LAW360

Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10169 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Behind The 'CVR Spin' Method Of Unlocking Assets In M&A

By **Ryan Murr, Stephen Glover and Branden Berns** (March 11, 2024, 5:33 PM EDT)

Ryan Murr

Stephen Glover

Branden Berns

The S&P 500 recently reached all-time highs, with a forward price-to-earnings multiple that is well above the market's historical average.

Against this backdrop of rising equity valuations, fueled by the so-called Magnificent Seven stocks — Apple Inc., Microsoft Corp., Google LLC parent Alphabet, Amazon.Com Inc., NVIDIA Corp., Meta Platforms Inc. and Tesla Inc. — and a boom in large pharma driven by GLP-1 drugs used for weight loss, buyers and sellers in the mergers and acquisition setting are finding that they frequently have divergent valuation expectations.

In the current environment, buyers often value a target company based on a subset of the target company's assets, typically the most mature assets, whereas sellers expect to be compensated for their entire asset portfolio, including earlier-stage assets that may be more speculative or addressing a market that is less attractive to the buyer.

In the biopharma sector,[1] this dynamic is often manifested in one of two ways: the buyer is valuing a later-stage drug program and is not ascribing value to an earlier-stage set of assets, or the buyer is valuing an asset in a particular therapeutic space, e.g., oncology, and is not ascribing value to assets in other indications or therapeutic areas — e.g., cardiometabolic.

This misalignment of valuation expectations can lead to several challenges in consummating an M&A transaction.

When valuation expectations are misaligned, transactions can be more difficult to negotiate and, more importantly, consummate. Counterparties are often left with several bad alternatives:

- Acceding to the other party's demands and paying too much or receiving too little for the desired assets;
- Walking away from the transaction; or
- Undertaking the long and expensive process of spinning the noncore assets out to target's stockholders.[2]

In this context, it is not surprising that executing M&A transactions for companies with a diverse product portfolio — whether in terms of stage of development or therapeutic focus — can be challenging, particularly when the traditional spinoff process is not viewed as a viable option due to time, complexity or other factors.

Traditional Spinoff Requirements

The spinoff of noncore assets in a traditional fashion involves the formation of a new entity, which we will call SpinCo here, by a public company, which we will call RemainCo.

RemainCo transfers the noncore assets to SpinCo and then dividends the SpinCo shares to the RemainCo stockholders.

This distribution of SpinCo shares via dividend is exempt from registration under the Securities Act of 1933 provided that the distribution fits within the U.S. Securities and Exchange Commission's 1997 guidance set forth in Staff Legal Bulletin No. 4, or SLB 4.

Under SLB 4, the distribution must meet certain criteria, including a requirement that RemainCo provide sufficient information about SpinCo to its stockholders and public markets.

This information is typically provided on Form 10 and includes carveout financial statements of SpinCo — i.e., historical financial statements relating to the operation of the noncore assets, looking back over the past several years — and disclosures about SpinCo's business, operations and risks.

The Form 10 must be filed with the SEC, which will review and provide comments on the draft disclosures and financial statements.

Best case, the spinoff is completed approximately 90 days after the filing. Alternatively, if Form 10 is not available under SLB 4, then the spinoff must be registered on Form S-1, which is the registration statement form used for initial public offerings — with the attendant IPO review and comment process.

Including the time typically required to prepare and audit the carveout financial statements, as well as prepare the disclosures required by Form 10 or Form S-1, six months is a reasonable estimate of the time needed to complete the spinoff process — assuming that the logistics of separating the businesses do not require additional time.

In light of the disclosure requirements under SLB 4, a spinoff of noncore assets in the midst of an M&A process is usually impractical.

Although many acquisitions can be completed as soon as 45 days after announcement — assuming no antitrust delays, spinoffs take much longer and add significant complexity.

In an effort to resolve this market dislocation and help create greater value for stockholders, an alternative transaction, the contingent value right, or CVR, spin can be used.

This transaction can allow for the separation of noncore assets in connection with the sale of the public target company — where the target company stockholders would be entitled to the economic benefits of these assets post-closing, and could ultimately even own the equity of SpinCo directly through a post-closing registration process with the SEC.

CVR Spin

The lynchpin to a CVR spin is the SEC's long-standing position regarding when a contingent value right, or CVR, will be viewed as a contractual right to receive future contingent payments and will not be viewed as a security that is subject to regulation under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Beginning with a no-action letter in 1988,[3] which has been built upon through many subsequent no-action letters, the SEC staff has articulated the following five principal factors that will drive the determination of whether a CVR issued in connection with an M&A transaction is classified as a contractual right and not as a security:

1. The CVRs are an integral part of the consideration to be received in the business combination.

2. The CVRs do not convey voting rights or dividend rights and do not have a stated rate of interest.

3. The CVRs are not assignable or transferable — except by operation of law.

4. The CVRs are not represented by any form of certificate or instrument.

5. Any amounts paid under the CVR will not depend on the operating results of the surviving company (or the issuer of the CVR).[4]

Among these factors, the third factor — nontransferability — is generally regarded as the most important. Based on these factors, a properly constructed CVR will be viewed under federal securities laws as a contractual right and not a security that is subject to registration under the 1933 act and ongoing regulation under the 1934 act.

Most often, CVRs are issued by the acquiror and have one or more contingent payments tied to the achievement of a milestone or earnout event relating to the target business.[5]

However, in other transactions, CVRs have been issued by a company to its own stockholders, typically in the context of a reverse merger transaction where legacy public company stockholders are entitled to receive the value, if any, realized from post-closing payments or cash flows relating to legacy public company assets.

Building on this body of CVR no-action letters, and borrowing elements from CVRs issued to a target's own stockholders, it is possible to construct a CVR that preserves the economic benefits of the spun-off assets for the target's stockholders, but without the need for the registration of the transaction under the 1933 act or the registration of the resulting company under the 1934 act.

Initially, the CVR spin involves the formation of a new entity, SpinCo, that will receive the assets of the target company that are not wanted by the buyer or are not being appropriately valued in the sale transaction — the secondary assets.

SpinCo then issues common stock to the target company, after which the target transfers the SpinCo common stock to a newly established trust, or the CVR trust.

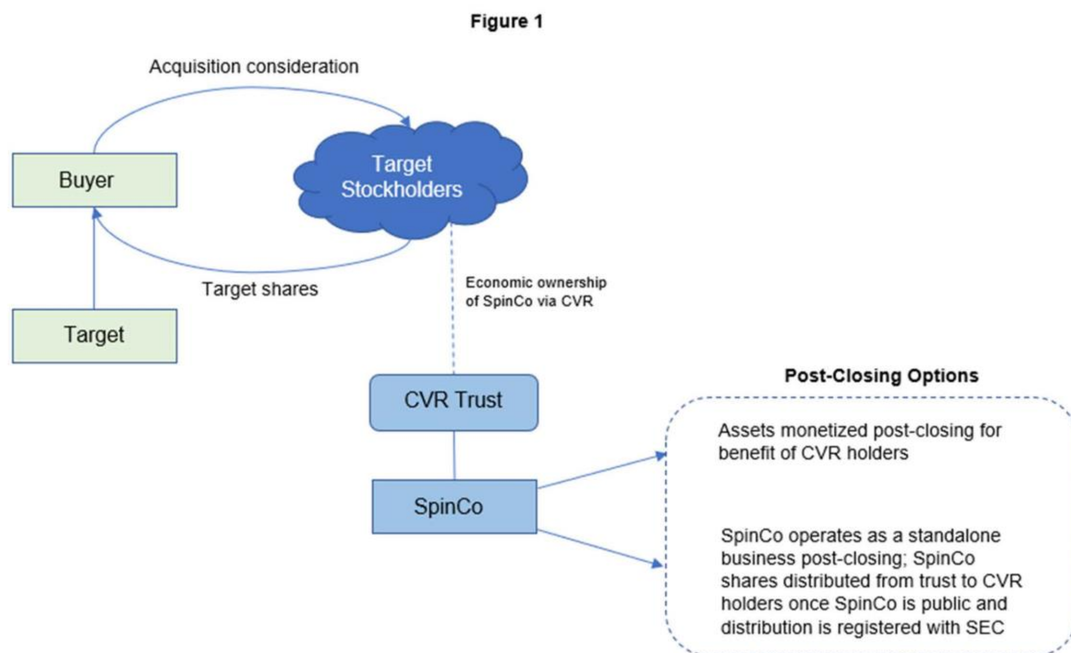
In consideration for the transfer of the stock into the CVR trust, the trust grants back to the target the right to receive 100% of the proceeds arising from the SpinCo shares, including proceeds arising from any subsequent sale of the shares.[6] The target company then distributes this entitlement from the CVR trust to the target stockholders via a nontradeable CVR.

Following this distribution, the target stockholders are the sole beneficiaries of the SpinCo shares held in trust. This interest arises from the CVR, although the CVR holders may not transfer these interests and do not have voting rights.

Figure 1 below illustrates the final structure for the CVR spin, with the target stockholders receiving acquisition consideration from the buyer and holding an indirect interest in SpinCo through the CVRs that derive value from the SpinCo shares held in the CVR Trust.

Once the CVR spin is complete, the shares held in trust may either be liquidated — e.g., in connection with a subsequent sale of SpinCo — or SpinCo may continue as a going concern.

In the latter case, SpinCo could subsequently file a registration statement on Form S-1 or S-4, depending on the nature of the transaction, registering with the SEC the distribution of the shares out of the CVR trust to the CVR holders, with the CVRs ultimately being canceled following this distribution or exchange



The terms of the CVR must be carefully crafted to ensure that the CVRs will not be deemed securities, while preserving the essential economic benefits of the SpinCo shares held in trust.[7]

Advantages

The principal benefit to the CVR spin is the ability to retain value for the target stockholders with respect to the secondary assets in a time-sensitive manner.

This obviously benefits the target stockholders, but also benefits the buyer by removing a valuation impediment for deals with multiple assets of differing strategic value to the buyer.

The CVR spin also offers several advantages over a traditional spinoff that is registered on Form 10 or Form S-1. Specifically, the CVR spin may be accomplished relatively quickly — and certainly within the time required to consummate a tender offer for the target.

The CVR spin may also be documented in a streamlined fashion, without requiring buyer and seller to negotiate terms of the documentation. Because the CVR imposes no ongoing obligations on the buyer, the usual sticking points in CVR negotiations — e.g., the level of post-closing effort that must be undertaken to achieve a given milestone — are not presented in a CVR spin.

The CVR spin is also significantly less expensive to implement than a traditional spinoff, where a registration statement is typically required — form 10 or form S-1 — which necessitates the preparation and auditing of carveout financial statements and disclosures regarding the spun-off business.

Once a traditional spinoff is completed, the resulting company must then operate as a public company, with the associated costs and burdens — admittedly, also with trading liquidity and the ability to access public capital markets.

On the other hand, in a CVR spin, the SpinCo would initially have only one stockholder, the CVR trust, and would not be subject to the ongoing reporting requirements under Sections 12(g) or 15(d) of the 1934 act.

However, if the SpinCo board should subsequently decide that it wished to list SpinCo on a national securities exchange, the SEC registration process could be undertaken at a later time.

In the interim period, the SpinCo board of directors retains the flexibility to seek to monetize SpinCo's assets in a subsequent M&A transaction or develop the assets further as a private going concern.

Other Considerations

Tax

The transfer of the SpinCo shares into trust and the distribution of the economic ownership of the shares via the CVR would be expected to be a taxable transaction for the target company — which may be offset by net operating losses, if available — and result in taxable income to the target stockholders who receive the CVR.

If the target does not have current or accumulated earnings and profits at the time of the CVR distribution, then the value of the CVR would be expected to lower the tax basis of the target stockholders.

If the target does have current or accumulated earnings and profits, the receipt of the CVR would be expected to give rise to taxable income and may give rise to withholding obligations, which should be considered carefully with regard to foreign stockholders.

However, for a target that has net operating losses exceeding the value of SpinCo and no current or accumulated earnings and profits, tax considerations for the CVR spin should be manageable.

Antitrust

From an antitrust perspective, the transfer of the shares of SpinCo into the CVR trust may be a reportable transaction that requires a notification under the Hart-Scott-Rodino Act, but only if the value of the shares is above the higher HSR size-of-transaction threshold — approximately $445 million as of 2023.[8]

If an HSR filing is required, this could be completed in parallel with the HSR filing for the acquisition, although we would note a potential misalignment in the HSR notification periods, where tender offers benefit from an abbreviated 15-day review period, versus the regular 30-day review period that would apply to the CVR spin, if a filing was needed.

Accounting

Upon transferring the SpinCo shares into the CVR trust and distributing the CVR to the target stockholders, the target will not exercise control over SpinCo.

The lack of control should result in the deconsolidation of SpinCo and the target under U.S. generally accepted accounting principles. To the extent that SpinCo wishes to subsequently consummate an IPO or register its shares on Form 10, it would need audited historical financial statements.

Depending on whether the assets contributed to SpinCo constitute a business under SEC rules and generally accepted accounting principles, SpinCo may require carveout financial statements reflecting historical financial results covering a period of time prior to the spinoff.

To account for that possibility, the CVR agreement should contain customary covenants providing for the cooperation of the target with the preparation of carveout financial statements, if needed post-closing.

SEC

In addition to carefully constructing the CVR to avoid classification as a security, the target should give consideration to disclosure requirements relating to the CVR spin, as well as other relevant SEC rules.

These would include disclosures in the target's 14D-9 or proxy statement relating to the business combination transaction.

Additionally, following the transfer of the SpinCo shares into the CVR trust, the target may be required to file a current report on Form 8-K under Item 2.01 — completion of acquisition or disposition of assets.

In the case of a significant disposition, the target may also be required to file pro forma financial information under Item 9.01, Financial Statements and Exhibits. Registrants must also be mindful of

required compliance with respect to other regulatory regimes that may apply to a CVR spin.

Conclusion

Although buyers and sellers are frequently confronted with the scenario where valuation expectations diverge over the treatment of noncore assets, spinoffs in the public M&A context remain uncommon due to significant delays associated with the SEC registration process.

As a result, either buyers overpay from their perspective or target stockholders ultimately receive less value, assuming that the transaction is consummated and negotiations do not break down due to these issues.

The CVR spin affords the parties a means of effectively and efficiently spinning off noncore assets, while retaining flexibility for SpinCo's post-closing path to either monetize or develop the assets for the further benefit of the target stockholders.

Ryan A. Murr is a partner at Gibson Dunn & Crutcher LLP and co-chairs the firm's life sciences practice group.

Stephen Glover is a partner at the firm.

Branden C. Berns is a partner at the firm.

Gibson Dunn partners Brian J. Lane, James J. Moloney and Pamela Lawrence Endreny contributed to this article.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of their employer, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] For convenience, this article discusses the hypothetical purchase and sale of companies in the biopharma sector. However, the concepts discussed in this article would apply as well to M&A transactions in other industries.

[2] Spinoffs of business units outside of the M&A setting (e.g., Merck's 2021 spinoff of its women's health business into Organon & Co.) are a different matter. In that context, the public company has the luxury of time to separate the assets and operations for the new entity, prepare the historical carveout financial statements and complete the registration process with the SEC for the spinoff.

[3] See, Minnesota Mining and Manufacturing Company No-Action Letter (October 13, 1988), which permitted the issuance of a CVR that provided for contingent payments tied to the attainment of certain revenues by the acquired company, including revenues generated by new products not currently produced by the acquired company. See also, First Boston, Inc. (December 2, 1988); GID/TL, Inc. (March 21, 1989); Genentech Clinical Partners III (April 28, 1989); Quanex Corporation (July 28, 1989); Marriott Residence Inn Limited Partnership (February 20, 2002) and Marriott Residence Inn Limited Partnership II (May 8, 2002).

[4] Subsequent no-action letters have omitted this prong from the test (e.g., First Boston, Inc.

(December 2, 1988)).

[5] For example, Bristol Meyers Squibb issued a CVR to stockholders of Celgene that would have paid up to $9 per Celgene share if three late-stage drugs were approved by the FDA within a stated time period post-closing. One of the approvals came in February 2021, which was approximately five weeks after the December 2020 deadline that would have triggered an aggregate CVR payment of $6.4 billion. CVR holders unsuccessfully sued, alleging that BMS has deliberately delayed the approval in order to avoid the payout.

[6] Consideration needs to be given to the treatment of dividends in light of the terms of the CVR no-action letters.

[7] Depending on the planned development and/or disposition of the assets transferred to SpinCo, the Target could instead elect to transfer the SpinCo shares into a liquidating trust and distribute non-transferrable interests in the trust (in lieu of using the CVR as the distribution vehicle). In that case, the Target would be relying on a parallel line of SEC no-action letters concluding that liquidating trust interests are not securities (see, e.g., Gibson Dunn no-action letter (May 18, 2012) relating to trust interests issued in connection with the General Motors bankruptcy).

[8] Because the trust will have zero assets prior to the transfer, the size-of-parties test will not be met in any transfer, leaving only the larger size-of-transaction threshold as a potential basis for a filing under the HSR Act.