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TRANSACTIONS

Contingent value rights: a middle ground in M&A boom

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With the recent boom in M&A activity, buyers and sellers have been enjoying a robust deal market. M&A volume in 2014 continues to run at a breakneck pace, with deal volume in the first six months of the year eclipsing full-year deal volume for each of the past eight years. However, despite the robust market dynamics, frothy equity market valuations are straining traditional valuation metrics. With the S&P trading near an all-time high, buyers are likely to find it more difficult to justify the premiums that target companies may seek. In this environment, we may see buyers increasingly turn to "contingent value rights" as a tool to bridge valuation gaps and get deals done, although challenges exist with these structures that offer contingent back-end payouts.

Contingent value rights, or "CVRs," are a payment right issued to the target company's stockholders as part of an acquisition. CVRs come in two varieties: price-protection CVRs and event-driven CVRs. Both types of CVRs provide the target stockholders with the potential of additional consideration post-closing, although they work quite differently.

Price-protection CVRs are used in stock-for-stock transactions to provide the target company's stockholders with a guaranteed minimum trading value for the acquirer's stock over a period of time after closing. This type of CVR, which has been used sparingly, first came to prominence in a high-profile takeover battle a decade ago. During this particular bidding war, the winning bidder ultimately prevailed by adding a price-protection CVR to its bid, ensuring that its stock offered in the deal would be worth at least a minimum amount for up to three years after the transaction. Although there are a number of other notable examples, the prevalence of price-protection CVRs is much less than the event-driven CVR.

With an event-driven CVR, the target company stockholders are given the right to receive a post-closing payment (which could be in cash and/or the buyer's stock) if certain events come to pass. These could include: the achievement of a particular milestone (such as regulatory approval); the achievement of certain financial goals (such as minimum product sales); or another value-creating event (such as the successful resolution of pending litigation). Because the buyer will make the payment only if a specified value-creating event occurs post-closing, it lowers the risk of overpaying for the target company. Likewise, if the seller is seeking to be paid in part for its belief that it would successfully achieve the event anyway in the absence of a deal, then the addition of a CVR may be an attractive way to provide the sellers with potential upside beyond the initial deal price. A recent high-profile example of an event-based CVR is Sanofi-Aventis's hostile takeover bid for Genzyme. In that transaction, Genzyme initially refused to accept Sanofi's bid, claiming Sanofi failed to value Genzyme adequately for the potential future value of its drug candidate being developed to treat multiple sclerosis. If successfully developed, Genzyme argued that this drug would meaningfully change the value of its business and make the initial offer inadequate. Only when Sanofi added a $14 per share CVR (tied to the successful development and commercialization of the drug) to the cash bid of $74 per share did Genzyme agree to the sale.

Although buyers use CVRs in a relatively small percentage of all M&A deals, a substantial portion of all CVR transactions occur within in the life sciences industry. The reason for the relative prevalence of CVR deals in this industry primarily stems from the binary nature of drug development. If a pharmaceutical company's drug is successful in clinical studies or receives FDA approval, it may be worth billions of dollars. However, if the studies are unsuccessful or if a development-stage drug faces rejection with the FDA, then a drug candidate may be worthless. As a result of this heads-you-win/tails-you-lose nature of the pharmaceutical industry, buyers tend to worry about overpaying, while sellers worry about selling out at too low a price. In the context of this deal dynamic, a CVR provides the ability to bridge what might otherwise be insurmountable differences between the buyer's bid and the seller's ask.

However, as useful as CVRs can be, they present several challenges, particularly for event-driven CVRs. Sellers tend to be leery that contingent payments will actually be realized post-closing, as the efforts being undertaken to achieve the payout event will be in the buyer's control. Although a buyer may provide well-reasoned assurances that the achievement of a particular payout milestone also enhances the value of the acquired assets, sellers often remain concerned that their interests may not be aligned with the buyer's after a sale closes.

For example, if the parties have agreed on an event-based CVR tied to operating performance of the acquired business post-closing, one could easily imagine a scenario where the buyer may later decide that it would be better to divert its resources to a different business line or subsidiary in order to maximize the return for the overall business enterprise. In a scenario such as this, the buyer's operating decisions after closing will have a direct impact on the achievement of the payment milestone or event. This tension between sellers and buyers has led one market observer to describe the CVR as a "back-pocket tool popular with deal makers and unpopular with some shareholders." Many shareholders will discount the potential value of the CVRs and will assume the worst in terms of the prospects for payout after closing. However, carefully drafted provisions in the purchase agreement can help ameliorate many of these concerns.

To address the seller's concerns around how the business will be conducted after closing, the parties typically heavily negotiate the "due diligence" provisions of the purchase agreement. These are the terms setting forth specifically what level of effort a buyer must undertake after closing in pursuit of the payment milestones. Due diligence provisions can range from being expressly disclaimed by the buyer, to very specific conditions calling out amounts of future expenditures and minimum personnel levels to support key business activities. When carefully drafted, a well-tailored due diligence provision can provider sellers with a higher degree of assurance that they will get what they bargained for in the sale of the business, while at the same time providing buyers with greater certainty in terms of what actions they need to undertake to minimize claims that they have breached the acquisition agreement.

In addition to the due diligence standards setting forth the required levels of effort to be undertaken, buyers and sellers will also frequently negotiate whether a CVR will be transferrable by the target company stockholders after closing. Generally, federal securities laws treat a transferrable CVR as a "security" (even if payable in cash) and may require more time and expense to issue in an acquisition. In contrast, federal law does not treat a non-transferrable, cash-based CVR as a security, and the buyer, including foreign buyers who may not currently be subject to registration and reporting requirements with the SEC, can issue cash-based CVRs more easily. In the last several years, deals to purchase a number of public companies used non-tradable, cash-settled CVRs. While not common, this deal structure affords buyers an easier way to sweeten their offers, without subjecting their bids to the potential additional complications of registering securities with the SEC. For foreign buyers not currently filing reports with the SEC, this deal structure may be particularly appealing.

Despite the potential utility of CVRs, their use remains somewhat limited, with sellers (and many buyers) often preferring "clean" transactions with no back-end consideration. When markets are in balance between supply and demand, and equity valuations are within normal ranges, these "clean" deals are easier to construct. However, when M&A markets are out of balance — either too hot or too cold — then CVRs may provide a path forward for both sides to feel like they are not giving up too much in the transaction.

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