- In drafting payment triggers, key principles from licensing/collaboration deals should be applied:
  - (i) Aim to connect with value creation
  - (ii) Strive for objective, unambiguous triggers
  - (iii) For milestones based upon success, be sure to define success and avoid term sheet language (e.g., “proof of concept”)
  - (iv) For royalties, include definition of royalty-bearing product, definition of net sales, adjustments for stacking, generic/biosimilar competition, royalty term, cap
  - (v) For financial targets (e.g., EBITDA), may need to specify accounting standards

Contingent Value Rights:

Fundamentals and Recent Developments

Diligence Obligations

- For development, regulatory and commercialization CVR triggers, holders will want the acquirer to be obligated to use some level of efforts to reach milestones
- CVR diligence standards range from none at all, to “diligent efforts” or “commercially reasonable efforts,” to dedicated amounts of resources (e.g., FTEs, dollars)
- Boils down to leverage in negotiation
- Defining “commercially reasonable efforts”
  - Push for internal standard, rather than industry standard
  - Ideally, one product, for one indication, for one major market
  - Avoid time-based objectives due to vagaries of drug development
  - Consider safe harbors, such as minimum spend or FTEs
  - Include disclosure that acquirer may be working on similar or alternative programs and consider enterprise-wide needs to pick leading programs

Contingent Value Rights:

Fundamentals and Recent Developments

Form of CVR Payout – Cash vs. Securities

- CVR payouts may be made in cash, acquiror stock or some other security of the acquiror
- If settled in publicly traded stock, the valuation of the shares at settlement can be done through trading prices over a period of time or with a pre-determined price
- Acquirors may want to cap the number of shares issuable for CVR payouts to prevent significant dilution
- Some acquirors negotiate the right to make CVR payments in either cash or securities, or some combination of both, at their discretion

Transferability / Listing

- Many targets prefer that a CVR be transferable, registered and listed, in order to provide liquidity to holders and allow holders to realize proceeds through the sale of CVRs before payouts become due
- Transferability generally means the CVRs are securities (see discussion following)

Contingent Value Rights:

Fundamentals and Recent Developments

Securities Act Considerations

- A CVR, even if payable in cash, may require registration under the Securities Act of 1933 if it is considered a “security”
- SEC No-Action Letters generally deem CVR to be a security unless CVR:
  - Is an integral part of the deal consideration
  - Does not provide holders rights common to stockholders
  - Is non-interest bearing
  - Is not assignable or transferable except by operation of law
  - Is not represented by any form of certificate or instrument
  - Is not dependent on the operating results of any party involved
- Many targets may prefer to have CVRs registered as tradable securities
- Registration can be done on the same form as other types of acquiror securities issued in the transaction (typically on Form S-4)
- Creates additional burden and delay if remainder of consideration is cash only, as registration statement must be prepared and declared effective by the SEC

A CVR that is not deemed to be a security and instead is deemed to be a “contractual right” need not be registered but cannot be transferable.

Contingent Value Rights:

Fundamentals and Recent Developments

Exchange Act Considerations

- CVRs may also give rise to registration and reporting obligations under the Exchange Act of 1934:
  - Section 12(b) requires registration of any security listed on a national securities exchange
  - Section 12(g) requires registration of a class of “equity security” that is held by 2,000 or more persons if the issuer has assets exceeding $10M
- Registration typically effected on a Form 8-A, with information incorporated by reference from the Securities Act registration statement
- Exchange Act reporting may not be an issue for acquirors that are already reporting companies but can be a significant burden for acquirors that are not reporting companies
- Even for existing reporting companies, depending on the nature of the CVR, additional periodic disclosure may be required
  - If CVR payouts are tied to Net Sales or FDA approval, the issuer will need to consider what disclosure is material when measured against the CVRs vs. the issuer’s operations as a whole
- Some CVR agreements specifically require enhanced disclosure for the benefit of CVR holders

Contingent Value Rights:

Fundamentals and Recent Developments

Recent Development #1

- Is a CVR a security?
  - *Is an integral part of the deal consideration*
  - *Is not dependent on the operating results of any party involved*

Recent Development #2

- CVRs in M&A transactions and Shell Company Status

Contingent Value Rights:

Tax Aspects

Treatment on Receipt

- Open Transaction Doctrine
  - *Burnet v. Logan, 283 U.S. 404 (1931)*
  - *Applies only if there is no reasonably ascertainable FMV, which in government's view is only in "rare and extraordinary" cases. Treas. Reg. §§1.1001-1(g)(2)(ii), 15A.453-1(d)(2)(iii)*
  - *If open transaction, not taxable until payments are received; treated as additional consideration for stock sale, imputed interest*
  - *Would not apply to publicly traded CVRs*
- Cash Equivalency Doctrine
  - *Cash method taxpayers should not be taxed on non-negotiable instruments*
  - *Rejected by IRS, 9th Circuit (Warren Jones Co. v. Comm'r, 524 F.2d 788 (9th Cir. 1975)), Court of Claims (Campbell v. U.S., 661 F. 2d 209 (Ct. Cl. 1981)*
  - *Expanded availability of installment sale reporting may make cash equivalency doctrine less sympathetic case*

Contingent Value Rights:

Tax Aspects

Treatment on Receipt (cont'd)

- Installment Sale Reporting
  - *Not available if target stock is publicly traded or if CVR is publicly traded, since no illiquidity problem*
  - *If installment method is available, gain is deferred*
  - *Generally capital gain when received (other than imputed interest)*
  - *Sub-optimal basis recovery because assumes maximum possible payout (or if no maximum, pro-rates basis over relevant time period)*
  - *May result in capital loss at the end that cannot be carried back*
  - *For taxpayer with aggregate installment obligations of more than $5 million, interest charge under §453A on deferred tax liability as though underpaid*

Contingent Value Rights:

Tax Aspects

Treatment on Receipt (cont'd)

- If not open transaction, cash equivalency, or installment sale, then closed transaction
  - *Gain or loss on stock sale fully realized in year of sale, including FMV of CVR*
  - *Basis in CVR equal to FMV*
  - *Future payments under CVR taxable when received to extent exceeding basis in CVR*
  - *Portion of future payments taxable as interest*
  - *Loss on CVR if basis not fully recovered when CVR terminates*

Contingent Value Rights:

Tax Aspects

Treatment on Future Payments

- Character of future payments depends on how CVR is viewed
  - *Separate contract right*
  - *Cash settled call option with respect to acquirer or target stock (inverse of price protection CVR treatment as cash settled put option under Rev. Rul. 88-31)*
  - *Debt instrument*
  - *Purchase price adjustment under original contract*
  - *Origin of the claim doctrine. Arrowsmith, 344 U.S. 6 (1952)*

Contingent Value Rights:

Tax Aspects

CVRs Distributed to Acquiror Shareholders

- Issuance of CVRs
  - *Current property distribution (closed transaction) or open transaction*
  - *Open transaction only available if CVRs not separately tradeable*
  - *But there is likely a reasonably ascertainable FMV*
- Receipt of payments
- Reporting (Form 1099-B) and withholding tax considerations

DOJ M&A Safe Harbor Policy

[New DOJ Policy for Voluntary Self-Disclosures in M&A Transactions]

New DOJ M&A Safe Harbor Policy: Overview of Prior State

- Preexisting DOJ voluntary self-disclosure policies, but no policy specifically directed to M&A transactions
- DOJ's position on successor liability in M&A transactions conveyed in patchwork through cases, speeches, *FCPA Resource Guide*, and Halliburton Opinion Release
- DOJ's 2008 Halliburton FCPA Opinion Release
  - Halliburton's pre-acquisition due diligence stymied by foreign legal restrictions resulting in "insufficient time and inadequate access to information" necessary to assess risks under the U.S. Foreign Corrupt Practices Act ("FCPA")
  - Halliburton Opinion detailed specific procedures for Halliburton to follow in pre- and post-acquisition context; among other directives, DOJ required completion of steps, and disclosure of misconduct, within 180 days of closing
  - DOJ agreed not to prosecute Halliburton assuming satisfaction of procedures detailed in Opinion, but provided no safe harbor for target company
  - Reach of Opinion limited to Halliburton's particular transaction
- *FCPA Resource Guide* published by DOJ and the SEC described high-level guiding principles:
  - "DOJ and SEC . . . recognize that, in certain instances, robust pre-acquisition due diligence may not be possible"
  - In such instances, the agencies "will look to the timeliness and thoroughness of the acquiring company's post-acquisition due diligence and compliance integration efforts"

New DOJ M&A Safe Harbor Policy: Key Aspects of New Approach

- October 4 Monaco speech set expectation that "[a]cquiring companies that **promptly and voluntarily disclose** criminal misconduct **within the Safe Harbor period**, and that **cooperate** with the ensuing investigation, and engage in requisite, timely and appropriate **remediation, restitution, and disgorgement**" "will receive the **presumption of a declination**"
- **Deadlines**:
  - ***Disclosure of misconduct***: within six months of closing (potentially sooner), regardless of when misconduct discovered
  - ***Remediation of misconduct***: within 12 months of closing
- **Exceptions:**
  - Extension of deadlines subject to prosecutorial "reasonableness" analysis
  - Immediate self-disclosure expected if misconduct identified involves (1) national security threat or (2) ongoing or imminent harm
  - Policy inapplicable to conduct that is (1) required to be disclosed or (2) already known to DOJ
- **Benefits:**
  - Presumption of declination applies to (1) acquiring company even if aggravating factors exist at acquired company; (2) acquired company only if no aggravating factors at acquired company
  - Disclosed misconduct at acquired company will not affect future recidivism analysis for acquiring company

New DOJ M&A Safe Harbor Policy: Challenges + Questions Remain

Additional considerations:

- For a company to be eligible for its benefits, DOJ's new Safe Harbor policy requires:
  - Cooperation with any ensuing DOJ investigation, and remediation; and
  - Disgorgement of ill-gotten gains by acquired and/or acquiring company

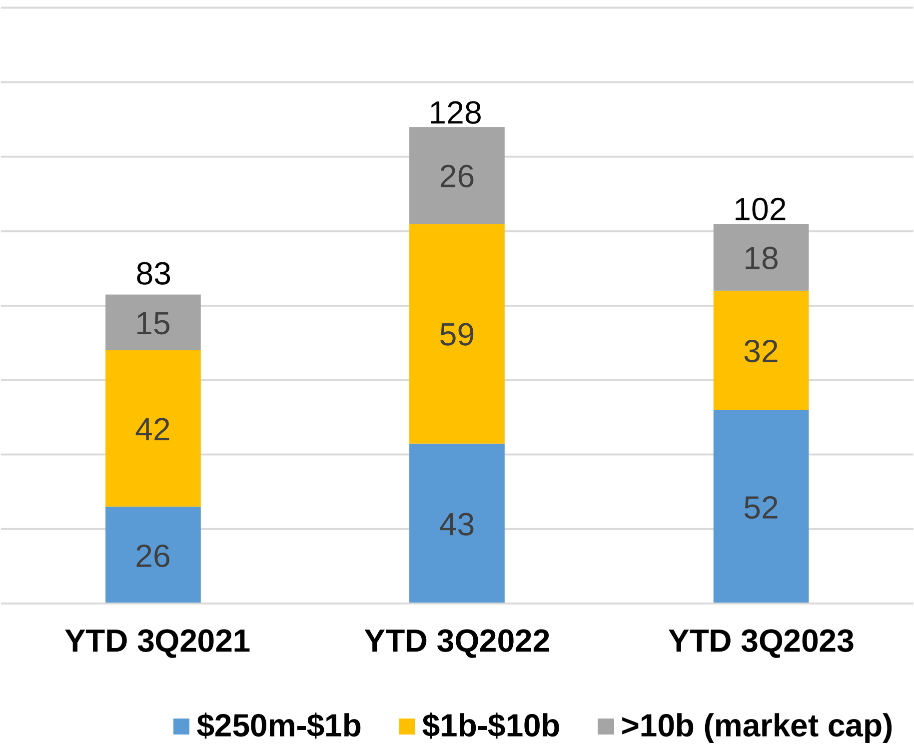
Questions remain:

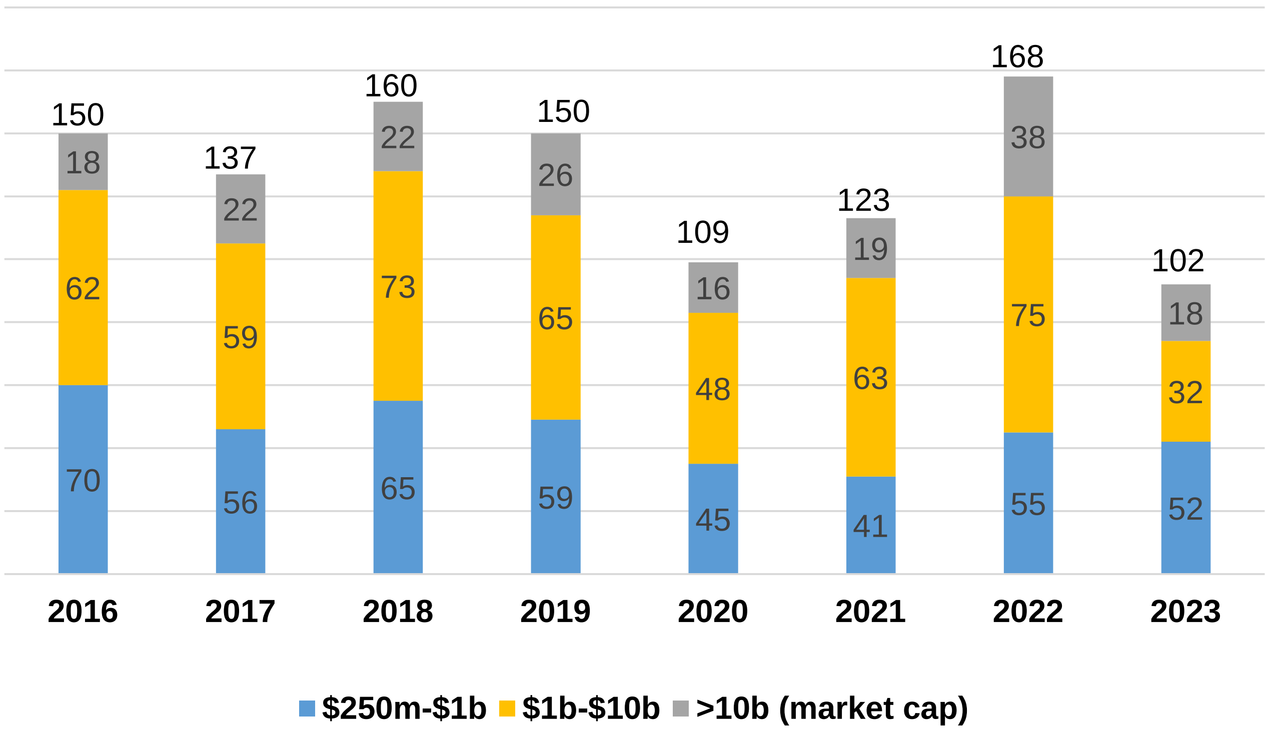
- What factors into the prosecutorial "reasonableness" analysis that might extend disclosure timelines?
- What constitutes a matter of national security requiring a more immediate disclosure?
- How can/should companies adjust their due diligence processes to meet DOJ's expectations and aggressive timelines?
- Will DOJ require disgorgement of ill-gotten gains where it lacks jurisdiction over acquired company's prior misconduct?
- Etc.

Shareholder Activism Update

Activism is the New Normal

Activist Campaigns



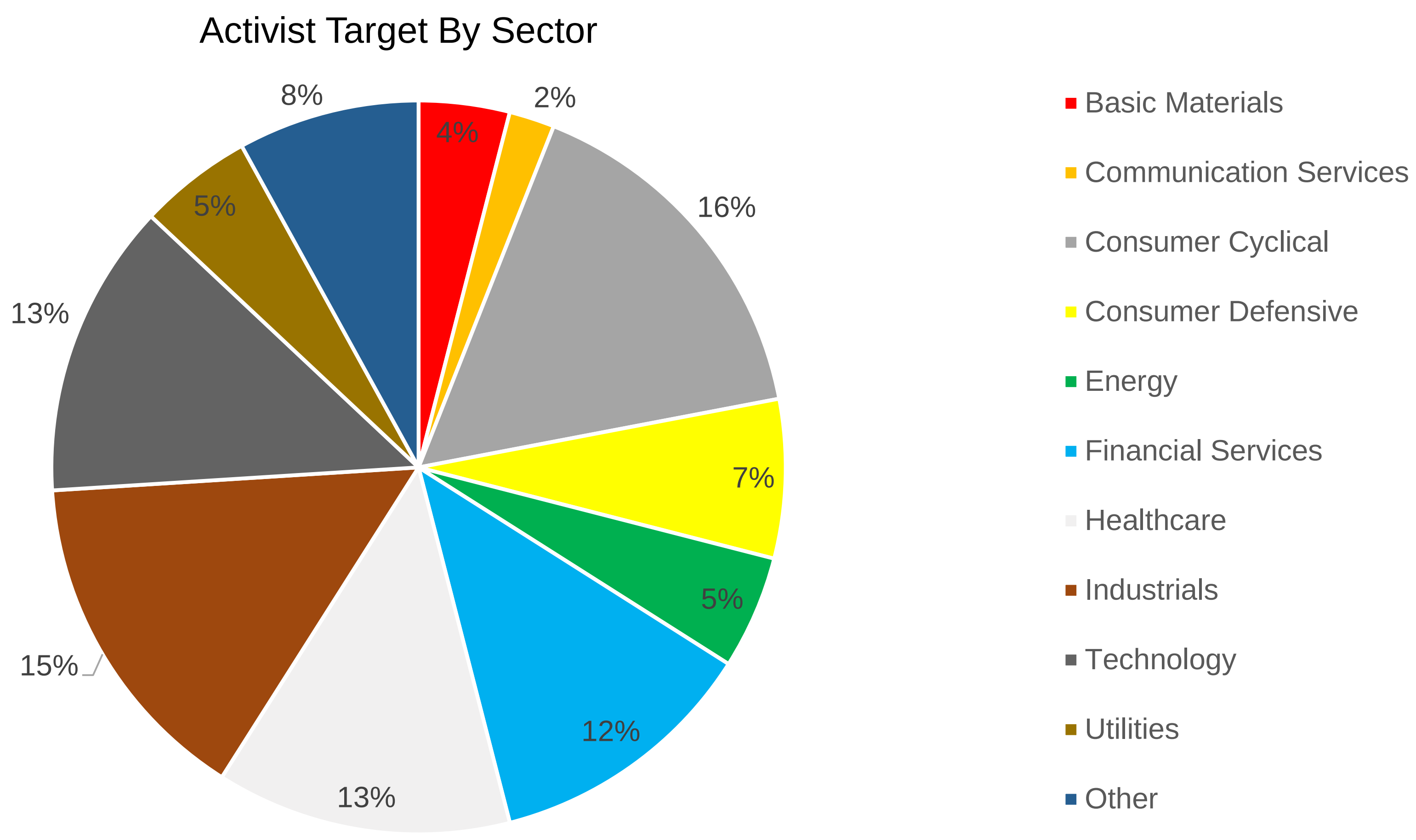


Source: FactSet; data is for campaigns targeting U.S. companies with market capitalization greater than $250mm, at time of campaign announcement. Represents the following campaign types: Board control and representation, enhance corporate governance, maximize stockholder value, remove director(s), remove officer(s), and seat(s) granted –no publicly disclosed activism; excludes campaigns where only activist value demand was block merger/acquisition

Activism is the New Normal

No Company is Immune from Activism

In 2023, activist investments have been spread across all sectors. Heavily regulated sectors such as utilities and communications see very limited numbers of activist investments, while consumer, industrials and technology companies remain at the top of the most heavily targeted companies in the U.S.



Source: Activist Insight representing data in first half of 2023.

Common Activist Objectives

Common Activist Objectives
Removal of CEO and/or Board member(s)
Push for return of capital
Campaign against allocations of capital that do not allegedly create value
Push for sale of Company
Push for spin-offs/divestitures
Review and reduce executive compensation and corporate costs
Other governance proposals

Activist Playbook

Strategies Used by Activists

- Submit stockholder proposals
- Lobby stockholders for public support early
- Use press and social media to build publicity
- Enlist high quality directors as nominees
- Willingness to incur substantial campaign expenses
- Litigation to access board minutes in order to gain inside knowledge of board relationships
- Wage multi-year campaigns
- Make proposals to acquire company

Activist approaches often include criticism of the board and senior management

Common Criticism of Incumbent Directors

- Lack of industry expertise
- Being “over-boarded”
- Lack of stock ownership in the company
- Lengthy tenure

Recent Trends and Takeaways

- M&A-related activism has increased, despite the M&A market challenges
- Increased focus on operational improvements and cost controls
- Full impact of the new universal proxy rules remains to be seen
    - New universal proxy rules did not lead to more proxy contests in the 2023 season
    - Increases the focus on individual directors
    - Increases activists' leverage in negotiating settlements
    - Potentially disadvantages a dissident seeking to replace majority of the Board
- Institutional investors continue to support activist nominees in proxy fights
- Increased focus on advance notice bylaws, including scrutiny in courts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