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WEBINAR

Hot Topics in Life Sciences M&A: Milestones, Options and Reverse Mergers

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- Submit questions via the Q&A feature
- Questions will be answered as time permits
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WEBINAR

Speakers

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Agenda

- Earn-outs and Contingent Payments
- Option and Warrant Deals
- Reverse Mergers

Earn-Outs and Contingent Payments

Earn-Outs and Contingent Payments – Pros and Cons

- Pros
  - Bridges pricing negotiations (i.e., provides seller with a potentially higher purchase price; protects buyer from overpaying)
  - Allocates business risk among buyer and seller
  - If continuing with business, gives key sellers/target management some ability to create post-closing value
- Cons
  - Significant risk of post-closing disputes and litigation (disputes arise in ~31% of earn-out deals according to 2019 SRS data)
  - Right to receive payment is typically non-transferable (often even in public M&A context)
  - Buyer may give up some post-closing autonomy to seller through efforts, reporting/information and audit requirements
  - Sellers will likely have limited visibility into likelihood of payout or business/clinical strategy

Earn-Outs and Contingent Payments – Key Considerations

- Although relatively rare in M&A deals in other industries (~15% according to 2019 SRS data), earn-outs/contingent payments are very common in life sciences/medical device transactions (~70-80% according to 2019 SRS data)
  - More than ~50% of all earn-out deals paid out at least some amount (according to 2019 SRS data)
- Definition of payment triggers
  - Development
  - Regulatory and approval
  - Commercial (e.g., net sales milestones and/or royalties)
  - Priority review vouchers
  - Sublicenses/transfer revenue
- Definition of "Earn-Out Products"
  - Should seller benefit from improvements/alterations?
- "Net Sales"/"Buyer Selling Parties" Definitions

Earn-Outs and Contingent Payments – Key Considerations

- Commercially Reasonable/Diligent Effort standards vs. disclaimers of buyer obligations
- Post-closing audit/reporting obligations of buyer
  - Seller “meddling” vs. buyer’s “black box”
- Acceleration events, e.g., buyer default, change of control, sale of underlying assets
- Lack of transferability
- Public vs. Private – Earn-Outs vs. Contingent Value Rights (CVRs)
  - Special considerations for registered and tradeable CVRs
- Future payments payable in buyer stock
- Accounting considerations

Earn-Outs and Contingent Payments – Key Considerations

- Litigation/dispute risk:
  - "[A]n earn-out… typically reflects disagreement over the value of the business that it bridges when the seller trades the certainty of less cash at closing for the prospect of more cash over time… But since value is frequently debatable and the cause of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation." Airborne Health, Inc. v. Squid Soap, LP, 984 A.2d 126, 132 (Del. Ch. 2009)
  - Delaware Courts have recognized the implied covenant of good faith and fair dealing
- Methods of dispute resolution – neutral expert, court litigation, arbitration
- Role of seller/Stockholder Representative if multiple sellers, and Rights Agent in public M&A/CVR context
- Liability caps and liquidated damages
- Indemnity offsets/set off rights

Earn-Outs and Contingent Payments – Structuring and Tax Considerations

- Installment method
  - If available, permits seller to defer tax on earnout payments until receipt
    - Portion of the earnout payments would be treated as ordinary interest income
    - If seller has right to receive more than $5 million of earnout payments, interest charge will apply to deferred tax
  - Not available for sale of public company stock
    - Taxation of CVRs unclear
      - May be required to include fair market value of CVR at time of receipt in amount realized for purposes of of determining gain/loss at time of sale
      - Possible that can treat as “open transaction” if value of CVR cannot be reasonably ascertained, in which case tax would be deferred until payments made under CVR

Earn-Outs and Contingent Payments – Structuring and Tax Considerations

- Payment for stock or compensation?
  - If the earn-out payment is tied to the continued employment of employee(s), earn-out payment may be compensation not a deferred payment for stock
    - Specific facts need to be analyzed, such as:
      - Is shareholder/employee receiving more than pro rata share of consideration?
      - Are non-employee shareholders' payments subject to same contingencies?
    - Compensation will be subject to ordinary income tax rates (rather than capital gain tax rates) and employment taxes

Option and Warrant Deals

Option Deals – Background

- Potential forms:
  - License
  - Specified assets
  - Entire company
- Basic idea of an option to acquire the company:
  - Buyer pays an upfront option fee to the company in exchange for the option to acquire the company at a later date
  - Commitment to provide R&D funding
  - Purchase price payable upon exercise of option

Option Deals – Background

- Pros
  - Often perceived as a “first step” towards an acquisition
  - Gives the target/seller funding for R&D
  - Gives the target a clear path to an exit
  - Gives the buyer certainty of price
  - Gives the buyer a captive R&D platform
- Cons
  - Acquisition options can be quite difficult to negotiate
  - Potentially long period between signing, exercise of option and closing
  - The seller/target is encumbering itself and potentially capping its upside
  - Taint of an unexercised option
  - Buyer is potentially investing significant money and time in a deal that might not materialize

Option Deal – Key Considerations

- Option trigger
- Option exercise period
- Purchase price
- Relationship during option period and consent rights
  - Joint steering committee for development decisions
  - Basic operations
    - Hiring and firing
    - Capex
    - Development of non-core programs
  - R&D funding
  - Diligence obligations
- Use of proceeds

Option Deal – Key Considerations

- Restrictive covenants
- Put right
- Deal certainty
  - Negotiation of definitive agreements
  - Stockholder approval
- Accuracy of representations and warranties / ability to update disclosure schedules
- Antitrust approval

Option Deals – Structuring and Tax Considerations

- If C corporation, often structured as entire company to avoid double tax
- If option is not exercised, do not want shareholders to have income equal to the amount originally paid for option. Therefore, structure so that buyer is buying option from company (not shareholders).
  - Company issues warrant to buyer to acquire new class of stock in company
  - If buyer exercises warrant, all other classes of stock redeemed by company for amount paid by buyer to exercise warrant
- Execution of option may result in change-of-control for Section 280G purposes (golden parachute rules)

Reverse Mergers

Reverse Mergers – Background

- Typically structured as a reverse triangular merger in which a merger subsidiary of a public company merges with and into a private company, with the private company becoming a wholly-owned subsidiary of the public company
  - "Legal buyer" versus "Economic buyer"
- The private company stockholders receive shares of the public company and end up as its controlling stockholders
- For private company, can be a viable alternative to an IPO
- For public company, may be a way to leverage limited retained assets as alternative to dissolution/liquidation (e.g., listing and remaining cash)

Reverse Mergers – Background

- Pros (for private company versus an IPO)
  - Potential for lower cost and faster timeline
  - Timing and pricing not dictated by market conditions
  - May be less time intensive for management
  - Less dilution for existing stockholders
  - No Underwriters
- Cons (for private company versus an IPO)
  - Generally raise less capital
  - Difficult to obtain market support or attention (i.e., their shareholders become your shareholders)
  - Social issues
  - Assumption of legacy liabilities

Reverse Mergers – Background

- Pros (for public company)
  - Potential to extract value from assets that may be difficult to monetize (e.g., listing and cash which would be taxed if distributed via dividend)
  - Potential alternative to liquidation/dissolution or a traditional M&A sale
  - Can distribute assets to pre-transaction shareholders (e.g., cash or pipeline assets)
- Cons (for public company)
  - Private companies may not value non-cash assets as much as board/management or existing shareholders
  - Time pressure given ongoing cash burn
  - Cost/delay of S-4/proxy statement and need for SEC review
  - Social issues

Reverse Mergers – Key Considerations

- Public company: publicly listed in good standing, some cash, and little/no ongoing business activities (i.e., pipeline shut down due to negative trial results)
- Exchange ratio negotiations
  - Public company shares outstanding (including equity awards)
  - Amount of anticipated public company cash at closing
  - Private versus public company valuation
  - Public company liabilities
- Mutual due diligence
- Concurrent capital raise
- Minimum cash condition and definition of "Closing Net Cash"
- Often public M&A style representations and warranties and indemnity package
- Termination Triggers/Fiduciary Outs
- Expense Reimbursement for "Naked No Votes"

Reverse Mergers – Background

- Disclosure considerations
  - S-4/proxy statement
    - "Background of the Merger" section describing public company's process
    - Private company financial statements and pro forma financial statements
    - Disclosure of private company's business and pipeline (i.e., similar to an IPO/S-1 business section)
  - "Super 8-K"
    - Once a shell company (i.e., no or nominal operations and assets (excluding cash) ceases to be one (i.e., by executing a reverse merger), it must file a "Super" Form 8-K with the SEC within four business days of such change, which is extensive and requires disclosing the information called for on a Form 10
    - Even if the public company was never a "shell" and no "Super" 8-K is required, following the closing, market must have sufficient information to evaluate the combined company

Reverse Mergers – Structure and Tax Considerations

- Typically structured as tax-free reorganization
  - Private shareholders defer tax until sale of public company stock received
  - Requirements for tax-free reorganization need to be satisfied
    - Some cash consideration (including future contingent payments payable in cash) possible while maintaining tax-free status
- Options
  - Private company options generally assumed by public company
  - Public company options will remain outstanding
    - Options generally will expire within short period after termination of employment
    - If options are underwater, may need to incentivize key employees of public company to remain through closing with transaction bonus, increased severance, etc.

Questions

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