



Contingent Value Rights (CVRs)

*Igor Kirman and Victor Goldfeld,
Wachtell, Lipton, Rosen & Katz*

This Note explains contingent value rights (CVRs), including the most common structures, the key features of a CVR and the advantages and disadvantages of employing a CVR. This Note also identifies the principal securities, accounting and tax considerations associated with CVRs.

The contingent value right (CVR), an instrument committing an acquiror to pay additional consideration to a target company's stockholders on the occurrence of specified payment triggers, has long been a creative structuring technique for public M&A dealmakers. Sometimes referred to by other names, such as contingent payment rights, CVRs were first used in several high-profile transactions in the late 1980s to guarantee the value of acquiror shares used as merger consideration. More recently, CVRs have been primarily used to bridge valuation gaps relating to uncertain future events that would impact the target company's value.

Despite their resurgence in recent years, CVRs are not often used in public M&A transactions, in part due to their complexity and risks. However, experience suggests that CVRs can be usefully deployed to solve some of the valuation and closing challenges that parties encounter and help get deals done.

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THE FRAMEWORK OF A CVR

There are two main types of CVRs:

- **Price-protection CVRs.** These guarantee the target's stockholders the value of acquiror shares issued as consideration in the transaction (see *Price-protection CVRs*).
- **Event-driven CVRs.** These give additional value to the target's stockholders depending on specified contingencies (see *Event-driven CVRs*).

Because CVRs are created by contract and have been used to address a wide range of problems, they have evolved into customized instruments. While a comprehensive review of all the nuances that can be included in a CVR is beyond the scope of this Note, it is worthwhile to focus on some of the key features that are most often seen in these two varieties of CVRs.

PRICE-PROTECTION CVRS

Price-protection CVRs are used in transactions in which the consideration includes publicly traded securities, generally the acquiror's stock. This type of CVR is meant to assure the target's stockholders of the value of the consideration over some post-closing period. These CVRs typically provide for a payout equal to the amount (if any) by which the specified target price exceeds the actual price of the reference security at maturity. This value protection technique, which is similar to a put option granted to target stockholders, represents additional value for target stockholders.

The price-protection CVR rose to prominence when it was used to decide the epic takeover contest between Viacom and QVC for control of Paramount Communications in 1993 and 1994. After several rounds of bidding in which both Viacom and QVC proposed transactions including cash and stock consideration, Viacom tipped

the scales in its favor by adding a CVR to the consideration. That CVR offered Paramount stockholders an additional payment to the extent that the market value of Viacom stock was less than specified target prices on the first, second or third anniversary of the closing (as chosen by Viacom). At the first anniversary, Viacom paid out about \$1.44 for each CVR (as compared to a maximum potential cash payout at that maturity date of \$12 for each CVR), for a total payment of about \$82 million.

Viacom also used a CVR (referred to in that transaction as a variable common right) in its purchase of Blockbuster in 1994. It offered Blockbuster stockholders the right to receive an additional fraction of a share of Viacom Class B common stock. The exact additional amount was dependent on the market price of Viacom Class B common stock during the year following the closing.

While price-protection CVRs have also been used in recent years, their use has been less frequent than the event-driven variety (see *Event-driven CVRs*).

Target Prices, Caps and Maturity Dates

Typically, a price-protection CVR has a maturity of one to three years. At maturity the holder receives a payment of either cash or securities if the market price of the acquiror's stock is below a target price. Parties usually set the target price above the pre-announcement trading price of the securities tied to the CVR. This effectively guarantees price appreciation. But the target price could also be set at or below the pre-announcement price, offering protection against declines.

Price-protection CVRs typically also include a floor price, which caps the potential payout under the CVR if the market value of the reference shares drops below the floor, functioning as a "collar." For example, in the Viacom/Paramount CVR, the first-year floor price was \$36, meaning that the maximum payout to CVR holders would be \$12 (\$48 target price minus \$36) because any share price below \$36 effectively would be treated as if it were \$36 for this purpose. Floor prices vary depending on the deal, but often range between a 25% and 50% discount to the target price.

Sometimes an acquiror may negotiate for the right to extend the CVR's maturity date as protection against short-term fluctuations in share prices. Typically any extension carries with it an increase in the target price and the floor price (often in the range of 5% to 10% a year). For example, in the Viacom/Paramount CVR, Viacom had the right to extend the maturity date two separate times, in each case by one year. The target price was \$48 on the first maturity date, rose to \$51 on the second maturity date and rose again to \$55 on the third. Similarly, the floor price increased from \$36 on the first maturity date, to \$37 on the second and to \$38 on the third. While Viacom did not exercise this extension right, acquirors tend to like the flexibility of the option, which can send a bullish signal to the market.

Cash Versus Stock

A threshold issue in any CVR negotiation, regardless of the nature of the payment trigger, is whether the CVR will be payable in cash and/or securities. If a CVR is to be settled at

least partially in stock, the parties must determine how those shares will be valued at settlement. The shares are usually valued according to either:

- A formula based on trading prices over a period of time (which may, in the case of a price-protection CVR, be the same formula used to determine the current market value for purposes of determining whether payment is due).
- A predetermined price (less frequently).

For example, in Clinical Data's 2008 agreement to acquire Avalon Pharmaceuticals, Avalon's stockholders received CVRs payable on satisfaction of certain milestones. The CVR was to be settled in stock that was valued at a predetermined fixed price (the volume-weighted average trading price of Clinical Data common stock for the 15 trading days ending on the date of the merger agreement). In some cases, parties include a mechanism (similar in effect to the "floor" concept see above) that limits the number of shares issuable on settlement of the CVR to protect against dilution in the case of a large stock price drop.

Occasionally the parties negotiate limits on the acquiror's obligation or right to issue shares to settle a CVR payment, which may:

- Protect the acquiror and its stockholders against significant dilution in case of a large drop in the acquiror's stock price. One method of accomplishing this is to put a floor (or a minimum) on the value used to determine the number of shares issuable on settlement. Another way to achieve the same result is to limit the overall stock payout by capping the amount of shares payable under the CVR, as was the case in the Viacom/Blockbuster CVR.
- Address other concerns, such as:
 - **Securities registration.** In ViroLogic's 2004 acquisition of ACLARA Biosciences, ViroLogic could make a portion of the CVR payment with its stock, but only if issuance of the stock was exempt from registration under Section 3(a)(9) of the Securities Act of 1933 (Securities Act) or was made under an effective Securities Act registration statement. Otherwise, the entire payment due would have to be made in cash.
 - **Avoiding need for stockholder approval.** In the 2006 Iconix/Mossimo transaction, the parties agreed to cap the aggregate number of shares issuable at the closing and at the maturity of the CVR to 19.99% of the acquiror's issued and outstanding shares (at the closing date or the end of the CVR measurement period), possibly to avoid stockholder approval requirements under stock exchange rules. The balance of any payment due under the CVR would be made in cash.

To provide additional flexibility, the acquiror may be given the right to settle the CVR in either cash or stock, at its election. Some examples of this election feature can be found in the following transactions: Viacom/Paramount (1994), Markel/Terra Nova (2000), ViroLogic/ACLARA BioSciences (2004) and Aldabra/Boise Paper (2008). In the Viacom/Paramount CVR, Viacom not only could elect between cash and stock, but it could also use a range of Viacom securities to settle the CVR.



Redemption and Early Termination

Some CVRs permit the acquiror to redeem the CVRs, usually at a price equal to the target price less the current market price of acquiror shares on the redemption date, discounted back from the maturity date. Although an acquiror may prefer having the option to redeem the CVRs, exercising that right may, depending on the stated discount rate, send a bearish signal on expected future price appreciation.

Price-protection CVRs sometimes have early termination provisions, which provide for the CVRs to expire automatically in the event that the current market value of the acquiror's stock exceeds the target price (or some higher price) during the measurement period. Examples of these types of early termination provisions can be found in the following mergers: Viacom/Blockbuster (1994), ViroLogic/ACLARA BioSciences (2004) and Iconix/Mossimo (2006). To protect the holders of CVRs against a short-term price appreciation that would prematurely terminate the CVR, the early termination provision is often structured to require sustained price appreciation (for example, a period of 30 consecutive trading days).

Other Covenants and Events of Default

Certain covenants are designed to give CVR holders additional protections (both in price-protection and event-driven CVRs), such as:

- **Reservation of stock.** This type of covenant can be included in a CVR that may be settled with the acquiror's stock and requires the acquiror to reserve sufficient shares to satisfy the CVR obligations.
- **Stock exchange listing.** Where the CVR is to be listed, the CVR agreement typically requires the acquiror to use some level of efforts to cause the CVRs to be approved for listing on the relevant securities exchange.
- **Deal-specific matters.** Transactions involving unusual CVR structures should also include covenants appropriately tailored for the circumstances. For example, the Dow Chemical/Marion (1989) and Rhone Poulenc/Rorer Group (1990) transactions (involving CVRs tied to the value of target securities) both:
 - prohibited the acquiror from causing the target to make any extraordinary distribution (defined as any dividend or distribution exceeding the ordinary quarterly dividends); and
 - included restrictions on the incurrence of liens by the acquiror.

CVR agreements may also include limited event of default provisions tied to, for example:

- Failure to make payment on the CVR when due.
- Certain breaches of the CVR agreement.
- Certain bankruptcy and insolvency events.

The occurrence of an event of default generally gives rise to certain remedies, including, in some cases, the accrual of interest until payment is made and/or the right to accelerate future CVR payments.

Other Common Provisions

Other features commonly associated with price-protection CVRs include:

- **Prohibition on share repurchases.** The acquiror and its affiliates are restricted from purchasing the acquiror's own stock (and occasionally, engaging in hedging activity) during the valuation period. This type of prohibition limits the potential upward pressure on acquiror stock that could lessen the value of the CVR. Although restrictions on share repurchases typically do not cover the announcement of a repurchase, there have been lawsuits against acquirors claiming that an announcement of an intention to make a tender offer for the reference securities (or other allegedly false statements) were made to artificially inflate the stock price.
- **Protections against extraordinary transactions.** The acquiror may be required to make an early settlement of the CVR obligation if it enters into certain extraordinary transactions, such as a sale of substantially all of its assets or some mergers. In this case the acquiror would likely pay to CVR holders the difference, if any, between:
 - the target price (discounted back for this purpose from the scheduled maturity date to the date of the transaction); and
 - the value of the consideration received in the transaction (or the floor price, if greater).

CVR agreements may also prohibit the acquiror from engaging in certain types of mergers or in a sale of substantially all of its assets unless the successor entity assumes the CVR obligations.

- **Anti-dilution adjustments.** CVRs frequently include provisions that adjust the target price and floor price upon the occurrence of certain events relating to the acquiror's shares (such as a stock dividend or stock split and, in some cases, certain mergers). However, CVR agreements do not typically provide for an adjustment in the event of a below-market share issuance. In the case of a CVR to be settled in stock, a stock-for-stock merger might also result in an adjustment of the securities issuable at maturity of the CVR. In that case any adjustment must be harmonized with any provision requiring the acquiror to make an early settlement of the CVR obligation upon certain mergers.

EVENT-DRIVEN CVRS

In recent years, CVRs have more frequently been used by acquirors and targets as a means of bridging a valuation gap related to a contingency. For example, these types of CVRs have included payouts dependent on:

- Milestone achievement (such as Food and Drug Administration (FDA) drug approval or entry into licensing agreements).
- Financial performance metrics (such as drug sales or company performance).
- Proceeds from litigations, sales of assets or tax refunds.

For examples of transactions with these and other types of events triggering payment under a CVR, see *Table, Deals With Event-driven CVRs*.

An event-driven CVR that is tied to financial performance metrics, such as EBITDA or revenues, is effectively the public M&A version of an earn-out. For example, when Fresenius agreed to acquire APP Pharmaceuticals in 2008 for \$23 per share in cash, it included a CVR that could deliver up to an additional \$6 per share in cash. The CVR was dependent on whether APP's aggregate EBITDA for 2008, 2009 and 2010 (taking into account certain adjustments in connection with asset sales) exceeded a specified threshold. Many CVRs with earn-out features are focused on the financial performance of one or more particular products or segments of the target (for instance revenues from a particular drug), rather than company-wide measures (as in the Fresenius/APP transaction).

Event-driven CVRs have been particularly common in health care and biotech M&A deals, accounting for more than a majority of all uses. The prevalence of event-driven CVRs in the healthcare and biotech industries is explained by:

- The disproportionate impact that even a single successful or failed drug could have on the valuation of the target.
- Industry familiarity with the use of milestones in commercial arrangements, such as licensing and research and development agreements.

Sanofi-Aventis's recent agreement to acquire Genzyme for \$20 billion and Celgene's 2010 agreement to acquire Abraxis BioScience for \$2.9 billion are recent examples of CVRs with payments dependent on achieving regulatory milestones and product sales.

In the Sanofi/Genzyme transaction, each CVR provided for additional payments (up to an aggregate of nearly \$4 billion) based on FDA approval, a production milestone and four different product sales milestones. In the Celgene/Abraxis transaction, each CVR provided for additional payments to the Abraxis stockholders (up to an aggregate of \$650 million) if certain FDA approvals were achieved before specific dates. The CVR also provided for a further payment if aggregate annual net sales of a chemical compound and certain Abraxis pipeline products exceeded \$1 billion during specified periods.

Event-driven CVRs can be structured to address both contingent assets and contingent liabilities. For instance:

- A CVR that passes along a portion of a litigation recovery is an example of a CVR tied to a contingent asset.
- A CVR that pays out the portion of escrowed funds remaining after satisfaction of a litigation liability is an example of a CVR tied to a contingent liability. A CVR structured in this manner would require the parties to determine the amount to set aside for the potential liability, however, which may have a negative impact on settlement negotiations. Another method of addressing a potential litigation liability is to issue CVRs to the acquiror's stockholders that would ultimately be settled with a number of shares that increases with the size of the ultimate judgment or settlement in the litigation, diluting the interest of former target stockholders.

Payment Triggers

A key economic and legal term of an event-driven CVR is the definition of the payout trigger. For example, if the relevant trigger is FDA approval, the parties must be careful how to define the drug (or component thereof) and specify whether or not approval can be given subject to conditions (such as requiring certain labeling), and if so, what type. In the 2009 Endo Pharmaceuticals/Indevus Pharmaceuticals deal, the amount payable under the CVRs depended, in part, on whether the relevant drug was approved with certain labeling requirements. The payment trigger may also require that the regulatory approval be granted for at least a specified time period.

Some CVRs employ multiple triggers. For example, where FDA approval is a trigger, it is also common to see a trigger related to drug sales. In Ligand's 2009 agreement to acquire MetaBasis Therapeutics, separate CVR instruments were used to reflect the separate triggers (in that case, four CVR agreements were used). The separate payment triggers may or may not be dependent on one another, and may or may not provide alternative means of satisfying a particular payment trigger. For example, the Sanofi/Genzyme CVR employed four separate product sales milestones that looked at drug sales both during specified periods and on a rolling basis (with some overlap permitted between two of the four triggers).

Another variable in the event-driven CVR is the duration, which depends on the nature of the trigger and how soon after closing the contingency is expected to be resolved. CVRs tied to financial performance metrics or drug approval often use multi-year periods, with one to five years being common. The period over which drug sales revenue is measured often starts only once regulatory approval has been obtained, rather than on the date the CVR is issued.

Determining the Amount of the Payout

Another key economic term of an event-driven CVR is the formula for determining the amount of the payout. Where the trigger depends solely on meeting a milestone (such as regulatory approval), the payout is often a binary event. However, it can also be related to other variables such as timing of approval or attached conditions. In cases where variables tied to financial performance are incorporated into the trigger, the CVR might provide for a range of payments depending on the results.

This is illustrated in the Celgene/Abraxis CVR where one of the triggers provided for the following payments related to drug sales:

- 2.5% of annual net sales between \$1 billion and \$2 billion.
- An additional 5% of annual net sales between \$2 billion and \$3 billion.
- An additional 10% of annual net sales in excess of \$3 billion.

Financial metric CVRs might also include special rules for calculating the relevant measurement metric, for example rules for calculating drug sales on a net basis after specified deductions.



Support Obligations

Because an acquiror frequently can influence the payout on an event-driven CVR (such as through its investment and marketing efforts), targets negotiating CVRs often request provisions designed to align incentives.

For example, where CVR holders are entitled to a large share of proceeds from a particular litigation, the target may give the acquiror incentives to maximize any recovery. Some ways to accomplish this are to:

- Provide the acquiror an economic stake in the outcome by assigning a portion of the litigation proceeds to the acquiror.
- Impose a duty to prosecute the litigation in good faith, with a view to maximizing the value of the proceeds.
- Allow a representative of the CVR holders to have partial or complete control over the conduct of the litigation and/or any settlement agreement. The representative generally has the right to engage and consult with counsel, tax experts, valuation firms and other experts and third parties. These arrangements typically require that the acquiror be responsible for some amount of litigation expenses, with any expenses in excess of the agreed amount to be deducted from the litigation proceeds.

In CVR instruments where the payout depends on FDA approval or other product development milestones, target companies often require the acquiror to undertake a specified level of efforts to achieve the milestones. The consequences of not having this type of covenant were illustrated in the 2003 OSI Pharmaceuticals/Cell Pathways CVR. In that CVR, payment was triggered by the filing of an FDA application for either of two drugs by a specified date. Two years before the deadline, OSI stopped developing both products, eliminating the possibility of payouts under the CVR.

A typical covenant calls for the acquiror to use commercially reasonable efforts to continue development of a particular product. For example, in the CVR issued in the 2008 ViroPharma/Lev Pharmaceuticals transaction, ViroPharma was required to use “commercially reasonable effort consistent with pharmaceutical industry practices relating to products in a similar stage of marketing, development and approval and with similar economic potential, and considering the regulatory, legal, business, commercial and other facts and circumstances.” Other examples of CVRs employing a commercially reasonable efforts or similar standard are Indevus/Valera (2006) and Ligand/Seragen (1998).

Another efforts standard sometimes used is diligent efforts (sometimes with specific language defining this standard). The Sanofi/Genzyme CVR used both a specifically defined “diligent efforts” standard for some purposes as well as a “commercially reasonable efforts” standard for others. In other situations, acquirors retain the sole discretion to make decisions concerning milestones that serve as triggers for the CVR (as in the Ligand Pharmaceuticals/Pharmacopeia CVR). Sole discretion and similar clauses may help an acquiror avoid committing itself to actions

that, in the future, may not be in its best interest. However, granting broad discretion to the acquiror may leave CVR holders without protection in situations where the interests of the parties are no longer aligned.

Reporting Obligations and Audit Rights

Event-driven CVR agreements may require the acquiror to provide periodic reports to CVR holders of information relevant to the value of the CVR, such as the performance of the relevant operating segment, product line or loan portfolio on which the value of the CVR depends. For example, in the Fresenius/APP CVR, Fresenius was required to provide an adjusted EBITDA calculation in detail (along with a reconciliation to the most comparable GAAP measure) in its annual and quarterly reports filed with the SEC.

In addition, in some cases the CVR agreement expressly grants audit rights to CVR holders. These clauses often limit the frequency of audits and require reasonable advance notice. When negotiating audit rights, the parties must decide who pays for audits.

In the Celgene/Abraxis CVR, for example, the parties agreed that holders of a majority of CVRs could request one audit a year, but the requesting CVR holders would bear the cost of any audit (through a reduction in future CVR payments), unless the acquiror underpaid by more than 10%. In contrast, the Fresenius/APP CVR contained no limits on the number of audits and allocated the costs of the audits to the acquiror.

Other Protections

Transactions with affiliates. A target company may insist that a CVR tied to its financial performance include provisions restricting certain transactions with the acquiror’s affiliates. For example, the Eaton/Fusion Systems CVR agreement (based on net sales) included a covenant prohibiting the acquiror from engaging in material transactions with affiliates that would reduce net sales during the measurement period, unless the transaction was on arms’-length terms. Another way to achieve a similar goal is to build a rule into the calculation of the relevant performance metric that ignores the effect of affiliate transactions that are not on arms’-length terms.

Disposal of assets. Another feature sometimes found in event-driven CVRs is a required payout in the event the acquiror disposes of the assets or businesses to which the CVR is tied. Also, some CVR agreements broadly prohibit the acquiror from entering into any agreement that restricts the company’s ability to timely make any CVR payment.

THE PROS AND CONS OF CVRS

While the advantages and disadvantages of a CVR structure are best understood in the context of a particular transaction and largely depend on the type of CVR employed, there are several common themes that should be kept in mind.

POTENTIAL ADVANTAGES OF USING CVRS

Bridging Valuation Gaps

A key use of CVRs has been as a tool for bridging valuation gaps, especially in relation to a significant contingency. In some cases the parties can reach agreement on the appropriate value of a large part of the target business, but have fundamental disagreements about the likely future impact of a material contingency on the target's value. CVRs can offer the parties a way to save the transaction from falling apart over valuation.

Increasing Deal Certainty

A CVR can also provide an acquiror with protection similar to that offered by a closing condition without threatening the overall transaction. For example, if an acquiror has concerns about the likelihood of a development-stage drug receiving approval by the FDA or about the risk of an adverse judgment in a significant litigation, it may want to delay the signing or closing until the contingency has been resolved. This type of uncertainty may be unacceptable to the target. In this situation, a CVR can allow the parties to close a deal without resolving the contingency, and can also cut down on the acquiror's need for additional due diligence related to contingencies that are covered by the CVR.

For example, it was reported that ViroPharma's initial proposal to acquire Lev Pharmaceuticals was conditioned on Lev receiving FDA approval and orphan drug exclusivity for one of its drugs. By employing a CVR with payment triggers tied in part to satisfaction of these milestones, ViroPharma was able to drop that condition.

Providing Financing Benefits

Some acquirors may realize financing-related benefits from the use of a CVR. By reducing the total consideration required at closing, the CVR can act as a form of deferred financing. This can be an advantage depending on the acquiror's needs for and ability to obtain financing on acceptable terms through other means. A related point is that the delay in payment in a price-protection CVR gives the acquiror's management team time to realize value from synergies, which may reduce the likelihood that the CVR payment will be triggered.

Improving Market Perceptions

A CVR can also be beneficial in terms of market perceptions. For example, a price-protection CVR can signal management's confidence in the combined company's future performance. An acquiror's agreement to use a CVR whose value increases inversely with its stock price is generally perceived to be a bullish signal.

POTENTIAL DRAWBACKS OF USING CVRS

Execution Risks

A significant disadvantage to CVRs, and the likely reason for their relatively limited use, is their complexity. Because CVRs are highly-structured instruments with many variables, a large number of legal and other issues can arise when negotiating and implementing these devices.

CVR agreements are generally lengthy and involve many issues that require detailed negotiation and careful drafting, requiring time and resources that can otherwise be devoted to other aspects of the deal. In addition, including CVRs as a component of the deal could impose requirements under the federal securities laws that potentially lengthen the timeline to closing (see *Securities Law and Other Legal Considerations*).

Potential for Dispute

The complexity of CVRs can increase the risk of potential litigation in a transaction. One possible type of dispute involves a claim that the acquiror did not use adequate efforts to cause satisfaction of the CVR trigger conditions. A typical CVR likely would not entitle its holder to fiduciary protections under the law of most states. Indeed, most CVR agreements include express language limiting a CVR holder's rights to those set out in the agreement. Examples of this type of limiting language can be found in the CVR agreements from the following transactions: Celgene/Abraxis (2010), Ligand/MetaBasis Therapeutics (2009), Fresenius/APP (2008), Cytogen/Cytorad (1994) and ViroLogic/ACLARA BioSciences (2004).

However, as noted above, parties often impose efforts standards such as "commercially reasonable efforts" or "diligent efforts" that may be vague enough to form the basis of a claim. In addition, as a contractual instrument, a CVR may be deemed to include an implied covenant of good faith and fair dealing. In this regard the CVR holder can possibly claim that the acquiror breached an implied obligation to use efforts to enable the CVR holders to satisfy the event trigger. However, this type of claim may be difficult to sustain, particularly where contractual language grants the acquiror discretion in running the acquired business post-closing.

Rossdeutscher v. Viacom, a case involving the CVRs issued by Viacom in its acquisitions of Paramount and Blockbuster, illustrates a type of claim that can arise in the context of price-protection CVRs (*768 A.2d 8 (Del. 2001)*). In this case the plaintiffs claimed that Viacom released false economic data to artificially and temporarily inflate the value of Viacom's common stock during the measurement period of both CVRs to reduce the payment owed to the CVR holders. On appeal, the Delaware Supreme Court (applying New York law) held that the plaintiff's complaint stated claims for breach of the implied covenant of good faith and fair dealing inherent in the CVRs. A similar claim based on Rule 10b-5 under the Securities Exchange Act of 1934 (Exchange Act) was made by a holder of CVRs issued in the Dow Chemical/Marion transaction.

Negative Effect on the Acquiror and its Stock

In the case of event-driven CVRs, a potential disadvantage is that the acquiror may face significant multi-year operational restraints as a result of commitments to CVR holders. CVR agreements may have significant support obligations related to milestones or other triggers. Contractual restrictions may constrain the acquiror's management team and board of directors in making operational choices that would otherwise be preferable in the absence of these commitments.



CVRs can also have negative effects on the acquiror's stock. One drawback is the overhang associated with the potential payout under a price-protection CVR. Unlike in the event-driven variety, where large payouts are generally associated with positive outcomes, a payout under a price-protection CVR highlights poor stock price performance. Another potential drawback is the possibility that arbitrageurs, who tend to buy these CVRs and hedge their exposure with the acquiror's stock, may at times generate unwanted trading activity in the acquiror's shares.

In the case of CVRs where the payout is settled in stock, acquirors must reserve adequate shares and register (if not registered at the time of the initial transaction) and list them. Likewise, if the payout is in cash, acquirors must arrange for financing in advance, which has an associated cost. Target companies unwilling to assume the financing risk can try to require acquirors to deposit cash in escrow to satisfy any CVR obligations.

In addition, acquirors may be required to record the CVR as a liability on their balance sheets, which may be subject to subsequent mark-to-market adjustments that could result in income statement charges (see *Accounting Considerations*).

Valuation and Transferability Issues

While CVRs may be useful tools for bridging valuation gaps, there is also a possibility that they create their own valuation issues. Usually the greatest disagreement during negotiations concerns the selection of performance metrics or price-protection targets and the value of the CVRs.

Discussions regarding the intrinsic value of CVRs can be tricky because parties considering a CVR structure often negotiate price on parallel tracks (one track including the CVRs in the consideration and the other track not including the CVRs). In these situations an acquiror (in the case of a price-protection CVR) or target (in the case of an event-driven CVR) may be bullish about its prospects when discussing a deal not including CVRs. However, they may be less willing to stand behind these valuation claims when the parties are constructing and valuing a CVR.

Because target stockholders may not be natural holders of CVRs, they may undervalue CVRs as merger consideration. To enhance their value, parties can choose to make CVRs transferable (in which case, they are often also listed on a stock exchange), although nontransferable CVRs have been employed even in large public company deals. If transferable, arbitrageurs or event-driven hedge funds often end up acquiring a significant percentage of those CVRs. For example, it was reported that arbitrageurs held as much as 75% of each of the Viacom/Paramount and Viacom/Blockbuster CVRs.

These arbitrageurs and hedge funds often purchase CVRs at a discount to their intrinsic value and capture a significant part of the gains associated with them. For example, the Celgene/Abraxis CVRs traded at just 35% of their probability-adjusted net present value 30 days after the closing, while the Fresenius/APP CVRs traded at 55% of their probability-

adjusted net present values during the same period. As a result, even where a CVR is transferable, it is possible that the acquiror's cost of issuing the CVR is greater than the value that the target stockholders place on it.

A transferable CVR is likely to require registration under the federal securities laws, which may create timing disadvantages, although the protections of the securities laws also might be viewed as increasing the value of the CVRs (see *Securities Law and Other Legal Considerations*).

In some cases the possible consequences of registration may be viewed as so burdensome that the parties condition the very existence of the CVR on its exemption from registration. For example, in the 2000 Saga Systems/Software AG transaction, the CVR agreement provided that if the SEC requested registration of the CVR, the parties would use reasonable efforts to satisfy the SEC that the CVR was not a "security," and that the CVRs would terminate without any payment if registration was required.

Credit Risk

A CVR exposes its holders to the credit risk of the acquiror because it typically is an unsecured obligation that may not be repaid in full in the event of bankruptcy. CVR agreements often contain provisions expressly subordinating the CVRs to senior obligations of the acquiror. Also, CVR holders receiving securities of the acquiror as part of the consideration may even find that their bankruptcy claims arising under the CVRs can be subordinated to all other unsecured obligations (not only senior obligations) of the acquiror under Section 510(b) of the Bankruptcy Code.

Courts have subordinated price-protection CVR claims where the CVRs were deemed to be "obligation[s] undertaken by [the debtor] in connection with the issuance of [its] stock" (see *In re Kaiser Group Intl.*, 260 B.R. 684, 687 (Bankr. D. Del. 2001)). On the other hand, though the precedential value is unclear because of other factors in the case, there was no subordination where the CVRs were deemed "claims to recover payment due under agreements of sale of businesses" and merely "deferred compensation" providing the "bargained for sales price" (see *In re Nationsrent, Inc.*, 381 B.R. 83, 92 (D. Del. 2008)). CVR holders who remain investors in the acquiring company are more likely to be at risk of subordination than holders who "divest [themselves] of all indicia of share ownership" (see *In re Kaiser Group Intl.*, at 688).

Disclosure Obligations

The use of a CVR that requires registration under the Exchange Act may impose additional ongoing disclosure and reporting obligations on an acquiror (see *Exchange Act Registration and Reporting*). For some acquirors, such as private or foreign companies, this may represent a large administrative and financial burden.

For an overview of public company periodic reporting and disclosure obligations, see *Practice Note, Periodic Reporting and Disclosure Obligations: Overview* (<http://us.practicallaw.com/7-381-0961>).

SECURITIES LAW AND OTHER LEGAL CONSIDERATIONS

DOES A CVR REQUIRE REGISTRATION UNDER THE SECURITIES ACT?

The issuance of a CVR, even if payable in cash, may require registration under the Securities Act if it is considered a “security.” In a series of no-action letters, the SEC has developed a multi-factor test that is applied to determine whether a CVR is a security as defined in Section 2(a)(1) of the Securities Act. The SEC has indicated that the following five factors (with some variation in wording) must be present to conclude that a CVR is not a security:

- The rights are an integral part of the consideration in the merger.
- The holders of the rights have no rights common to stockholders (such as voting and dividend rights).
- The rights are non-interest bearing.
- The rights are not assignable or transferable except by operation of law.
- The rights are not represented by any form of certificate or instrument.

(See *Minnesota Mining and Manufacturing Co. SEC No-Action Letter* (available October 13, 1988).)

Although these five factors are generally considered key in analyzing whether the SEC will deem a CVR a security, no-action letters have also, on occasion, noted additional factors as supporting the conclusion that the CVR is not a security, including:

- The right is not dependent on the operating results of any party involved.
- Almost all of the holders of the rights will continue with the surviving corporation as employees.
- The value of the payments resulting from the rights is a small fraction of the overall consideration.

(See *Genentech Clinic Partners III SEC No-Action Letter* (available April 28, 1989) and *Northwestern Mutual Life Insurance Co. SEC No-Action Letter* (available March 3, 1983).)

In particular, while the link between CVR payments and the operating results of the acquiror has been listed as a factor in many no-action letters, it has not been consistently applied. Even where that factor has been discussed, acquirors have often successfully argued that the CVR being issued does not depend on the overall operating results of the company, but rather on the results of a particular product or subsidiary (usually the target company) (for example, see *Essex Communications Corp. SEC No-Action Letter* (available June 28, 1988), *GID/TL, Inc. SEC No-Action Letter* (available March 21, 1989) and *Genentech Clinic Partners III SEC No-Action Letter* (available April 28, 1989)).

In practice, transferability of the CVR is likely the most significant determinant of whether or not SEC registration is necessary. If the target company is willing to accept nontransferable CVRs, the parties typically can structure the CVR in a manner that does not require registration.

If a CVR is deemed a security, its issuance can generally be registered on the same form as other types of acquiror securities, if any, issued in the transaction (on a Form S-4, in the case of a typical merger transaction). In the case of stock-settled CVRs, the underlying shares are usually also registered on the same form. Even if a CVR is a security, it may be possible to structure the CVR in a manner that does not require registration of its issuance under the Securities Act. For example, in the 1997 Eaton/Fusion Systems transaction, the target distributed transferable CVRs to its stockholders through a dividend. For an examination of the disclosure requirements of a registration statement on Form S-4, see *Practice Note, Registration Statement: Form S-4 and Business Combinations* (<http://us.practicallaw.com/5-384-6225>).

EXCHANGE ACT REGISTRATION AND REPORTING

CVRs may also give rise to registration and reporting obligations under the Exchange Act. Section 12(b) of the Exchange Act requires registration of any security listed on a national securities exchange. Even where CVRs are not listed, it may be necessary to register them under Section 12(g) of the Exchange Act, which requires registration of a class of “equity security” that is held by 500 or more persons if the issuer has assets exceeding \$10 million. For this analysis, the acquiror must determine whether the CVRs fall under the definition of equity security in Section 3(a)(11) of the Exchange Act, which includes specific instruments such as warrants but is also broadly defined to include “any stock or similar security” (*Rule 3a11-1, Exchange Act*). In practice, most CVR issuers who register under the Securities Act also register under the Exchange Act.

Where Exchange Act registration is required, it is usually effected on a Form 8-A. Once CVRs have been registered under the Securities Act, registration under the Exchange Act typically would not impose a significant burden, because it is likely that the acquiror can simply incorporate the information in the Securities Act registration statement into the Exchange Act registration statement. For information on the requirements of registration on Form 8-A, see *Practice Note, Registration Statement: Form 8-A* (<http://us.practicallaw.com/9-382-2519>).

Section 13 of the Exchange Act requires an issuer of a security registered under Section 12(b) or 12(g) to file periodic reports (such as annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K). There appears to be no direct SEC authority discussing the disclosure requirements concerning a CVR registered under the Exchange Act. However, parties should be aware of the possibility of additional disclosure as a result of Exchange Act registration. For example, if a CVR is tied to the settlement of a litigation, there may be questions regarding whether the Exchange Act would require ongoing disclosure of developments concerning that litigation, even if the litigation would not otherwise be material to the acquiror and developments would not ordinarily be disclosed in the acquiror’s Exchange Act filings.



The questions concerning the disclosure and reporting requirements for CVRs (particularly of the earn-out variety) can be viewed as similar to those raised in the context of tracking stock. Generally tracking stock is an additional class of stock that a company creates to track the performance of a particular business or division. Like tracking stock, an earn-out CVR registered under the Exchange Act is a security whose value depends on a particular business or division of a company.

The SEC has stated that an issuer of tracking stock must include financial statements about the tracking stock in its Exchange Act reports. The burden of Exchange Act registration of CVRs may be even greater on private companies or foreign issuers, which may not otherwise have Exchange Act reporting obligations at all (or have only limited obligations). For an overview of public company periodic reporting and disclosure obligations, see *Practice Note, Periodic Reporting and Disclosure Obligations: Overview* (<http://us.practicallaw.com/7-381-0961>).

LISTING CVRS ON A SECURITIES EXCHANGE

CVRs may be traded on a securities exchange, provided that the requisite listing standards are met. To be listed on the New York Stock Exchange (NYSE), an issue of CVRs must meet the following conditions:

- At least one million CVRs must be outstanding.
- There must be at least 400 CVR holders.
- The CVR must have a minimum life of one year.
- The CVRs must have a market value of at least \$4 million.

(Section 703.18, NYSE Listed Company Manual.)

CVRs may be delisted from the NYSE when either:

- The market value of the CVRs is less than \$1 million.
- The related equity security to which the cash payment at maturity is tied is delisted.

As a result, in the case of a price-protection CVR, delisting of the CVR may occur where the reference security is trading at a sufficiently high level.

For a CVR to qualify for listing on NASDAQ, the acquiror must have:

- More than \$100 million in assets.
- Stockholders' equity of at least \$10 million.
- Annual income from continuing operations before taxes of at least \$1 million in the most recently completed fiscal year or in two of the three most recently completed fiscal years. In the case of a company that is unable to satisfy this income criteria, NASDAQ generally requires the company to have the following:
 - assets in excess of \$200 million and stockholders' equity of at least \$10 million; or
 - assets in excess of \$100 million and stockholders' equity of at least \$20 million.

(Rule 5730(a), NASDAQ Listing Rules.)

In addition, the CVR issue must have:

- At least 400 CVR holders.
- A minimum public distribution of at least 1 million units.
- A minimum market value/principal amount of at least \$4 million.

For more information on the listing requirements for the NYSE and NASDAQ, see *Practice Note, Selecting a US Securities Exchange* (<http://us.practicallaw.com/3-381-1953>).

TRUST INDENTURE ACT MATTERS

The terms of a CVR are typically embodied in a separate CVR agreement, with the form attached as an exhibit to the merger agreement. The CVR agreement is usually executed at the closing. In rare cases involving nontransferable CVRs, the CVR terms have been set out in the merger agreement rather than in a stand-alone document. Before drafting the terms of the CVR, the parties must determine whether a CVR has to be qualified under the Trust Indenture Act of 1939 (TIA). When it applies the TIA requires, among other things, that CVRs be issued under an indenture and that a trustee be appointed to protect the rights of the CVR holders (see *The Role of the Trustee or Representative*).

Under TIA Section 304(a)(1), a security will be exempted if it is not any of the following:

- A note, bond, debenture or evidence of indebtedness, whether or not secured.
- A certificate of interest or participation in any note, bond, debenture or evidence of indebtedness.
- A temporary certificate for, or guarantee of, any note, bond, debenture, evidence of indebtedness or certificate.

As a result, qualifying under the TIA is required only in connection with debt securities. Where CVRs combine elements of debt and equity, determining whether TIA qualification is required can be a difficult judgment call.

Qualifying under the TIA protects CVR holders by mandating that certain provisions be automatically included in the CVR agreement or indenture. For example, TIA Section 316(b) requires that any CVR holder's right to receive payment generally not be impaired without the holder's consent.

The TIA also automatically includes in each qualified agreement certain default provisions that can be modified by contract. This includes the Section 316(a) provision authorizing the holders of a majority of the CVRs to instruct the trustee to assert claims or exercise powers under the CVR agreement.

THE ROLE OF THE TRUSTEE OR REPRESENTATIVE

Because the number of CVR holders can be large, CVR agreements generally appoint a trustee, rights agent or other representative to oversee the rights of the holders and perform certain actions on their behalf. The powers and responsibilities

of the trustee or representative depend partly on whether the agreement must be qualified under the TIA (see *Trust Indenture Act Matters*).

The trustee or representative generally is either named in the form of CVR agreement or chosen mutually by the parties after signing the merger agreement. Where the CVR agreement is qualified under the TIA, the trustee must meet certain independence and capital requirements set out in the TIA. If a trustee subsequently becomes conflicted, he may be required to resign. In some cases CVR holders can petition a court for removal and replacement of the trustee. TIA-qualified CVR agreements also typically allow holders of a specified percentage of CVRs (usually a majority) to remove a trustee and appoint a successor.

A typical trustee or representative is responsible for certain administrative functions, including:

- Maintaining a register of the CVRs and their current holders.
- Facilitating any transfers (if permitted).
- Handling payments to the holders.

When acting under a TIA-qualified agreement (see *Trust Indenture Act Matters*), the CVR trustee usually has broad powers to act on behalf of the holders. However, holders of a specified percentage of CVRs (generally a majority) have the right to instruct the trustee to take certain actions on behalf of the CVR holders, such as requesting an audit or claiming a breach. In a CVR agreement that is not TIA-qualified, the threshold for directing the action of the representative is sometimes set lower (as low as 20% in some cases).

In some cases the CVR agreement requires the acquiror to deliver a certificate to the trustee or representative stating its calculation of the payment amount (or that no payment is due). It may also permit holders of a certain percentage of CVRs to direct the trustee or representative to object to the acquiror's determination within a specified period.

In addition, many CVR agreements also limit the ability of individual holders to institute any action against the acquiror under the agreement, except where the trustee or representative has failed to follow the instructions of the holders of the required percentage of CVRs. However, as a result of TIA Section 316(b), individual holders cannot be limited from bringing a claim under a TIA-qualified agreement if the action concerns the right of the holder to receive payment. TIA-qualified agreements also tend to lack dispute resolution or arbitration clauses that limit individual holders' options in the event of a dispute (though the TIA technically only forecloses these limitations where the right to sue for payment is involved). On the other hand, non-TIA-qualified agreements often include arbitration or dispute resolution clauses, particularly where there is a complex mechanism for determining the outcome of the contingency or the payment due.

Both TIA-qualified and non-TIA-qualified agreements often have a multi-tiered approach to amendments. Some amendments can be made by the acquiror and trustee or representative without the consent of any holders. These are generally administrative

amendments that do not have a significant impact on the rights of the CVR holders or amendments to add acquiror covenants giving CVR holders additional protections. Other amendments typically require the consent of the holders of a designated percentage of the CVRs (often 50%).

However, under TIA Section 316(b), TIA-qualified agreements require the unanimous consent of the holders for amendments that affect the amount or payment date(s) of the CVRs. By contrast, some non-TIA-qualified agreements can be amended with the consent of holders of the designated percentage, regardless of whether or not the amendment may have an adverse impact on individual holders.

For more information on the TIA and the rights of securityholders, see *Practice Note, Indenture and Indenture Trustee: Governing Laws: Directions to Trustee* (<http://us.practicallaw.com/9-386-4929>).

SPECIAL ISSUES IN TENDER OFFERS

While most CVRs have been issued in transactions structured as one-step mergers, CVRs can also be used as consideration in a tender offer (see *PLC What's Market, Sanofi-Aventis/Genzyme Tender Offer Summary* (<http://us.practicallaw.com/whatsmarket.do>)). This may raise additional issues under the Williams Act and various SEC tender offer rules (see *Practice Note, Tender Offers: Overview: Regulation of Tender Offers* (<http://us.practicallaw.com/1-382-7403>)). The SEC has issued comments on tender offer filings raising the question of whether or not the use of CVRs violates Exchange Act Rule 14e-1(c), which requires that the offeror "pay the consideration offered ... promptly after the termination ... of a tender offer."

For example, in Endo Pharmaceuticals' tender offer for all shares of Indevus Pharmaceuticals, the SEC questioned whether unregistered future cash payments contingent on regulatory and commercial milestones would comply with Rule 14e-1(c) when the additional payments may not be made for five years (if at all). Endo Pharmaceuticals succeeded in arguing that it did not violate the prompt payment requirement because the CVRs should be viewed as contractual rights to receive additional cash payments in the future if certain events occur. As a result, the tendering Indevus stockholders did promptly receive their consideration (the contractual rights issued on closing of the tender offer), even if no cash was paid at that time.

Although a tender offer structure generally may provide timing benefits relative to a one-step transaction, parties should be aware that tender offers involving CVRs deemed to be "securities" can create timing delays. As a general matter, the offering of securities in an exchange offer must be registered under the Securities Act. This requires SEC clearance of the registration statement and typically has a longer timeline to complete than a cash tender offer (see *Checklist, Tender Offer Timeline* (<http://us.practicallaw.com/2-383-1032>)).

Unless there is another means of issuing the CVR without registration (for example, by distributing the CVR as a dividend as

discussed above), parties should determine whether the desire for speed of execution outweighs the benefits of using a CVR.

For an overview of tender offers, including the types of tender offers, how a tender offer is initiated and the steps required to complete a tender offer, see *Practice Note, Tender Offers: Overview* (<http://us.practicallaw.com/1-382-7403>).

ACCOUNTING CONSIDERATIONS

Generally, the accounting treatment for CVRs under US GAAP is governed by the revised Statement of Financial Accounting Standards No. 141 (SFAS 141R). SFAS 141R mandates fair value accounting for contingent consideration in business combinations. Before the adoption of SFAS 141R, contingent payments were usually recognized only when the contingency was resolved.

After the adoption of SFAS 141R, the issuance of cash-settled CVRs requires the acquiror to set up a liability account on its balance sheet equal to the fair value of the CVRs at the time of closing. The fair value of the CVRs is typically determined at issuance by one of two ways:

- Discounting the probability-weighted future payments at an appropriate risk-adjusted rate.
- Using derivative valuation methods such as the Black-Scholes option pricing model.

Because the fair value of the CVR is deemed part of the consideration paid in the transaction, under the purchase accounting method for business combinations mandated by SFAS 141R, the fair value of the CVR will also be reflected on the asset side of the balance sheet (generally by an equal increase in the goodwill account).

Each quarter, the established CVR liability must be marked to market, with the resulting increases and decreases flowing through the income statement. At settlement, any cash ultimately paid reduces the previously established CVR liability without further impact on the income statement (to the extent that the marked-to-market liability accurately predicted the cash ultimately paid at settlement).

Where CVRs are to be paid in stock, the same accounting rules generally apply. As with cash-settled CVRs, the acquiror must

establish an appropriately valued liability that must be marked to market. The only significant difference in treatment arises at settlement, at which time the equity account is increased.

TAX TREATMENT

The US federal income tax consequences resulting from the target stockholder's receipt of a CVR and the receipt of payments under a CVR depend on a variety of factors, including:

- Whether the target's securities are publicly traded.
- Whether the CVR has a reasonably ascertainable fair market value.
- The type of consideration payable under the CVR.

Generally, a target stockholder who receives a CVR with a reasonably ascertainable fair market value in a taxable acquisition of a publicly traded corporation must include the fair market value of that CVR in determining the amount of gain or loss recognized. By contrast, if a CVR does not have a reasonably ascertainable fair market value, the target stockholder may be able to defer the recognition of income until payments are received under the CVR.

Use of a CVR in a transaction that otherwise qualifies as a tax-free reorganization may not result in immediate taxation to the exchanging stockholders or jeopardize the tax-free nature of the transaction if the CVR provides for certain features, including that:

- It can only give rise to the receipt of additional stock.
- The maximum number of shares which may be issued is stated.
- Not more than 50% of the total number of shares issued in the transaction are issued under the CVR.
- All the stock will be issued within five years.
- The CVR is not transferable.

(*Revenue Procedure 84-42*.)

Therefore, merger partners may be able to structure either a tax-free or a taxable transaction without having CVRs jeopardize the desired overall tax treatment.

DEALS WITH EVENT-DRIVEN CVRS

EVENT	DEALS
FDA Approval	Sanofi-Aventis/Genzyme (2011), Celgene/Abraxis (2010), Endo Pharmaceuticals/Indevus Pharmaceuticals (2009), ViroPharma/Lev Pharmaceuticals (2008), Boston Scientific/Rubicon (2005) and Ligand Pharmaceuticals/Seragen (1998).
Product Sales Revenues	Sanofi-Aventis/Genzyme (2011), Forest Laboratories/Clinical Data (2011), Celgene/Abraxis (2010), Endo Pharmaceuticals/Indevus Pharmaceuticals (2009), ViroPharma/Lev Pharmaceuticals (2008), Boston Scientific/Rubicon (2005) and Baxter International/Somatogen (1998).
Operating Performance	Fresenius/APP Pharmaceuticals (2008), Onstream Media/Narrowstep (2008) and Toro/Exmark Manufacturing (1997).

Contingent Value Rights (CVRs)

EVENT	DEALS
Sale of Assets	NYSE Euronext/American Stock Exchange (2008), Petters Group/Polaroid (2005), Software AG/Saga Systems (2000) and Harvey's Casino Resorts/Pinnacle Entertainment (2000).
Litigation Collections	Vision Technologies Kinetics/Milltope Group (2003) and Symphony Technologies and Tennenbaum & Co./Information Resources (2003).
Accounts Receivable Collections	Psychiatric Solutions/PMR Corp. (2002).
Tax Refunds	Cambium Learning Group/Voyager Learning Company (2009).

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Contact Us

Practical Law Company
747 Third Avenue, 36th Floor
New York, NY 10017
646.562.3405
plcinfo@practicallaw.com
www.practicallaw.com

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