The ABCs of CVRs: A Guide for M&A Dealmakers

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The contingent value right ("CVR"), an instrument in which an acquiror commits to pay additional consideration to a target company's shareholders upon occurrence of specified payment triggers, has long been a creative structuring tool for M&A dealmakers.[2] Beginning in the late 1980s, CVRs were used in several high-profile transactions in order to guarantee the value of shares received as merger consideration. In recent years, CVRs have been used more frequently to bridge valuation gaps relating to uncertain future events, such as whether a milestone (for example, receipt of FDA drug approval) will be achieved, the level of future sales of a business or a product, or results of specific events such as a litigation or an asset sale. The recently announced $20 billion acquisition of Genzyme by Sanofi-Aventis, which began as a hostile deal and involved a CVR tied to FDA approval and a number of production and sales milestones, is the largest deal ever to use such a CVR. Despite a resurgence in recent years, CVRs are still a rarely used tool in large public transactions, in part due to their complexity and risks. However, they are an important deal technique, which can assist M&A dealmakers in solving valuation and deal risk issues. This article seeks to navigate the M&A practitioner through the intricacies of the CVR structure, highlighting both the potential advantages and the pitfalls.

The Anatomy of the CVR

Although CVRs are customizable contractual instruments that have been used to address a wide range of issues, it is worthwhile to focus on some of the key features that are most often seen in the two main types of CVRs: price-protection CVRs, which give downside protection to target shareholders with respect to the value of shares issued as consideration in the transaction; and event-driven CVRs, which may give additional value to target shareholders depending on specified contingencies.

Price-Protection CVRs

Price-protection CVRs are used in transactions in which the consideration includes publicly traded securities, generally acquiror's stock. The purpose of this type of CVR is to provide assurance to the target's shareholders as to 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 of the CVR, making their value inversely related to the price of the underlying security. Such value protection, which is similar to a put option granted to target stockholders, represents additional value for target shareholders.

Price-protection CVRs made their first high-profile appearance in Dow Chemical's acquisition of approximately 67% of the shares of Marion Laboratories and combination of Marion and Dow's pharmaceutical division, Merrell Dow, in 1989. In that transaction, shareholders of Marion (renamed Marion Merrell Dow) received CVRs issued by Dow whose value was tied to the performance of Marion Merrell Dow's shares. The Dow Chemical/Marion transaction (like the 1990 Rhone Poulenc/Rorer Group transaction) was unusual in that the reference security was the common stock of the target, which remained a separate public company, in contrast to the more typical situation where acquiror shares are the reference security.

The price-protection CVR rose to prominence with its use 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 each of Viacom and QVC had proposed transactions including cash and stock consideration, Viacom tipped the scales in its favor with the addition of a CVR that offered Paramount shareholders 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 (at Viacom's election). Viacom also used a CVR in its purchase of Blockbuster in 1994, offering Blockbuster shareholders the right to receive up to an additional 0.13829 of a share of Viacom Class B common stock, with the exact fraction dependent on the market prices of Viacom Class B common stock during the year following the closing. Price-protection CVRs have also been used in recent years, although their use has been less frequent than the event-driven variety described below.

Target Price, Caps & Maturity Dates. Typically, the CVR has a maturity of one to three years, and at maturity the holder receives a payment of either cash or securities, subject to a cap, if the market price of the acquiror's stock is below a "target price." For example, in the Viacom/Paramount deal, the package of consideration received for each Paramount share included, among other things, 0.93065 of a Viacom CVR per share. Viacom was required to pay holders of the CVRs the amount, if any, by which the target price exceeded the "current market value" at the maturity date, which was defined as the median of the averages of the closing prices of Viacom shares during each 20 consecutive trading-day period that both began and ended in the 60 trading days immediately preceding (and including) the maturity date.[3] The target price has typically been set above the pre-announcement trading price of the securities to which the CVR is tied, thereby effectively guaranteeing some level of price appreciation, but it could also be at or below the preannouncement price. 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 and thus acts 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, but have often been set at 25-50% discounts to the target price.

Sometimes, as protection against short-term fluctuations in share prices, a CVR provides that the acquiror may extend the maturity date. Typically, any such extension carries with it an increase in the target price and the floor price (often in the range of 5-10% per 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. But whereas at the first maturity date, the target price was $48, it rose to $51 on the second maturity date and to $55 on the third. Similarly, the floor price rose 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, issuers tend to like the option, which can, if exercised, send a bullish signal to the market.

Cash vs. Stock. A threshold issue in any CVR negotiation, irrespective 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 in stock, the parties also will need to determine the valuation of the shares issuable at settlement. The shares are usually valued pursuant to a formula based on trading prices (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) or, much less frequently, a predetermined price.[4] Occasionally, parties include a mechanism (similar in effect to the "floor" concept discussed 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.

In order to provide additional flexibility, the acquiror may be given the right to settle the CVR in either cash or stock, at its election.[5] In the Viacom/Paramount CVR, Viacom not only could elect between cash and stock, but could use any type of Viacom securities.

Redemption and Early Termination Provisions. Some CVRs permit the issuer to redeem the CVRs, usually at a price equal to the target price less the current market price of acquiror shares as of the redemption date, discounted back from the maturity date. Although an issuer may prefer the optionality of being able 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 also 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.[6] To protect the holders of CVRs against short-term price appreciation, the early termination provision is often structured to require sustained price appreciation (for example, over a period of 30 consecutive trading days).

While less common, a redemption or early-termination feature can also be included in an event-driven CVR. For example, the Sanofi/Genzyme CVR included a redemption option for Sanofi in the event that the CVR traded below a specified price and certain sales milestones were not met, with the redemption price being the volume-weighted average CVR price over a specified forty-five trading period prior to redemption.

Prohibition on Share Repurchases. Price-protection CVRs also typically will restrict the issuer and its affiliates from purchasing the issuer's own stock (and, occasionally, hedging activity) during the valuation period, in order to limit the potential upward pressure on acquiror stock that could lessen the value of the CVR, but typically repurchase announcements have not been restricted.

Protections Against Extraordinary Transactions. Price-protection CVRs often provide that certain sale transactions by the CVR issuer, such as certain mergers or a sale of substantially all of its assets, require the issuer to make an early settlement of the CVR obligation by paying 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 disposition) and the value of the consideration received in the transaction (or the floor price, if greater). CVR agreements also typically prohibit the CVR issuer from engaging in certain mergers or in a sale of substantially all of the assets unless the successor entity assumes the CVR obligations.

Anti-dilution Adjustments. Because price-protection CVRs are tied to the market value of acquiror shares, such CVRs typically include provisions that adjust the target and floor prices upon certain events relating to the acquiror's shares, such as a stock dividend or stock split and, in some cases, certain mergers. In the case of a CVR that may be settled in stock, a stock-for-stock merger might also result in an adjustment of the securities issuable at maturity of the CVR. Any adjustment triggered by a stock-for-stock merger would, of course, need to be harmonized with a provision requiring the issuer to make an early settlement of the CVR obligation upon certain mergers, if one is included. CVR agreements do

not, however, typically provide for an adjustment in the event of a below-market issuance.

Event-Driven CVRs

In recent years, CVRs have more frequently been used by acquirors and targets as a means of bridging a valuation gap with respect to a contingency. For example, such CVRs have included payouts dependent on financial performance metrics, achieving milestones such as FDA drug approval or receiving royalty payments, or proceeds from litigations, sales of assets or tax refunds, among other triggers.[7] CVRs of this type have been particularly common in health care and biotech M&A deals, accounting for more than a majority of all such uses. The prevalence of event-driven CVRs in the healthcare and biotech industries is explained by the disproportionate impact that even a single successful drug could have on the valuation of the target, and because such companies are familiar with the use of milestones in commercial arrangements, such as licensing and R&D agreements. For example, Sanofi-Aventis' recent agreement to acquire Genzyme for $20 billion and Celgene's 2010 agreement to acquire Abraxis BioScience for $2.9 billion both employed CVRs with payments dependent on achieving certain drug-related milestones. 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.

Event-driven CVRs can be structured to relate either to contingent assets or to contingent liabilities. For example, a CVR that provides for additional payments based on proceeds from a lawsuit against a third party may be viewed as a pass-through of a contingent asset.[8] In contrast, a CVR also can be structured to address a contingent liability, such as a pending litigation against the target, by setting aside value to cover any eventual liability. For example, the target's shareholders can be issued CVRs that provide for payment of a sum that decreases with the size of the ultimate liability. A CVR structured in this manner would, however, require establishment of benchmarks for the expected amount or range of the potential liability, which may have a negative impact on settlement negotiations. Another potential method of addressing a potential litigation liability is to issue CVRs to the *acquiror's* shareholders that would ultimately be settled with a number of shares that increases with the size of the ultimate judgment or settlement in the litigation, thus diluting the interest of former target shareholders.

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 an additional $6 per share in cash, depending 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.

Event 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 regulatory approval, the parties will need to specify whether approval given subject to conditions (*e.g.*, subject to including certain labeling) would still result in payment.[9] The payment trigger might also require that the regulatory approval be granted for at least a specified time period.

Some CVRs employ multiple triggers. 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), in addition to two triggers based on FDA approval and production milestones. 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).

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. In CVRs where regulatory approval

must be obtained before the product can be sold, the measurement period may not start until the approval is obtained or the first sale is made.

Determination of Amount of 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 whether a milestone such as regulatory approval is met, the payout is often a binary event, although it can depend on other variables, such as timing of approval or attached conditions. Where variables tied to financial performance are incorporated into the trigger, the CVR might provide for a range of payments depending on the results (*e.g.*, one of the Celgene/Abraxis CVR triggers provided for payment of 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 and an additional 10% of annual net sales in excess of $3 billion). Earn-out CVRs might also include special rules for calculating the relevant measurement metric.

Support Obligations. Because an acquiror frequently can influence the ultimate payout on an event-driven CVR (such as through its investment and marketing efforts), targets negotiating CVRs often add 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 want to give the acquiror incentives to maximize such recoveries. One way to do so is to provide the acquiror an economic stake, which is why CVR agreements do not generally assign 100% of the litigation proceeds to CVR holders. Such CVRs also may impose a duty to prosecute the litigation in good faith with a view to maximizing the value of the proceeds. In addition, such CVRs often cede direct control over the day-to-day conduct of the litigation as well as authority over whether to accept a settlement agreement to a representative of the CVR holders or to a group that includes such a representative.

In CVR instruments where the payout depends on FDA approval or other product development milestones, parties often require the acquiror to undertake a specified level of efforts to achieve the milestones. The consequences of not having such covenants were illustrated in the 2003 OSI Pharmaceuticals/Cell Pathways CVR, in which the payment trigger was tied to the FDA's acceptance of applications for either of two drugs by a specified date; two years prior to the deadline, OSI stopped developing both products. A typical covenant is for the acquiror to use "commercially reasonable efforts" to continue development of a particular product. Another efforts standard sometimes used is "diligent efforts," occasionally 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, issuers retain the "sole discretion" to make decisions with respect to matters that may affect whether the CVR triggers are satisfied (as was the case, for example, in the Ligand Pharmaceuticals/Pharmacopeia CVR).

Reporting Obligations and Audit Rights. Event-driven CVR agreements may require the issuing company 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 "adjusted EBITDA" in detail (along with a reconciliation to a traditional GAAP measure) in its annual and quarterly reports filed with the Securities and Exchange Commission (the "SEC"). In the Sanofi/Genzyme CVR, Sanofi was required to make available (with the trustee and on its website), among other things, quarterly sales and production information.

In addition, in some cases, the CVR agreement expressly provides for audit rights. Acquirors often insist on clauses that limit the audit right, for example limiting it to once per year and upon reasonable notice; targets may request audit rights to extend for some period beyond the CVR measurement period. Further, the parties need to decide who pays for such audits. In the Celgene/Abraxis CVR, for example, the parties agreed that holders of a majority of CVRs could request one audit per year, but that the requesting CVR holders would bear the cost of any audit (through a reduction in future CVR payments) unless the

issuer 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 issuer.

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 when considering a CVR structure.

Potential Advantages

Valuation Gaps. As noted above, 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 will be able to reach agreement on the appropriate valuation of a large part of the target business, but have fundamental disagreements as to the likely future value of a significant contingency. For example, after Sanofi-Aventis launched a hostile bid for Genzyme, it took months of negotiations over valuation before the parties bridged the gap with a CVR. As the CEO of Sanofi-Aventis noted, the parties agreed on 90 percent of Genzyme's value, but "10 percent of $20 billion is a lot of money."[10]

Increased Deal Certainty. A CVR also can 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 FDA approval or about the risk of an adverse judgment in a significant litigation, it might resist doing an acquisition until the contingency has been resolved, either as a condition to signing or closing, which may be unacceptable to the target. In this situation, a CVR can allow the parties to agree to a transaction without significant non-consummation risk. In addition, an acquiror may also be comfortable with more streamlined due diligence with respect to certain issues when the value of certain contingent assets is made the subject of a contingent payout.

Financing Issues. Some parties may perceive financing-related benefits from the use of a CVR. First, by reducing the total consideration required for the payment at closing, the CVR can act as a form of deferred financing, which can be an advantage depending on the acquiror's needs 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 odds that the CVR payment will be triggered. As Dow Chemical's corporate director of mergers and acquisitions explained when discussing the Dow Chemical/Marion transaction, Dow viewed the CVR, which provided for a cash payment if the trading price of the combined company's common stock fell below specified levels, "as a non-cash currency, which, in the event that Marion Merrell Dow's stock appreciated, would not have to be paid off."[11]

Market Perceptions. A CVR also can 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, as 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

Execution Risks and Potential for Dispute. A key 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 in their negotiation and implementation. CVR agreements are lengthy and involve many issues that require detailed negotiation and careful drafting, thus requiring time and resources that can otherwise be devoted to other aspects of the deal. Moreover, as discussed in more detail below, the inclusion of CVRs as a component of the deal could impose requirements under the federal securities laws that potentially lengthen the timeline to closing.

The complexity noted above can lead to a related disadvantage—risk of potential litigation. One possible type of dispute and litigation exposure involves claims 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 and, in fact, most CVR agreements include express language limiting a CVR holder's rights to those set forth in the agreement.[12] However, as noted above, parties often impose efforts standards such as "commercially reasonable efforts" or "diligent efforts" that are vague enough to provide the basis for a challenge. In addition, a CVR, as a contractual instrument, may be deemed to include an implied covenant of good faith and fair dealing, thus creating the possibility of claims that the acquiror breached an implied obligation to use efforts to enable the CVR holders to achieve the earn-out, although such a claim may be difficult to sustain, particularly where contractual language grants the acquiror leeway in running the acquired business post-closing.

Valuation. While CVRs may be useful tools for bridging valuation gaps, they may also create their own valuation issues. The largest potential source of disagreement during the negotiation process is over the selection of performance metrics or price-protection targets, and the valuation of the CVRs. Discussions with respect to the "intrinsic value" of CVRs can be tricky because parties considering CVRs often conduct valuation negotiations on parallel tracks, one in which the CVRs are included in the deal consideration and one in which they are not. In such 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, but be less willing to stand behind such valuation claims when the parties are seeking to construct and value a CVR.

In addition to these critical valuation issues, it is also likely that target shareholders (including arbitrageurs who normally buy target shares) are not natural holders of CVRs, and as such may apply a discount in valuing them. In many cases, in order to enhance their value, the acquiror is required to make CVRs liquid by permitting the target's shareholders to transfer them. In such cases, arbitrageurs or event-driven hedge funds often end up acquiring a significant percentage of such CVRs at a discount to their intrinsic value.

Effect on Acquiror and its Stock. One potential drawback of a price-protection CVR is the overhang associated with the potential payout. Unlike in the event-driven variety, where large payouts are generally associated with positive outcomes, a payout under a price-protection CVR highlights poor share price performance. Another potential drawback is the possibility that arbitrageurs, who tend to buy such CVRs and delta hedge their exposure with acquiror's stock, may generate unwanted trading activity in the acquiror's shares.

In the case of CVRs where the payout is settled in stock, acquirors will need to reserve adequate shares and register (unless the underlying shares are registered at the time of the initial transaction) and list them. Likewise, if the payout is in cash, acquirors will need to arrange for financing in advance of its need, which has an associated cost. Target companies unwilling to assume the financing risk may seek to require acquirors to place cash in escrow to satisfy any CVR obligations. In addition, as discussed further below, acquirors may also be required to record the CVR as a liability on their balance sheet, which may be subject to subsequent mark-to-market adjustments that could result in income statement charges.

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

Credit Risk. A CVR also exposes its holders to the credit risk of the issuer because it typically is an unsecured obligation of the issuer, which may not be repaid in full in the event of bankruptcy.[13] In fact, CVR agreements often contain provisions expressly subordinating the CVRs to senior obliga-

tions of the issuer. In addition, CVR holders receiving securities of the issuer (*e.g.* stock) as part of the transaction 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 issuer under Section 510(b) of the Bankruptcy Code.

Disclosure. As discussed further below, the use of a CVR that requires registration under the Securities Exchange Act of 1934, as amended (the "Exchange Act") may impose additional ongoing disclosure and reporting obligations on an issuer, which, for some issuers, such as private or foreign companies, may represent a large burden.

Securities Law and Other Legal Considerations

Trust Indenture Act. Because of the typically large number of CVR holders, a trustee, rights agent or other representative is usually appointed to oversee the rights of CVR holders and to perform certain actions on their behalf. The powers and responsibilities of the trustee or representative depend partly upon whether the agreement needs to be qualified under the Trust Indenture Act of 1939, as amended (the "TIA"). Under Section 304(a)(1) of the TIA, a security will be exempted if it is not "(A) a note, bond, debenture, or evidence of indebtedness, whether or not secured, or (B) a certificate of interest or participation in any such note, bond, debenture, or evidence of indebtedness, or (C) a temporary certificate for, or guarantee of, any such note, bond, debenture, evidence of indebtedness, or certificate." As a result, qualification under the TIA is necessary only in connection with debt securities, which may require difficult judgments in cases where the CVR combines elements of debt and equity.

Where the TIA applies, it requires that CVRs be issued under an indenture, and that a trustee be appointed to protect the rights of the CVR holders. Qualification under the TIA brings with it protections for CVR holders by mandating that certain provisions be automatically included in the CVR agreement or indenture. For example, Section 316(b) requires that the right of any CVR holder to receive payment generally may not be impaired without his consent. The TIA also automatically includes in each qualified agreement certain default provisions that can be modified by contract, including 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.

Transferability and Listing. A CVR can be transferable or nontransferable, even in large public company deals.[14] Structuring a CVR as a transferable instrument enhances its value to target shareholders by ensuring liquidity for holders. Transferable CVRs are often, but not always, listed for trading on stock exchanges.[15] As discussed in more detail below, a transferable CVR is likely to require registration under the 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.[16]

Securities Act. The issuance of a CVR, even if payable in cash, may require registration under the Securities Act of 1933, as amended (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 will be 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) are almost always required to be present to conclude that a CVR is not a security:

(1) the rights are an integral part of the consideration to be received in the merger;

(2) the holders of the rights are to have no rights common to stockholders such as voting and dividend rights;

(3) the rights bear no stated rate of interest;

(4) the rights are not assignable or transferable except by operation of law; and

(5) the rights are not represented by any form of certificate or instrument.[17]

Although these five factors are generally considered the key determining factors in analyzing whether the SEC will consider a CVR a security,[18] no-action letters have also, on occasion, noted ad-

ditional factors as supporting the conclusion that a CVR is not a security, including:

(1) the right is not dependent on the operating results of any party involved;

(2) almost all of the holders of the rights will continue with the surviving corporation as employees; and

(3) the value of the payments resulting from the rights is a small fraction of the overall consideration.[19]

In particular, while the link between CVR payments and the operating results of the issuer has been listed as a factor in many no-action letters,[20] it has not been consistently applied. Even where the factor has been discussed, issuers have often been able to successfully argue 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).

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 will usually also be 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 via a dividend.

Exchange Act. 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. The issuer 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."[21] In practice, most CVR issuers who register under the Securities Act also register under the Exchange Act.

Where Exchange Act registration is required, such registration is usually effected on a Form 8-A. If the issuance of CVRs has been registered under the Securities Act, registering the CVRs under the Exchange Act typically would not impose a material burden; in fact, it often will be possible to simply incorporate the information in the Securities Act registration statement into the Exchange Act registration statement.

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

- At least 1 million CVRs must be outstanding;
- There must be at least 400 CVR holders;
- The CVR must have a minimum life of one year; and
- The CVRs must have a market value of at least $4 million.[22]

A CVR issue may be delisted from the NYSE when the aggregate market value of the publicly-held CVRs is less than $1 million or when the related equity security to which the payment at maturity is tied is delisted. As a result, in the case of a price-protection CVR, delisting may be possible where the reference security is trading at a sufficiently high level.

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

- In excess of $100 million in assets;
- Stockholders' equity of at least $10 million; and
- 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.[23]

In addition, the CVR must have:

- At least 400 holders;
- A minimum public distribution of at least 1 million units; and
- A minimum market value/principal amount of at least $4 million.[24]

Accounting Considerations

Generally, the accounting treatment for CVRs under U.S. GAAP is governed, as of 2009, by the revised Statement of Financial Accounting Standards No. 141 ("SFAS 141R"), which mandates fair value accounting for contingent consideration in business combinations. Prior to the adoption of SFAS 141R, contingent payments were usually recognized only when the contingency was resolved.

Following the adoption of SFAS 141R, the issuance of CVRs that provide for payment in cash requires the establishment of a liability account on the issuer's balance sheet equal to the fair value of the CVRs at the time of closing. The fair value of the CVRs will generally be determined by discounting the probability-weighted future payments at an appropriate risk-adjusted rate, or by using derivative valuation methods such as the Black-Scholes option pricing model. Since the fair value of the CVR is considered 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 is required to 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 issuer must establish an appropriately valued liability that must be marked-to-market. The only significant difference in treatment arises at settlement, at which time, since there is no cash outflow, the equity account is increased instead.

Tax Treatment

The federal income tax consequences resulting from the 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, and the type of consideration payable under the CVR. Generally, in an otherwise taxable acquisition of a publicly-traded corporation, a target shareholder who receives a CVR that has a reasonably ascertainable fair market value would be required to include the fair market value of such CVR in determining the amount of gain or loss recognized in the exchange. In contrast, if a CVR received in such transaction does not have a reasonably ascertainable fair market value, the selling shareholder 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 shareholders or jeopardize the tax-free nature of the transaction if the CVR provides for certain features, including, that (i) it can only give rise to the receipt of additional stock, (ii) the maximum number of shares which may be issued is stated, (iii) not more than fifty percent of the total number of shares to be issued in the transaction are issued pursuant to the CVR, (iv) all the stock will be issued within five years, and (v) the CVR is not transferable.[25] Accordingly, merger partners may be able to structure either a tax-free or a taxable transaction without having CVRs jeopardize the desired overall federal income tax treatment.

Conclusion

Recent mergers, especially in the healthcare and biotech industry, have returned attention to the use of CVRs as a way of helping parties bridge

valuation gaps or otherwise deal with uncertain future events. While the use of CVRs presents challenges, including complexity and dispute risk, CVRs present an attractive tool for dealmakers to get deals done in the face of uncertainty. As useful as they may be, CVRs are highly customized agreements with great variation and numerous traps for the unwary. Lawyers must not only devote attention to difficult contractual terms, which can become the subject of dispute or litigation, but also be aware of securities law, accounting and tax considerations. Recent experience suggests that CVRs can be usefully deployed to solve some of the trickiest contingencies that parties encounter in public M&A transactions and, as such, should be in every M&A dealmaker's toolkit.

NOTES

1. We would like to thank our colleagues Eric Robinson and Eiko Stange for their comments. Another version of this article appeared in *The Practical Law Journal* and a longer version appears at practicallaw.com.
2. CVRs are sometimes referred to by other names, for example, "contingent payment rights," "deferred payment rights" or simply "contingent consideration."
3. The methodology for determining the current market value at the third maturity date was slightly different.
4. An example of a CVR that valued shares issuable on settlement at a predetermined price is Clinical Data's 2008 agreement to acquire Avalon Pharmaceuticals, which involved a CVR that paid out shares upon certain milestone triggers, with the additional shares issuable being valued at $12.49 (the volume-weighted average trading price of Clinical Data common stock for the 15 trading-day period that ended on the date of the merger agreement).
5. The CVRs in Viacom/Paramount (1994), Markel/Terra Nova (2000), Aldabra/Boise Paper (2008) and ViroLogic/ACLARA BioSciences (2004) included such an election mechanism.
6. Such early termination provisions were included in the Viacom/Blockbuster (1994), ViroLogic/ACLARA BioSciences (2004), Cytogen/Cytorad (1994), Markel/Terra Nova (2000) and Iconix/Mossimo (2006) transactions.
7. In the Symphony Technologies and Tennenbaum & Co./Information Resources (2003), target stockholders received a CVR tied to the outcome of antitrust litigation by the target against third parties. Examples of CVRs tied to a separate sale of an asset include NYSE Euronext/American Stock Exchange (2008), Petters Group/Polaroid (2005), Software AG/Saga Systems (2000) and Harvey's Casino Resorts/Pinnacle Entertainment (2000). In Psychiatric Solutions/PMR Corp. (2002), the CVR was tied to collections on the seller's accounts receivable. Cambium Learning Group/Voyager Learning Company (2009) included a CVR tied to specified tax refunds.
8. For example, in Vision Technologies Kinetics/Miltope Group (2003), the CVR holders were entitled to receive 50% of the net proceeds from a litigation brought by Miltope against third parties involving claims arising out of an alleged breach of a confidentiality agreement. In Symphony Technologies and Tennenbaum & Co./Information Resources (2003), which involved antitrust litigation by Information Resources against third parties, CVR holders were entitled to receive 68% of the net litigation proceeds up to a specified amount, and 75% of any proceeds exceeding that amount.
9. For example, in Endo Pharmaceuticals/Indevus Pharmaceuticals (2009), the amount payable under the CVRs depended, in part, on whether the relevant drug was approved with or without certain labeling requirements.
10. *See* "Sanofi Agrees to Buy Genzyme for $20.1 Billion," *New York Times*, February 17, 2011, at B10.
11. *See* "Contingent-value rights: Entertaining derivatives," *Finance & Treasury*, July 11, 1994, at 2.
12. *Cf. Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) ("Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist. The obvious example is stock ownership. Until the debenture is converted into stock the convertible debenture holder acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."); *Corporate Property Assocs. 14 Inc. v. CHR Holding Corp.*, 2008 WL 963048, at *4 (Del. Ch. Apr. 10, 2008) ("Despite Corporate Property Associates' attempt to distinguish *Simons* because that opinion addressed convertible debentures as opposed to warrants, the same analysis applies—the convertibility of the warrants does not result in the imposition of fiduciary duties."). For examples of clauses limiting a CVR holder's rights to those set forth in the agreement, see Celgene/Abraxis (2010), Ligand/MetaBasis Therapeutics (2009),

Fresenius/APP (2008), Cytogen/Cytorad (1994) and ViroLogic/ACLARA BioSciences (2004).

13. This is not universally the case. For example, the CVR issued in the 1990 reorganization of Brooke Group, Ltd. was a senior obligation secured by a note and collateral requirements.
14. For example, whereas the CVRs issued in the recent Sanofi/Genzyme CVR deal are transferable, those in the Forest Laboratories/Clinical Data transaction announced just a week later are not.
15. For example, the CVRs issued in the Ligand/Metabasis (2009), Markel/Terra Nova (2000) and Eaton/Fusion Systems (1997) transactions were transferable, but were not listed on an exchange.
16. In some cases, the possible consequences of registration under the securities laws may be viewed as so burdensome that the parties would condition the very existence of the CVR on whether registration was required. For example, in Saga Systems/Software AG (2000), the CVR agreement provided that if the SEC requests 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.
17. *See, e.g.,* Minnesota Mining and Manufacturing Co. (Oct. 13, 1988).
18. Davis, Robert and Wang, Deborah, "Doubts About Earnouts—Analysis of Whether Earnouts are Securities," Cleary Gottlieb Steen & Hamilton LLP Mergers & Acquisitions Report, at 5-6 (2009); *see also* Aquila, Frank and Sawyer, Melissa, "Contingent Value Rights—Means to an End: Using CVRs to Bridge Valuation Gaps in Public Company M&A Deals," 2009 Emerging Issues Analysis, at 8 (Sept. 2009).
19. *See, e.g.,* Genentech Clinic Partners III (Apr. 28, 1989) ("[A]ny amount ultimately payable pursuant to the rights is not dependent on the operating results of [the issuer.]"); Northwestern Mutual Life Insurance Co. (Mar. 3, 1983) (a "substantial portion of [the consideration] is being paid in cash" and "most holders of the earn out right will be employees of [the issuer] and many can be expected to remain with the acquired business and contribute their efforts directly towards its profitability").
20. *See, e.g.,* Essex Communications Corp. (June 28, 1988); GID/TL, Inc. (Mar. 21, 1989); Genentech Clinic Partners III (Apr. 28, 1989); Marriott Resident Inn L.P. (May 8, 2002); Quanex Corp. (July 28, 1989).
21. *See* SEC Rule 3a11-1, 17 C.F.R. § 240.3a11-1.
22. NYSE Listing Company Manual, Rule 703.18.
23. In the case of a company which is unable to satisfy this income criteria, NASDAQ generally will require the company to have the following: (i) assets in excess of $200 million and stockholders' equity of at least $10 million; or (ii) assets in excess of $100 million and stockholders' equity of at least $20 million.
24. NASDAQ Listing Rule 5730(a).
25. IRS Revenue Procedure 84-42, 1984-1 C.B. 521.