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Contingent Value Rights - Means to an End: Using CVRs to Bridge Valuation Gaps in Public Company M&A Deals

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Setting a deal price is often the toughest issue in any negotiation, sometimes it is the only issue. In far too many deals, that gap cannot be bridged. Innovative dealmakers have long recognized that contingent value rights ("CVRs") could be the perfect – albeit highly structured – solution. CVRs are derivative securities or contract rights that pay holders upon the occurrence of specified contingencies. While CVRs have been used in pharmaceutical and biotech M&A deals, they are not used widely in M&A deals. That could be changing because CVRs are an extraordinarily flexible tool that can be structured in an infinite variety of ways to suit the facts and circumstances of a particular transaction.

Although the financial, tax, legal and other aspects of CVRs can add complexity to a deal, those issues are far from insurmountable. This article suggests that CVRs should become a regular component of an M&A lawyer's arsenal and highlights certain technical considerations associated with using CVRs. First, this article describes a number of potential ways in which CVRs can be used in M&A deals. Second, this article describes certain of the key characteristics of CVRs that factor into their design.

I. Uses of CVRs

Typically in M&A deals, CVRs fall into two broad categories: (1) performance driven CVRs and (2) event driven CVRs. A third category, financing-related CVRs, is not widely used in M&A but may have many practical applications.

Performance-Driven CVRs

Performance driven CVRs are linked to the issuer's performance over a certain period of time. In an M&A deal, for example, the buyer can issue performance driven CVRs to the target's stockholders, in addition to shares of buyer's common stock or cash. The CVRs could be structured in any of the following ways:

(1) Hedging Instrument. The CVRs would pay out cash or securities to the target's legacy stockholders if, on the maturity date, the buyer's stock is trading below an agreed level. CVRs with this design function as hedging instruments: They guarantee a minimum amount of consideration per target share after a prescribed period of time, even if the buyer's stock price drops after the deal is completed. These CVRs resemble put options by giving the target's stockholders down-side protection.[1] If they are separately traded instruments, these types of CVRs will have trading values that move inversely to the value of the underlying buyer stock (*i.e.*, as the buyer's stock price declines, the CVR would increase in value).

Why create a hedging instrument for target's stockholders, rather than letting the market generate its own hedging techniques? Among other reasons, the target's board may not feel comfortable agreeing to a transaction that requires stockholders to obtain their own hedges because that could lead to disparate outcomes for different types of stockholders. For example, sophisticated institutional stockholders are more likely than individual retail investors to have access to the knowledge and resources necessary to trade in derivatives. In addition, making the hedging instrument an official component of the deal consideration shifts the transaction costs associated with the instrument partially to the buyer and the buyer's legacy stockholders and partially away from the target's legacy stockholders.

CVRs that are designed like hedging instruments could be a particularly appealing option in an auction in which a potential buyer that is proposing to use stock consideration is competing with potential cash buyers. By including a CVR in its offer, the stock buyer may be able to make its offer more directly comparable to cash offers and to eliminate any concerns the target's board may have about volatility of the buyer's stock price. Such CVRs could also be used to deliver fixed value in a fixed exchange ratio deal in lieu of a floating exchange ratio/collar mechanism. Buyers should keep in mind, however, that issuing hedging CVRs can result in the buyer's stock price becoming depressed due to trading by arbitrageurs.

(2) Earn-Out Instrument. The CVRs would pay out cash or securities to the target's legacy stockholders if, on the maturity date, a business line, asset or other part of buyer that represents a legacy business of the target is performing at an agreed level. If the target believes that its future business plans are likely to generate greater value than is

1. For a good description of how a financial advisor may evaluate the pros and cons of using CVRs as hedging instruments in a particular transaction, *see* Goldman, Sachs & Co.'s Presentation to the Special Committee of Genentech Inc. in Exhibit (c)(2) to Genentech Inc.'s Schedule 14D-9/A filed on March 12, 2009. The presentation also cites a number of precedent merger transactions that used CVRs, including Wesfarmers-Coles (2007), Publicis-Saatchi & Saatchi (2000), BNP-Paribas (1999), Suez-Lyonnaise-Generale de Belgique (1998), Viacom-Blockbuster (1994) (VCRs), and Viacom-Paramount (1994). Other examples of transactions that used CVRs as hedging instruments include ViroLogic-Aclara (2004); Mannkind-Pfizer (2009); and Dow Chemical-Marion Laboratories (1991).

currently reflected in the target's stock price or the valuation multiple proposed by the buyer, the CVR would give the target's stockholders a means to participate in the future upside from the target's operations without sharing those benefits pro rata with the buyer's legacy stockholders. The CVRs simultaneously would allow the buyer to defer payments, giving the buyer time to realize synergies and manage downside risks before having to part with cash, securities or other assets. This type of CVR could help to bridge the gap between a conservative buyer's estimates of a target's future performance (*e.g.*, the "base case" view) and an optimistic target's expectations (*e.g.*, the "optimized case" view). This could be especially useful in transactions that require stockholder approval for both the buyer and the target because the CVRs can provide a means for balancing the need to pay the target's stockholder a price that is at a premium to its historical average stock price, while at the same time not causing the buyer to pay an EBITDA multiple that exceeds those paid in recent comparable transactions.[2]

CVRs that are designed like earn-outs are complex. Among other reasons, they suffer from the same difficult issues that affect any kind of earn-out, including the fact that the parties must agree on all of the following potentially contentious characteristics of the CVR prior to announcing a deal: (1) which assets or business lines will form the basis for measuring the value of the CVR and what metrics and targets will be used to assess the performance of those businesses; (2) the maturity date;[3] (3) who will perform the relevant calculations and how those calculations will be tested and verified; (4) how changes in the buyer's accounting policies after the deal closes will impact the CVR's value; (5) whether and to what extent the buyer can engage in businesses that compete with the businesses underlying the CVR; (6) whether the buyer can sell or discontinue the businesses underlying the CVR; (7) whether buyer should be subject to any ongoing operational restrictions to preserve the value of the businesses underlying the CVR; (8) whether buyer should be required to make any commitments to provide financing (including making capital expenditures) to, or to perform services on behalf of, the businesses underlying the CVR; and (9) to what extent value-drivers unrelated to the performance of the businesses underlying the CVR (such as the effect of an upturn in the economy generally or efficiencies generated by the buyer at the corporate parent level that have an ancillary benefit for the businesses underlying the CVR) should be "read out" of the measurement of the performance of the

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2. Examples of transactions that used earn-out CVRs include: Fresenius SE-App Pharmaceuticals (2008); Onstream Media-Narrowstep (2008); and Minnesota Mining and Manufacturing/Cardiovascular Devices (1988).

3. On average, it appears the maturity dates for CVRs used in M&A transactions are between 1 and 3 years. Under the New York Stock Exchange ("NYSE") listing rules, listed CVRs must have a minimum life of at least one year.

businesses underlying the CVR. The market value of earn-out CVRs will depend on the market's expectations regarding the future performance of the relevant businesses.

A further potential use of earn-out CVRs is as a form of equity compensation for management/employees of the target that will be employed by the buyer post-closing. In this context, the CVRs would be granted not to the target's public stockholders, but just to the target's employees who will continue to work for the buyer post-closing. This structure may be particularly useful for acquisitions of businesses like financial advisory businesses, where the retention of human capital is vital to the future success of the combined company, or in leveraged buy-outs as a means to structure deferred compensation for the management participants.[4]

Like tracking stock,[5] CVRs that are designed as earn-out instruments also raise issues concerning the need for separate financial reporting at the level of the business underlying the CVR. The SEC has stated that an issuer of tracking stock must include financial statements about the tracking stock in its Exchange Act reports. Many issuers provide separate financial disclosures for the benefit of CVR holders.[6]

(3) Post-Closing Adjustment Instruments. The CVRs would pay out if certain financial metrics of the target exceed the estimated metrics incorporated into the buyer's initial offer price. That is, the CVRs could function like a post-closing working capital, book value or net assets adjustment of the type more traditionally used in private company M&A deals. This could be especially desirable in a deal in which the buyer is otherwise paying cash or using a floating exchange ratio to deliver a fixed value for the target at

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4. Issuers should consider the applicability of "going private" transaction rules and the accounting and tax impacts of using CVRs as equity compensation. In addition, even if the transaction is using CVRs that do not have a compensatory purpose, a buyer will need to determine to what extent roll-overs of equity awards will take into account the CVRs that are being issued to the target's legacy stockholders.

5. Tracking stock is a separate class of stock of an issuer that "tracks" the results of a particular business line or division of the issuer. For example, Sprint once issued tracking stock that tracked the results of the Sprint PCS wireless division. The issuer retains control over the division and the holders of the tracking stock have limited voting rights. Tracking stock once was viewed as an alternative to a spin-off. After an initial surge of issuances of tracking stocks in the late 1980s and 1990s, however, tracking stocks are no longer widely used today. Since tracking stocks are analogous to earn-out CVRs in some respects, practitioners should review the literature regarding tracking stocks prior to structuring earn-out CVRs. That being said, when CVRs are being used as a form of merger consideration, they are perhaps more properly viewed as deferred payments rather than just merely "different slices of the same pie" (the latter being an oft-repeated criticism of tracking stock that was issued outside of the M&A context).

6. *See*, *e.g.*, Fresenius Kabi Pharmaceuticals Holding, Inc. Annual Report on Form 10-K for the year ended December 31, 2008, at 33 (issuer presents calculation of adjusted EBITDA under the CVR indenture for the fiscal year).

the closing. For example, if the target is in an industry (such as reinsurance) in which its stock price rises and falls largely in a direct relationship with the target's book value, the buyer could agree to pay the target $X per share based on the target's book value at the end of the quarter preceding the signing date. If the target's book value at the closing is greater than $X, the CVR would pay out the excess of the actual closing book value over $X. Using the CVR in this manner would give the buyer time after the closing date to close the target's books and calculate the target's actual book value on the closing date. Note, however, that the simplest version of this CVR would only provide a "one-way" adjustment – that is, absent an escrow arrangement, the buyer would still have to take the risk that the post-closing adjustment turns out to be a negative number.[7]

Event-Driven CVRs

Event driven CVRs are, as the name suggests, linked to the occurrence of uncertain events. In M&A deals, they can be used to provide buyer with "insurance" against the occurrence of contingent liabilities, and/or to provide the target's legacy stockholders with additional value if specified contingent liabilities are not realized. The following are examples of events that could form the basis for structuring event-driven CVRs: (1) settlement/final disposition of lawsuit;[8] (2) final resolution of a regulatory investigation or achievement of regulatory milestones; (3) final resolution of financial restatement; (4) results of a drug trial or similar type of value-driving event;[9] (5) the divestiture of specified assets and (6) escrow release from an indemnification or other escrow account. Event-driven CVRs have been widely used by pharmaceutical companies and biotech companies that are accustomed to structuring milestone payments as part of research collaborations with the Food and Drug Administration as an independent, third party arbiter of whether milestones have been achieved.

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7. It does not appear that the SEC has taken the view that the uncertainty/contingencies associated with the payments to be made pursuant to a CVR necessarily impact a shareholders' ability to grant a fully-informed proxy, so long as the issuer provides adequate disclosure regarding the contingencies, a copy of the CVR agreement, risk factors relating to the CVRs and any estimates made on the value of the CVRs as part of the total merger consideration. *See* Southpeak Interactive Corp., SEC Comment Letter Response (May 16, 2008); Clinical Data, Inc., SEC Comment Letter Response (June 15, 2009).

8. Historically, CVRs have been widely used outside of the M&A context in connection with litigation settlements in class action litigations. *See*, *e.g.*, Information Resources, Inc. Litigation Contingent Payment Rights Trust, Form 8-K, Exhibit 99.1 (May 16, 2006).

9. Examples of transactions that used CVRs based on product regulatory approvals include: Ligand Pharmaceuticals/Pharmacopeia (2008); Fresenius SE/APP Pharmaceuticals, Inc. (2008); OSI Pharmaceuticals/Cell Pathways (2003); Antigenics/Aronex Pharmaceuticals (2001); Elan/Liposome (2000); and Ligand Pharmaceuticals/Seragen.

The difference between performance-driven CVRs and event-driven CVRs is not always a bright line. Indeed, some transactions employ CVRs that include elements of both.[10] These categorizations are useful in that they provide a rubric for discussion, but in practice the names do not matter so long as the contractual provisions that define the CVRs are clear and enforceable.

Transaction Financing CVRs

CVRs may facilitate the buyer's transaction financing if they are issued to financing sources to supplement debt financing. The CVR pay-outs would be linked to distributions on the buyer's common stock – *i.e.*, the CVRs would pay-out if the buyer's stock traded above a particular level post-closing. Unlike the performance-driven CVRs described above, however, the CVRs would not be issues to all of the target's stockholders. The most likely application of these CVRs would be in a leveraged buy-out in which the target's stockholders are receiving cash. The buyer would cause private equity funds to subscribe to the CVRs in exchange for providing committed financing for the cash consideration. The principal benefit of these CVRs would be that they would allow the buyer to pay a higher cash price to the target's stockholders while sharing the risk with financing providers. Those financing providers, in turn, may have a greater appetite to accept risk in exchange for a greater potential return that would otherwise be available through a term loan, and may have more flexibility to diversify their portfolios across multiple investments. What is the advantage of using CVRs in this context rather than making a private placement of preferred stock? Depending on how they are structured, these CVRs may just be contract rights (not securities) and therefore the buyer and its financing sources may have more flexibility to structure them in a manner that satisfies accounting, tax and other requirements of the financing sources. The utility of these instruments in any particular transaction would obviously need to be carefully vetted.

II. Designing CVRs: Characteristics and Considerations

The characteristics, terms and conditions of a CVR may be set forth in disclosure documents or in an agreement with a trustee who acts on behalf of the CVR holders (the latter will certainly be the case if the CVRs are issued pursuant to an indenture

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10. *See*, *e.g.*, Essex Communications Corp., SEC No-Action Letter (June 28, 1988) (example of cash-settled CVRs used for a post-closing adjustment and an indemnification escrow).

agreement that is qualified under the Trust Indenture Act).[11] Covenants in the governing CVR agreement may impose restrictions on the activities of the issuer and/or give the trustee authority to monitor the issuer's activities.

Obviously the design of any CVR needs to accord with its underlying purpose, as described in Part I above, and with the buyer's financial needs. For example, will the CVRs be settled in cash, stock or other securities? A variety of different factors are relevant to this decision, including the buyer's access to cash, the dilutive impact of stock-settled CVRs and the impact on the issuer's P&L. A CVR's design also needs to take into account various characteristics that are not strictly economic. An illustrative description of certain of these issues is set forth below, but this article does not purport to address how each of these characteristics would play out in any particular circumstance. On these matters, a buyer should work closely with its legal counsel and financial advisor to assess the costs and benefits of these, and other, design elements of CVRs.

CVR Registration/Qualification Requirements

Whether a CVR is required to be registered under the Securities Act of 1933, as amended (the "Securities Act") depends on whether the CVR is a "security" or just a "contractual right". The Securities and Exchange Commission ("SEC") employs a five-pronged test to determine whether CVRs issued as merger consideration to selling stockholders is a security that must be registered under the Securities Act.[12] A CVR issued in a merger is not required to be registered if it meets the following criteria:

1. The CVR is an integral part of the consideration for the proposed merger;

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11. For an example of a CVR agreement with a trustee, *see* Monogram Biosciences, Inc.'s Form 8-K (Dec. 10, 2004) (Exhibit 10.3 is a Contingent Value Rights Agreement, dated as of December 10, 2004, by Virologic, Inc. to U.S. Bank National Association as Trustee). In that transaction, the CVRs were registered securities.

12. *See* Minnesota Mining and Manufacturing Co., SEC No-Action Letter (Oct. 13, 1988). The five-prong test appears to be derived, in part, from the traditional *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1945), analysis of whether a right is an "investment contract". *See*, *e.g.*, Northwestern Mutual Life Insurance Co., SEC No-Action Letter (March 3, 1983). Contingent value rights are not unique to transactions for U.S. issuers. *See*, *e.g.*, Centrica/EDF Group deal (May 2009); *see* also Contingent Value Rights: A New Takeover Currency? Michael Shaw, Gavin Davies, Mark Bardell and Kelly Bassett (April 2009) for a list of recent UK takeovers employing CVRs. The parties in any non-U.S. transaction need to consider to what extent the issuance of CVRs in an otherwise all-cash deal could subject the issuer to U.S. securities laws and reporting requirements.

2. The CVR does not have rights common to stockholders or represent an ownership interest in the buyer (*e.g.*, the CVR does not have rights to vote or receive dividends);[13]

3. The CVR does not bear a stated rate of interest;

4. The CVR is non-transferable and non-assignable, except by operation of law; and

5. The CVR is not represented by any form of certificate or instrument.

In some situations where the CVRs will be stock-settled, buyers "split the baby": they register the shares underlying the CVRs on a Form S-4 registration statement at the time of the business combination transaction (together with the stock consideration paid in the transaction). They do not, however, register either (1) the CVRs themselves at the time of the transaction or (2) the shares underlying the CVRs at the time of their actual issuance pursuant to the CVRs. Since the shares underlying the CVRs are not registered at the time of issuance, the recipients do not receive a current prospectus at the time they settle the CVRs. The theory of this approach is that (1) the CVRs are a contractual right, not a security, and therefore are not required to be registered; and (2) the investment decision with respect to the shares underlying the CVRs is made at the time of the initial transaction and the subsequent issuance of shares pursuant to the CVRs does not involve a new investment decision.[14]

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13. Certain SEC no-action letters also cite as relevant the fact that a CVR would not pay out to the holders depending on the operating results of the company. On its face, this would appear to imply that all earn-out CVRs are required to be registered. However, in Genentech Clinic Partners III, SEC No-Action Letter (March 23, 1989), the SEC appeared to accept that where the "earn-out" is based on the operating results of a division or a subsidiary, but not on the performance of the issuer as a whole, the CVRs do not represent an equity or ownership interest in the issuer itself and are not required to be registered (all other prongs of the test being satisfied).

14. Minnesota Mining and Manufacturing Co., SEC No-Action Letter (Oct. 13, 1988). In another "split the baby" permutation, in the Monogram Biosciences, Inc./ViroLogic deal (2004), ViroLogic registered the CVRs on Form S-4 and the Form S-4 described the manner in which the parties addressed the need for subsequent registration of shares issues pursuant to the CVRs as follows: "If ViroLogic elects to make any portion of a payment to holders of CVRs through the issuance of shares of ViroLogic common stock then, as a condition precedent, such shares must, among other things, be issued either in a transaction that is exempt from registration under the Securities Act through satisfaction of the requirements of Section 3(a)(9) of the Securities Act, or pursuant to an effective registration statement under the Securities Act. If these conditions precedent cannot be satisfied then ViroLogic must make the entire amount of any payment due under the CVRs in cash." Monogram Biosciences, Inc. Form S-4, at 122 (Nov. 4, 2004). ViroLogic also agreed to use commercially reasonable efforts to cause the CVRs to be approved for listing on an exchange. The ViroLogic CVRs were stated to be unsecured obligations of ViroLogic that ranked equally with all other unsecured obligations of ViroLogic.

In addition to registration requirements under the Securities Act, issuers of CVRs must also consider whether registration is required under the Securities Exchange Act of 1934, as amended (the "Exchange Act") or whether qualification of an indenture is required under the Trust Indenture Act of 1939, as amended (the "Trust Indenture Act").

Section 12(g) of the Exchange Act requires registration of "equity securities". If an issuer concludes that a CVR is not a security for purposes of the Securities Act, the issuer should also be able to conclude that it is not an "equity security" for purposes of the Exchange Act. Difficult questions, however, may arise if the issuer concludes the CVR is a security but has characteristics more akin to debt than equity.[15]

If the issuer determines the CVRs are debt securities, the issuer should also consider what action, if any, the issuer is required to take under the Trust Indenture Act with respect to qualifying an indenture related to the CVRs. Under Section 304(a)(1) of the Trust Indenture Act, qualification is only required for (A) "notes, bonds, debentures 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." Where the CVRs are not represented by certificates, bear no stated interest, and do not constitute a note, bond, debenture, or evidence of indebtedness as such terms are generally understood, Trust Indenture Act qualification may not be required.[16]

Even if registration of a CVR is not required by reason of an exemption or otherwise, a buyer should consider whether registration of the instrument would be desirable for valuation or other reasons.[17] Registering CVRs may be the first step to having them listed and becoming freely tradable. Freely tradable CVRs are more liquid, and that li-

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15. In Pension Benefit Guaranty Corp., SEC No-Action Letter (May 25, 1993), the SEC agreed to rely on counsel's opinion that the CVRs at issue were not "equity securities" within the meaning of the Exchange Act (and, hence, were not required to be registered under Section 12(g) of the Exchange Act) where the CVRs were "contingent obligations of the PBGC to pay specified amounts according to a formula" based on the performance of an entity's common stock such that the CVRs appeared to "combine elements of debt and equity and [were] hybrid instruments." No-action requests also frequently assert that no public policy would be served by requiring registration of CVRs under the Exchange Act where the CVRs are not transferable or assignable except by operation of law and where the issuer is already subject to Exchange Act reporting requirements.

16. *See* Essex Communications Corp., SEC No-Action Letter (Jan. 12, 1988) (registration/qualification of "deferred cash consideration right" not required). In contrast, *see* Green-Wood Assocs., SEC No-Action Letter (Sept. 12, 1990) (staff determined CVRs issued in exchange for bonds appeared to be "evidence of indebtedness" such that Securities Act registration and Trust Indenture Act qualification may be required).

17. In the transactions referenced in footnote 1, all of the CVRs were registered and all but one were listed.

quidity gives holders an opportunity to capture value immediately and may make the CVR a more attractive form of consideration in a public company merger. Certainly if the CVRs are being issued as a hedging instrument, it will be necessary that they trade freely. Recipients of CVRs may also ascribe greater value to registered CVRs because the holders may then obtain the benefits of disclosures and protections under the securities laws. Finally, recipients may ascribe value to the additional risk management and arbitrage opportunities available in connection with tradable CVRs. Especially where the buyer is already planning to file a Form S-4 registration statement with respect to the common stock it proposes to issue in the transaction, the benefits of registering and listing the CVRs may out-weigh the costs. On the other hand, there may be no reason to register a CVR that is cash-settled or that is being issued in a private placement as part of the financing arrangements for a cash acquisition.

Listing Requirements

Each of the major stock exchanges has issued listing standards applicable to CVRs.

New York Stock Exchange. The CVRs and the issuer must satisfy the following requirements[18]:

- The issuer must have assets in excess of $100 million and must satisfy the requirements of Paragraph 102.01 of the NYSE Listed Company Manual;
- There must be at least one million CVRs outstanding;
- There must be at least 400 holders of CVRs;
- The CVRs must have an aggregate market value of at least $4 million;
- The CVRs must have a minimum life of one year; and
- The CVRs may be delisted if their aggregate market value falls below $1 million.

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18. *See* SEC Order Approving Proposed Rule Change Relating to the Adoption of Listing Standards and a Membership Circular for Contingent Value Rights, Release No. 34-28072 (May 30, 1990).

NYSE ARCA. The CVRs and the issuer must satisfy the following requirements:

- There must be at least 600,000 publicly held CVRs with an aggregate market value of at least $18 million;
- There must be at least 1,200 public beneficial holders of the CVRs;
- The issuer must have total assets of at least $100 million;
- The issuer must (1) have a net worth of at least $4 million and (2) have pre-tax income from continuing operations of at least $1 million in the last fiscal year or two of the last three fiscal years; and
- The CVRs must have a maturity of at least one year.

NASDAQ. The CVRs and the issuer must satisfy the following requirements:

- The issuer must have assets in excess of $100 million and stockholders' equity of at least $10 million. In case an issuer is unable to satisfy the income criteria set forth in the Rule 5400 or 5700 Series, NASDAQ generally will require the issuer to have the following: (1) assets in excess of $200 million and stockholders' equity of at least $10 million; or (2) assets in excess of $100 million and stockholders' equity of at least $20 million;
- There must be at least 400 holders of the CVRs;
- There must be a minimum public distribution of 1 million CVRs; and
- The aggregate market value/principal amount of the CVRs must be at least $4 million.

Disclosure Requirements

If CVRs are listed, the issuer will be subject to Exchange Act reporting requirements. This may not be an unwieldy burden if the issuer already has another security listed on an exchange or registered under the Exchange Act.

When a CVR is an earn-out CVR whose value varies based on the performance of a division or business unit of the issuer, the issuer should consider whether it is required to satisfy any information reporting requirements at the level of the division or business unit. Such requirements could arise under the Exchange Act or pursuant to the agreement pursuant to which the CVRs are administered.

"Preferred Stock"-Like Rights

The design of a CVR should take into account whether the CVR will carry any rights and preferences akin to those typically provided to holders of preferred stock: *e.g.*, dividends, class voting/veto rights and redemption rights (optional v. mandatory). Decisions on these matters can affect the determination of whether the CVRs are "securities" or "equity securities" for Securities Act and Exchange Act purposes, among other matters.

Corporate Approvals

The nature of the corporate approvals required to issue CVRs will depend on whether the CVRs are equity securities, debt securities or contract rights. If the CVRs are registered and/or listed, the issuer will likely be required to obtain one or more legal opinions as the due authorization and issuance of the CVRs. Care should be taken to ensure all necessary stockholder and board approvals are obtained and that the issuer complies with all other actions necessary under state law and the buyer's organizational documents, as well as under any material contracts (such as credit agreements or indentures).

Fiduciary Duties

If a buyer issues CVRs that are securities, the buyer's board will have to consider how to balance the rights of CVR holders against the rights of holders of its common stock. For example, when the board makes decisions about how to allocate capital, new business opportunities and other corporate resources between different business units, the board should consider whether the existence of an earn-out CVR that is linked to the performance of a particular business unit will have any impact on the board's fiduciary obligations. State corporation law offers some guidance on how a board should balance the interests of one group of security holders as compared to holders of other classes of the corporation's securities.[19] If this issue can be anticipated, it can be addressed to a limited extent in the documentation defining the rights and preferences of the CVRs.

Fraudulent Conveyance and Other Insolvency Issues

A CVR issuer should consider the treatment of CVRs under applicable fraudulent conveyance and bankruptcy laws. Whether a CVR holder will be treated as a creditor (and the seniority thereof) or an equity-holder will depend, in part, on whether the CVR is viewed as an equity security, a debt security or a contractual right.

Enforcement Issues

A target whose stockholders will receive CVRs in the transaction must consider how its stockholders will be able to enforce the terms of the CVRs. If the CVRs are issued pursuant to a trust agreement, the trust agreement will likely give the trustee certain powers to enforce the terms of the trust agreement against the issuer. If the CVRs are not securities, however, the parties need to address whether the CVR-holders will have third party beneficiary rights under the merger agreement or other agreement pursuant to which the CVRs were granted. With respect to earn-out CVRs in particular, the parties need to address to what extent the CVR holders would have standing to bring claims that the buyer devoted inadequate resources to the underlying business unit and any fiduciary duty claims. In this respect, it may be wise for the buyer to consult with litigation counsel to assess to what extent CVR-holders may be able to form a separate class of plaintiffs and/or piggy-back on litigation brought by other groups of investors.

Tax Impact

A comprehensive analysis of the tax aspects of CVRs is beyond the scope of this article and an issuer should always seek advice from a tax specialist prior to creating a CVR. In fact, the classification of CVRs remains an open question under current Internal Revenue Service ("IRS") regulations. In Revenue Ruling 88-31, the IRS did address the issue in the context of a particular set of facts. In that transaction, the CVRs were hedging CVRs that were separately tradable but distributed at the same time as common stock. The IRS determined that the CVR diminished a stockholder's risk of loss from a

19. *See*, *e.g.*, *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999) and In re General Motors Class H Stockholder Litigation, 734 A.2d 611 (Del. Ch. 1999).

decline in value, so the CVR constituted an option within the meaning of Section 1092(d)(3)(B)(i)(I) of the Internal Revenue Code of 1986, as amended. Accordingly, the IRS stated that "any gain or loss recognized by the taxpayer on the sale . . . or on the exercise of the Right, is a short-term or long-term capital gain or loss, depending on the holding period" and the issuer of the CVR recognizes no gain or loss on the CVR issuance, on the repurchase of the CVR or on the lapse of the CVR. For federal income tax purposes, distribution of a CVR is usually treated as the receipt of a dividend distribution from the issuer of the CVR in an amount equal to the fair market value of the CVR on the date of distribution. If the CVR is traded publicly as a separate instrument, the fair market value may not be difficult to ascertain. A buyer should consider carefully (1) what disclosure, if any, the buyer will provide in its SEC filings regarding the tax treatment of the CVRs[20] and (2) whether the issuance of CVRs will have any impact on the tax treatment of the overall transaction (*e.g.*, if the transaction is intended to qualify as a tax free reorganization.

Accounting Impact

The issuer of a CVR should consult with its accountants regarding the accounting treatment of the CVR. Under Financial Accounting Statement 141R, contingent consideration used in M&A transactions (such as CVRs) are required to be recorded at fair value as liabilities on the closing date of the transaction. It is no longer possible to wait to record the liability until a later date when the contingency is resolved. The fair value of cash-settled CVRs would be subject to adjustment in each accounting period until the CVR matures. Equity-settled CVRs, in contrast, would not be subject to further adjustment.

Composition of Stockholder Base and Stockholder Communications

Ultimately, the appeal of CVRs as merger consideration may depend on the composition of the target's stockholder base. Institutional holders may be more amenable to receiving a CVR than retail holders.[21] A buyer should consult with its proxy solicitor as to how a CVR would be received by its stockholder base, taking into account historic arbitrage activity and the availability of viable alternatives. If the parties to an M&A deal decide to proceed with a CVR, they should take care that their investor presentations, disclosure

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20. *See*, *e.g.*, ViroLogic, Inc. Registration Statement on Form S-4, at 96 (Nov. 4, 2004) (noting that contingent value rights might be treated as debt instruments or in some other manner based on future regulations, court decisions or revenue rulings).

21. As of July 2009, Risk Metrics Group did not disclose any policy on CVRs on its website.

documents and other stockholder communications describe the CVRs accurately and in plain English.

III. Conclusion

There is a lot of untapped potential for the use of CVRs in M&A deals outside of the biotech and pharmaceutical industries. For the most part, CVRs could be especially useful in connection with acquisitions of companies that are distressed due to liquidity issues but that otherwise believe they have profit potential. As suggested, CVRs can be complex and do present numerous thorny issues that the parties and their advisors will need to address at the outset of the deal. This is a great opportunity for financial advisors and legal counsel to work together to structure "pareto optimal" solutions to valuation gaps in public company deals. With a little creativity, CVRs can be invaluable tools in bridging the value gap in M&A deals.

For more on mergers and acquisitions, *see* the M&A Practice Guide (LexisNexis) and Corporate Acquisitions and Mergers (Matthew Bender).

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