KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

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CVRs — A Bridge Too Far?

The use of CVRs will remain the exception rather than the norm, with their primary utility being the facilitation of a focused dialogue around achieving a mutually acceptable present valuation for significant contingencies or binary outcomes.

In a recent M&A Update we addressed the practical challenges of using earnouts in private company M&A to bridge the final valuation gap in sale negotiations. An equally daunting set of obstacles applies to the implementation of the public M&A version of earnouts — Contingent Value/Payment Rights (CVRs). We use the term CVRs to refer to a variety of techniques that provide public company target shareholders with valuation protection or additional consideration based on post-closing events. This protection can take several forms:

- the issuance of additional shares and/or cash to target stockholders in a stock-for-stock deal based on the performance of the buyer's shares during a post-closing period (*Value Protection CVRs*),
- the right to receive additional cash (or stock) consideration based on the post-closing financial performance of the target business (*Performance CVRs*), and/or
- the opportunity to receive additional cash (or stock) consideration, on a pass-through or participatory basis, driven by the post-closing outcome of certain identifiable contingencies (e.g., litigation, product development milestone, etc.) relating to the acquired company (*Contingency CVRs*).

While Value Protection CVRs were used in a number of high-profile deals in the 1990s (e.g., Viacom/Paramount & Blockbuster, General Mills/Pillsbury) with a range of interesting twists such as caps/floors, redemption rights and maturity extension options, we have since seen few if any deals using this tool. We suspect that available stock market liquidity and buyers' concerns about finality are overriding sellers' desire for long-term stock price protection.

While Performance CVRs have appeared in a small number of deals in the last decade (e.g., Fresenius/APP Pharma), usually based on post-closing EBITDA performance of the acquired business during a defined post-closing period, all of the challenges we identified in the context of similar private company earnouts are equally, if not more sharply, applicable. An added obstacle is establishing an enforcement mechanism pursuant to which the interests of the many former target shareholders (each of whom is likely to have a relatively small stake) are effectively represented, a pressing concern given the likelihood of disputes over compliance with covenants meant to protect the integrity and value of this modified earnout.

In recent years, the more common, but still relatively rare, form of CVR has been the Contingency CVR. Discussion of this tool most often arises where the parties, in valuing the target, attach a significantly different risk discount to a specific future contingency or where the divergence of outcome of such an event is so binary that agreement on an appropriate risk discount may be impossible. Examples include the results of a particular legal claim, the proceeds of a sale of a target business unit, or the outcome of resource extraction activities or product development milestones. In particular, with the uptick in M&A activity for biotech and other early-stage pharmaceutical companies, we have seen parties discuss, and sometimes use (e.g., Endo/Indevus, Metabasis/Ligand), Contingency CVRs to address the valuation uncertainties inherent in a product pipeline by tying additional cash consideration to the achievement of regulatory or commercial milestones for specified products in a period post-closing.

While the objective milestones or outcomes characteristic of Contingency CVRs make them less susceptible to some of the management obstacles and resulting disputes that apply to performance earnouts (and Performance CVRs), many of the challenges remain. These include determining the appropriate duration (with nearer term milestones being more easily addressed) and control over the relevant contingency (e.g., covenants related to managing litigation, regulatory process or product development and the extent of the required efforts by the buyer), as well as the enforcement concerns described above.

In addition, public company CVRs face a number of other unique challenges. These include the requirement that CVRs be, among other things, non-transferrable if the buyer wants to avoid registration of the instrument with the SEC, with associated timeline implications and post-closing reporting obligations. This non-transferrability, coupled with the extended timeframe for payout (usually one to three years) and potentially adverse tax treatment to target shareholders, leads targets and their shareholders to severely discount the potential value represented by the Contingency CVR. Conversely, the recent effectiveness of the accounting requirements of FAS 141(R), which requires recording of the fair value of the contingency at closing with subsequent changes in likely outcome being recorded through periodic earnings, results in potentially unattractive earnings volatility for the acquiror.

Experienced dealmakers will know that, much like the Jets' Super Bowl chances, CVRs are much more often discussed than actually seen. That is not to say that a preliminary discussion around using a CVR to bridge a valuation gap is not a constructive step in the process of reaching a final agreement on price. Parties almost always ultimately forego the use of a CVR because of the inherent complexity and, ironically, for exactly the same reason that a CVR often is first broached, except that the parties switch sides in the argument. Whereas a CVR is usually proposed because a buyer undervalues and a seller overvalues future performance or contingency outcomes, CVR discussions often collapse because the seller discounts the intrinsic value of the resulting CVR terms while the buyer overvalues the prospect of future payments. Moreover, the utility of CVRs is limited to a narrow band of mid-sized contingencies. To the extent the relevant contingency, and therefore the resulting valuation gap, is too large, parties will often choose an alternative structure to an outright acquisition (such as a development rights deal) that obviates the need for immediate resolution; if the contingency, and valuation gap, are relatively small, the complexities of the CVR model will usually lead parties to prefer a "split the difference" compromise.

The recent introduction by Genzyme of a potential CVR tied to the performance of Campath in its defense against Sanofi shows that CVRs will remain part of the deal conversation even in a stabilizing M&A market. That said, we expect that their actual use will remain the exception rather than the norm, with their primary utility being the facilitation of a focused dialogue around achieving a mutually acceptable present valuation for significant contingencies or binary outcomes.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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