# Deal Trends: Option Deals

**By Belinda Juran, Partner**

Have you had an easy time getting deals done in the last 18 months? -- Neither have my clients.

As the economy has tightened, technology-based companies with a high need for capital to move their development activities forward—such as biotech and medical device companies—have found it more difficult to find funding. Venture capital firms have become more cautious in investing in companies and, for a variety of reasons, the IPO market is not a realistic way for many companies to raise money. Therefore, biotech and other life science companies look to be acquired or to enter into strategic alliances with large life science companies to obtain the funds necessary to develop their products and to access the distribution channels to get them to market.

Acquisitions and strategic collaborations have been around for ages, and the typical deal structures are well known. The tightening of the money supply has, however, led to more creative—and complex—deals as those parties with money recognize the leverage they have and the unique opportunity that creates for them to generate more value for their money.

As a result, option deals are becoming more common. These deals take many forms, such as an option to acquire a license to a program or product, or an option to acquire the entire company, or hybrids of these. In each case, the "buyer" makes an up-front payment, an option fee, to get the right to acquire the license, or buy the company, on set terms upon the occurrence of some triggering event pursuant to a fully negotiated license or purchase agreement. Usually the trigger is tied to an event that will demonstrate the value of the seller's assets, such as the completion of a phase 2 clinical trial. Option deals therefore allow the buyer to reduce its risk, by deferring its purchase decision until it has more information about the value of the asset. Because the option fee is typically sufficient for the seller to move the program to the trigger point, the seller's shortterm financing needs are met.

The seller then works to achieve the trigger event and the buyer and seller will usually have negotiated the level of diligence that the seller must apply in order to achieve the trigger event. When and if the seller achieves the trigger event, the buyer has a limited period of time to determine whether to exercise its option. Upon exercise, the buyer pays a purchase price or license fee. Since the option fee usually did not include a premium to reward the seller for its success to date, the option exercise fee is often negotiated to include some premium to the seller for its past costs. In most of the recent deals, the buyer is also obligated to pay down-stream milestones and royalties or an equivalent earn-out in an acquisition deal. These down-stream payments reflect an allocation of risk and reward between the buyer and the seller—the buyer mitigates the risk that the option exercise fee overestimates the full potential value of the asset by agreeing to downstream earn out-type payments, while the seller shares in the upside if the asset generates measurable value to the buyer.

Of course, no deal is "typical". Sometimes the buyer proposes a very low option fee, which is insufficient for the seller to achieve the trigger point. That type of deal can only work if the seller has already arranged additional sources of financing—and even then the investors are unlikely to be comfortable committing to sell the asset later unless the potential payments fully compensate them for the extra investment needed up-front and the associated risk. There are numerous other variations on option deals, including deals where the seller has the right to require the buyer to purchase the asset. Careful consideration of deal terms by experienced business and legal advisors is important for each party to ensure that it's comfortable with the deal terms and risk and that the other party can't game the process.

Many of the issues to be considered and negotiated in option transactions are the same as those dealt with in traditional license or acquisition deals. However, there are some important considerations that are unique to—or exacerbated by--an option deal:

- Transaction costs are higher, because the parties need to fully negotiate a purchase or license agreement that might not close for several years—and may never close. Negotiating the allocation of risk between the parties, through representations and warranties, termination rights and other protections, for risks that might arise at any of multiple points along the way, increases the cost and complexity of these deals.
- To comply with antitrust laws, the buyer must determine, within 60 days prior to the expected closing, whether filings must be made with the FTC and DOJ under the Hart Scott Rodino Antitrust Improvements Act of 1976. The closing may not occur until the necessary waiting period under the HSR Act expires—and may never occur if the FTC or DOJ objects to the transaction.
- Care must be taken to properly describe the assets that the buyer will acquire or license to ensure that the seller will retain rights to move its other assets forward. This is more critical in an option deal because the buyer will acquire the seller's assets several years after entering the option deal, at which point the seller might have acquired many assets unrelated to those subject to the option and which it should properly retain.
- If the seller files for bankruptcy protection during the option period before the buyer has exercised its option, the option agreement may be rejected in bankruptcy, leaving the buyer with no enforceable right to the optioned assets. Both parties should seek advice from a bankruptcy attorney during the negotiation of the option deal if bankruptcy of either party is a possibility.
- Both parties' tax attorneys and accountants should be involved early to consider the implications of the financial structure of an option deal and help structure the deal. This is especially important at times like these when accounting standards are in transition.

Option deals reflect just one type of deal structure by which buyers and sellers can allocate risk and reward in a way that's comfortable to them, given each party's requirements, the overall market, and the alternatives available to each. Experienced attorneys and business advisors can help their clients determine the best deal structure to meet their needs.

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