

Client Alert

February 25, 2014

Using Contingent Consideration to Bridge the Value Gap in Acquisitions of Publicly Traded Life Science Companies

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M&A activity remains in the doldrums as we enter 2014. According to FactSet Mergerstat, in 2013, 446 transactions were announced involving a U.S. buyer or target in the life sciences sector, as compared to 527 in 2012. Many strategically sensible transactions are not getting done because of the inability of the seller and buyer to agree on price. In some cases, sellers see significant upside in the future trajectory of the business, while buyers may be unwilling to pay for that upside given the perceived risks in achieving it.

However, creative buyers and sellers are able to successfully bridge this value gap by using contingent consideration. Most recently, on January 8, 2014, Teva Pharmaceutical Industries Ltd. announced that it had agreed to acquire NuPathe Inc. in a deal valued at \$213 million. In addition to the cash consideration of \$3.65 for each NuPathe share, the merger agreement provided that the holder of each NuPathe share will also receive one contingent payment right, which entitles its holder to receive up to \$3.15 upon reaching certain specified net sales thresholds related to ZECUITY®.

These contingent payment rights, or CPRs, are essentially earn-outs for public company acquisitions. CPRs should be contrasted with instruments traditionally called contingent value rights, or CVRs (although the terminology has become muddled over time). A CVR is typically used in a deal where the seller wants protection for the value after the closing of the buyer's stock being used as consideration for the acquisition. For example, the seller's board may be concerned that the buyer's share price may not retain its value if the deal's projected synergies are not achieved, the integration is not smooth or the buyer's legacy business does not perform as expected. Early examples of the use of CVRs include Dow Chemical Company's 1989 acquisition of Marion Laboratories where, in addition to cash, Marion shareholders received CVRs that would pay the holder the difference between \$45.77 and the average trading price of the combined entity's stock over the 90-day trading period following the merger. A similar instrument was used in Viacom's 1994 acquisition of Paramount Communications, where Paramount shareholders received .93065 of a Viacom CVR that was tied to Viacom's common stock price on the maturity date; indeed, it was this downside protection offered by Viacom to Paramount's shareholders (and the confidence in the combined company's prospects that such protection signaled) that distinguished Viacom's offer from a competing bid by QVC and eventually resulted in Viacom's victory. Other examples of public company deals where the consideration included CVRs are Markel Corporation/Terra Nova (Bermuda) Holdings (2000), Quintiles Transnational Corporation/Pharmaceutical Marketing Services Inc. (1999) and Rhone-Poulenc/Rorer (1990).

In contrast, a CPR would be used in a deal where the buyer wants greater certainty in the value of the acquired business. As an additional benefit, the buyer can view the CPR as a financing mechanism, since it delays payment of a portion of the purchase price until it is earned. There are three general types of CPRs:

- financial performance benchmarks
- pass-throughs
- specific contingent events

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CPRs Utilizing Financial Performance Benchmarks. In the first type of CPR, the contingent payment is based on financial performance benchmarks, such as revenue, sales or EBITDA hurdles. Examples include:

- Endo Health Solutions' acquisition of NuPathe (2013). The consideration included a CPR tied to cumulative net sales of ZECURITY®.
- Cubist Pharmaceuticals' acquisition of Optimer Pharmaceuticals (2013). The consideration included a CPR tied to net sales of DIFICID® (fidaxomicin).
- Cubist's acquisition of Trius Therapeutics (2013). The consideration included a CPR tied to cumulative net sales of certain products.
- Spectrum Pharmaceuticals' acquisition of Talon Therapeutics (2013). The consideration included a CPR tied to one-time sales-based milestones for Marqibo® and regulatory approvals.
- AstraZeneca's acquisition of Omthera Pharmaceuticals (2013). The consideration included a CPR tied to worldwide net sales of Epanova™.
- Wright Medical Group's acquisition of BioMimetic Therapeutics (2012). The consideration included a CPR tied to aggregate sales of certain products.
- Cubist's acquisition of Adolor Corporation (2011). The consideration included a CPR tied to commercial milestones for Adolor's pipeline candidate, ADL5945.
- Forest Laboratories' acquisition of Clinical Data (2011). The consideration included a CPR tied to aggregate net sales of Viibryd or other products containing vilazadone hydrochloride.
- Sanofi-Aventis's acquisition of Genzyme (2010). The consideration included a CPR tied to production levels and worldwide sales of certain products.
- Celgene's acquisition of Abraxis BioScience (2010). The consideration included a CPR based on net sales revenue thresholds related to ABRAXANE® and Abraxis's nab-pipeline products.
- Fresenius's acquisition of APP Pharma (2008). The consideration included a CPR based on the excess of adjusted EBITDA above a threshold amount over a three-year period.

Like traditional private company earn-outs, one of the key challenges in using this kind of CPR is the need to agree upon objective and measurable benchmarks so as to avoid post-closing confusion and potential disputes over whether and how much contingent consideration is required to be paid.

CPRs Passing Through Identifiable Proceeds. In the second type of CPR, the CPR acts as a pass-through of the proceeds of a specific event. In essence, the potential value of the event is not included in the base consideration and is retained by the former shareholders through the CPR. This mechanism can be used, for example, to pass through the proceeds of a particular piece of litigation, insurance claim or sale of an asset. Examples include:

- Community Health Systems' acquisition of Health Management Associates (2013). The CPR payment was based on the net costs of certain legal matters involving Health Management Associates.
- Ligand Pharmaceuticals' acquisition of Neurogen (2009). One of the four CPRs issued as consideration in this deal represented the right to receive a pro rata portion of the cash paid by any buyer of Neurogen's real estate on or before the six-month anniversary of the merger.

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- Symphony Technology's acquisition of Information Resources (2006). The CPR holders were granted a right to receive 60% of the proceeds from Information Resources' antitrust lawsuit against AC Nielsen, The Dun & Bradstreet Corp. and IMS International, Inc.
- Investment Technology Group's acquisition of Hoenig Group (2002). The CPR payment was contingent on the recovery of insurance and other claims related to trading losses and unauthorized trading activity at Hoenig Group's United Kingdom subsidiary.
- Washington Mutual's acquisition of Bank United Corp. (2001). The CPR represented the right to receive the proceeds from a forbearance claim against the U.S. government.
- Harvey's Casino Resorts' acquisition of Pinnacle Entertainment, Inc. (2000). The CPR payment was contingent on the sale of 97 acres of land in Inglewood, California.

CPRs Triggered by Specific Events. In the third type of CPR, shareholders receive the additional consideration upon the occurrence of specific contingent events. The Spectrum/Talon CPR, which is triggered by regulatory approvals for Menadione Topical Lotion and one-time sales-based milestones for Marqibo®, falls partly into this category and partly into the first category. Because the value of a pharmaceutical company is so heavily dependent on the development status of its drug pipeline, this type of CPR, which can be tied to clinical hurdles, FDA approval or commercialization of a product, can be particularly useful in life sciences company acquisitions. Indeed, the predominant use for CPRs in recent years has been in life sciences deals, including:

- AstraZeneca/Omthera (2013)
- Wright/BioMimetic (2012)
- Spectrum/Allos (2012)
- Cubist/Adolor (2011)
- Sanofi/Genzyme (2010)
- Celgene/Abraxis (2010)
- Endo Pharmaceuticals/Indevus Pharmaceuticals (2009)
- OSI Pharmaceuticals/Cell Pathways (2003)
- Antigenics/Aronex Pharmaceuticals (2001)
- Ligand Pharmaceuticals/Seragen (1998)

However, the use of this type of mechanism has potential application beyond life sciences, to any company with a value heavily dependent on the occurrence of a specific, objective event.

In the 2009 Pfizer-Wyeth deal, one of Pfizer's early offers contained a CPR that was linked to Wyeth's pipeline Alzheimer's product meeting certain conditions related to regulatory approval. However, due to the severe market disruption and credit crisis shortly after the time of the initial offer, Pfizer lowered the value of its offer for Wyeth and removed the CPR from the proposal.

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As the Pfizer-Wyeth experience indicates, contingent consideration is not a cure-all. Indeed, attempting to use contingent consideration can add significant complexity.

First, the parties have to agree on appropriate parameters for the contingency. This can be relatively straightforward in the case of a CPR serving as a pass-through of proceeds from a legal claim, sale of a business or other contingent event, because both the occurrence of the event and the amount of proceeds can be easily defined and objectively identified. On the other hand, where the CPR provides for varying levels of payment at various levels of financial performance, the definition of the relevant hurdles and the resulting payments can be more difficult to define and agree upon, and therefore more likely to result in later dispute.

Second, if the CPR falls within the definition of a “security” for purposes of the federal securities laws, the issuer (typically the buyer) will be required to register the offer and sale of the security with the Securities and Exchange Commission (the SEC) under the Securities Act of 1933. The SEC considers the following factors in determining whether the CPR is a security, even if the CPR is payable entirely in cash:

- the instrument’s transferability/assignability
- whether payment is contingent upon operational performance
- the voting and/or dividend rights associated with the CPR
- whether the CPR represents an equity interest in the issuer
- whether the instrument bears a stated rate of interest
- whether the instrument is represented by a certificate

In most cases, the ability to trade the CPR is highly desirable, so that former shareholders are not forced to hold an illiquid instrument for several years after closing. If the transaction includes stock or other securities as consideration, then those securities will already be subject to Securities Act registration, and adding the CPR to the registration statement is not particularly burdensome. However, where the consideration otherwise consists of all cash plus the CPR, the cash component by itself would not have required registration and thus, the inclusion of the CPR results in the costs and delay of SEC registration where registration would not otherwise have been required. In many cash deals, the CPR has been made non-transferable so as to avoid the need for SEC registration. Recent examples include Endo/NuPathe, Cubist/Trius, Spectrum/Talon and AstraZeneca/Omthera.

Third, buyers need to be careful to ensure that the indenture or other agreement governing the CPR does not unduly impinge on the operational flexibility of the resulting company’s management, while nevertheless protecting the interests of the CPR holders. For example, it may be in the best interests of the selling shareholders to have significant limitations on the way the business is run so that the performance hurdles may be achieved, but the buyer may determine over time that taking the business in a different direction may be more likely to maximize value for the buyer. Sellers should consider what happens, for example, if the buyer chooses to abandon the further development of the pipeline drug to which the CPR applies, or instead licenses the chemistry to a third party before completing clinical trials. Buyers will want CPR agreements to specifically provide that the buyer is not obligated to produce or market any specific product. In the AstraZeneca/Omthera acquisition, each Omthera shareholder received a CPR which entitled it to certain amounts in

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the event the FDA accepted a new drug application for Omthera's two leading clinical candidates, Epanova and a pharmaceutical product that contains both rosuvastatin and Epanova as its sole active ingredients, prior to certain dates. The Contingent Value Rights Agreement for the CPR specified that, subject to certain limitations, AstraZeneca generally had the right, in its sole and absolute discretion, to direct and control the development, commercialization, manufacture, marketing, distribution and selling of Epanova and the rosuvastatin/Epanova pharmaceutical product in all respects, including the right to determine whether to test, develop or pursue, market, make any regulatory filings or seek any regulatory approvals with respect to, make any strategic product portfolio decisions affecting or otherwise advance, Epanova and the rosuvastatin/Epanova pharmaceutical product. This tension between sellers and buyers could make a CPR less attractive in many situations.

Finally, contingent consideration may also have tax implications for the target's shareholders. For example, in taxable transactions, installment sales rules generally do not apply when the target is publicly traded or the CPRs are readily tradable. As such, shareholders will not be able to defer gains on contingent consideration even if the CPR is scheduled to be paid in the next tax year or later. Parties can potentially work around this issue by structuring the CPR with the open transaction rules in mind. If at least one payment is contingent, the contingency is not remote or incidental and the value of the contingent payment or payments cannot be reasonably ascertained, the open transactions rules may permit the shareholder to defer the portion of its taxable gain relating to the CPR.

Cash-based CPRs received in otherwise tax-free transactions are generally taxable upon receipt of the CPR at the lesser of the gain realized on the transaction and the fair market value of the CPR. CPRs payable solely in stock of the buyer generally do not result in taxable gain if the transaction is otherwise tax-free. A selling shareholder's tax basis is allocated among the stock and CPRs received. Therefore, sales of stock that occur prior to the maturity of the CPR will be taxed at a rate that assumes a diluted tax basis. A portion of the shares received in respect of the CPR will generally be treated as imputed interest income.

Potential alternatives to contingent consideration include the use of tracking stock and staged acquisitions. Tracking stock is a separate class of stock that "tracks" the results of a particular business line or division of the issuer. Although tracking stock has fallen into general disfavor, tracking stock can be used as part of the consideration package to give the selling shareholders equity-like participation in the target company or in a subsidiary or division. For example, a tracking stock interest in the acquired subsidiary could provide the selling shareholders with an interest similar to a pass-through CPR, without the need for the buyer to actually divest the subsidiary.

A staged acquisition reduces the buyer's potential exposure by committing only to a partial acquisition, permitting the buyer to complete the transaction if the target has met its performance thresholds or desired event contingencies. This mechanism thereby shares with contingent payment rights both the ability to reduce the buyer's risk that it will pay a full purchase price even if the acquired company does not perform as expected and the ability to delay funding the full purchase price up front. Examples of staged acquisitions of publicly traded life science companies include:

- Novartis/Alcon Inc. (2008). Novartis acquired a 25% stake in Alcon from Nestlé and an option to purchase Nestlé's remaining 52% stake. Subsequently, Novartis exercised the option and also made an offer to squeeze out the remaining minority.
- MGI Pharma Inc./AkaRx (2007). MGI acquired the right to develop AkaRx's oncology drug and an option to acquire the company, which it subsequently exercised.

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Although contingent consideration is not a new (or simple) phenomenon, its use in public company acquisitions has been somewhat limited for these reasons. However, given the continued challenges in the market, creative deal participants can make use of contingent consideration to get good deals done.

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