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Using Contingent Consideration to Bridge the Value Gap

By almost any measure, M&A activity is decidedly up over the abysmal levels of a year ago. According to FactSet Mergerstat, in the first half of 2010, 2,696 transactions were announced involving a U.S. buyer or target, as compared to 2,129 in the same period of 2009. Nevertheless, it is also the case that many strategically sensible transactions are still not getting done because of the inability of the seller and buyer to agree on price. In some cases, sellers see significant upside in the future trajectory of the business, while buyers may be unwilling to pay for that upside given the perceived risks in achieving it.

In several recent transactions, the parties have successfully bridged this value gap by using contingent consideration. Most recently, on June 30, 2010, Celgene Corporation announced that it had agreed to acquire Abraxis BioScience Inc. in a deal valued at $2.9 billion. In addition to the cash and stock consideration of $58.00 in cash and 0.2617 shares of Celgene's common stock for each Abraxis share, the merger agreement provided that the holder of each Abraxis share will also receive one contingent payment right, which entitles its holder to receive payments upon certain future FDA approvals and net sales revenue thresholds related to ABRAXANE® and Abraxis's nab-pipeline products.

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

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

- financial performance benchmarks

- pass-throughs
- specific contingent events

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

- Fresenius's acquisition of APP Pharma (2008). The consideration included a CPR based on the excess of adjusted EBITDA above a threshold amount over a three-year period.
- Baxter International's acquisition of Somatogen (1998). The consideration included a CPR which represented the right to receive a pro rata portion of five percent of the net sales of certain products.
- Toro Company's acquisition of Exmark Manufacturing Company (1997). The consideration included a CPR based on Exmark's recast EBIT and its compound annual growth rate.

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

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

- Ligand Pharmaceutical's acquisition of Neurogen (2009). One of the four CPRs issued as consideration in this deal represented the right to receive a pro rata portion of the cash paid by any buyer of Neurogen's real estate on or before the six-month anniversary of the merger.
- Symphony Technology's acquisition of Information Resources (2006). The CPR holders were granted a right to receive 60% of the proceeds from Information Resources' antitrust lawsuit against AC Nielsen, The Dun & Bradstreet Corp. and IMS International, Inc.
- Investment Technology Group's acquisition of Hoenig Group (2002). The CPR payment was contingent on the recovery of insurance and other claims related to trading losses and unauthorized trading activity at Hoenig Group's United Kingdom subsidiary.
- Washington Mutual's acquisition of Bank United Corp. (2001). The CPR represented the right to receive the proceeds from a forbearance claim against the U.S. government.
- Harveys Casino Resorts' acquisition of Pinnacle Entertainment, Inc. (2000). The CPR payment was contingent on the sale of 97 acres of land in Inglewood, California.

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

- Endo Pharmaceuticals/Indevus Pharmaceuticals (2009)
- OSI Pharmaceuticals/Cell Pathways (2003)
- Antigenics/Aronex Pharmaceuticals (2001)
- Ligand Pharmaceuticals/Seragen (1998)

However, the use of this type of mechanism has potential application beyond life sciences, to any company with a value heavily dependent on the occurrence of a specific, objective event. For example, this type of CPR could be used for mining or oil and gas exploration companies, technology companies or companies heavily dependent on retaining a limited number of large customers.

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

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

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

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

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

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

Third, buyers need to be careful to ensure that the indenture or other agreement governing the CPR does not unduly impinge on the operational flexibility of the resulting company's management, while nevertheless protecting the interests of the CPR holders. For example, it may be in the best interests of the selling shareholders to have significant limitations on the way the business is run so that the performance hurdles may be achieved, but the buyer may determine over time that taking the business in a different direction may be more likely to maximize value for the buyer. Sellers should consider what happens, for example, if the buyer chooses to abandon the further development of the pipeline drug to which the CPR applies, or instead licenses the chemistry to a third party before completing clinical trials. Buyers will want CPR agreements to specifically provide that the buyer is not obligated to produce or market any specific product. In the OSI Pharmaceuticals/Cell Pathways acquisition, each Cell Pathway shareholder received a CPR which entitled it to .04 shares of OSI common stock in the event the FDA accepted a new drug application for either of Cell Pathways' two leading clinical candidates, Aptosyn® (exisulind) or CP461, prior to June 12, 2008. These CPRs lost value in 2006 when OSI stopped developing both products. This tension could make a CPR unworkable in many situations.

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

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

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

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

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

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

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