



COVINGTON

Preparing for an Exit

Five Key Workstreams for Life Sciences Companies
in Advance of a Change of Control Transaction

1 Know the Team

2 Prepare the Board

3 Plan for the Effect on Compensation and Benefits

4 Regulatory

5 Internal Housekeeping

COVINGTON

Preparing for an Exit

Five Key Workstreams for Life Sciences Companies in Advance of a Change of Control Transaction

Introduction

With M&A activity across the life sciences industry anticipated to increase as we move through 2024, now is the time for companies to assess their readiness for a potential change of control transaction – whether that transaction is a result of an unsolicited offer or a board-initiated sale process. Change of control transactions, particularly for publicly-traded companies, move quickly, allowing little time for the target company's (often already stretched) management team to get their arms around the numerous workstreams required to execute the deal.

These workstreams are both process-oriented and substantive, and include assembling a deal team, identifying and locating necessary diligence material and populating a data room, updating financial projections and briefing the board on valuation matters and their fiduciary duties, and addressing a myriad of employee, regulatory and intellectual property-related issues.

A change of control transaction will always seem like a whirlwind, but some advanced planning can streamline and make more manageable the deal process. With this in mind, we highlight below five key areas of focus to help stay a step ahead of a potential change of control transaction.

1 Know the Team

Determining who, both internally and externally, will comprise the deal team is a key first step in preparing for a change of control transaction. External advisors will include legal counsel, one or more financial advisors and, potentially, compensation consultants, investor relations firms and independent accountants. Determining who will comprise the internal deal team can be complicated – the executive team and general counsel (if not part of the executive team) generally will be “under the tent”; beyond that, there is a balancing exercise between involving the employees who best know the business and can assist with the diligence process and limiting the number of employees involved to help preserve confidentiality and limit disruption of the company's ongoing business.

The fewer employees who know of a potential transaction the better, but there may be some employees (for example, clinical personnel) not on the executive team whose participation in the deal process is critical to ensuring diligence questions are appropriately answered and, in some cases, the acquirer is comfortable with the team. All internal deal team members should be briefed on the need for confidentiality and the company's procedures for addressing market speculation regarding a potential transaction.

Practical Tips

- Many companies require employees on the deal team to sign confidentiality agreements.
- Public companies also will need to consider if and/or when to impose a special blackout period under their insider trading policies and notify sales agents they should pause sales under ATM programs if a change of control transaction is imminent.



2 Prepare the Board

The board of directors' process in considering a potential change of control transaction will be subject to intense scrutiny after the deal is announced (and, in some cases, even if a deal is not pursued). The record of the board's deliberations should reflect an informed, good faith and unconflicted process, which ideally should start prior to the board making the decision to sell the company. Key steps to help the board meet its fiduciary obligations include:

- proactively identifying potential conflicts of interest that may necessitate the use of a special committee to negotiate and evaluate potential transactions;
- keeping current and regularly discussing with the board the company's long term financial model and projections. These internally developed financial materials will serve as a basis for the fairness opinion that typically is delivered to the board and for the board's decision as to whether a potential transaction is in shareholders' best interest; and
- with the assistance of outside legal counsel and financial advisors, regularly briefing the board on its fiduciary duties, the current M&A landscape and valuation trends in the company's relevant life sciences sector. We often see outside legal counsel and financial advisor presentations incorporated into boards' annual meeting cycles.

3 Plan for the Effect on Compensation and Benefits

The impact of a change of control on compensation and benefit arrangements will be front of mind for many companies and their executive teams. An acquirer also will seek to understand the effect of these arrangements on the overall cost of the transaction and on the incentives of any key employees to remain with the organization post-closing.

Key questions to consider include:

- **How should outstanding incentive equity awards be treated in the transaction?** Often, incentive equity awards are cashed out at the price payable to shareholders, but in some situations, an acquirer may seek to assume some or all of the equity awards. In advance of a transaction, companies may want to review the change of control provisions in their plans and award agreements and consider whether updates are required (for example, specifying how accelerated



About Section 280G

Companies should be mindful of the potential impact of the “parachute” provisions of section 280G of the Internal Revenue Code in connection with a change of control. Under section 280G, certain officers, highly compensated individuals and greater-than-one-percent shareholders are subject to a 20% excise tax if they receive compensation that is contingent on a change in control and in excess of three times their “base amount” (generally, three times their average annual compensation for the previous five years). While private companies can avoid the adverse tax effects of section 280G by seeking shareholder approval, this “cleansing” vote is not available to public companies.

Engaging an advisor to conduct a section 280G analysis early in the process of a potential acquisition can help identify whether section 280G will present an issue and inform whether mitigation strategies might be available.

While it is now unusual for companies to include gross-ups in their standard executive agreements, public companies might consider negotiating section 280G gross-ups in connection with a change of control transaction.

vesting or assumption of awards in a transaction will apply to performance awards). Contingent value rights (or, in the private M&A context, earnouts or milestones) can pose tax compliance considerations for equity awards that will need to be addressed.

- **What severance arrangements, if any, will be in place?** A change of control often creates uncertainty around future employment—an acquirer may implement layoffs to address redundancies between the two organizations, and some employees, particularly those on the executive team, may not want to continue at a larger organization where their roles may change. A potential target company and its advisors should review any existing employment agreements with severance protections and any severance plans or policies and consider implementing new severance arrangements in light of a potential change of control.
- **Will retention awards be necessary or helpful in keeping employees engaged through closing?** The value associated with unvested equity awards may provide an incentive for employees to remain with the company. However, if employees hold options that are underwater or if certain employees who have received smaller equity awards will be stretched covering deal workstreams, cash retention awards may be warranted. Companies might consider putting retention arrangements with certain members of the deal team in place prior to the signing of a transaction.

4 Regulatory

Acquirers will be intensely focused on the regulatory status of a company’s development programs and its compliance with applicable regulatory legal requirements. Regulatory documentation should be assembled in an organized manner as part of the internal housekeeping discussed next, if not already well organized.

Relatedly, companies should consider who will be best positioned to speak on diligence calls to topics such as preclinical testing, clinical trials, development plans and progress, regulatory authority interactions and feedback across pertinent jurisdictions, non-patent regulatory exclusivities, pharmacovigilance, manufacturing and quality assurance, development and commercial supply chains, healthcare law compliance for both clinical and any commercial activities, key third-party relationships, pricing and reimbursement, and any government inspections, investigations or enforcement.

Relevant issues will vary by a company’s stage of development and scope of activities. These are all key areas of likely inquiry, and can influence an acquirer’s willingness to proceed and valuation. Undertaking some measure of objective “self diligence” in advance of a transaction can be useful to identify and address potential issues so that the company is in the best posture possible heading into a transaction.

5 Internal Housekeeping

Companies often do not conduct their day-to-day operations with a view towards a change of control, which necessitates some internal “housekeeping” when preparing for an acquisition. This housekeeping exercise is multifaceted and has the overall goals of (1) facilitating the deal process, (2) if a deal occurs, positioning the company to maximize shareholder value, (3) protecting existing directors and employees from liability and (4) minimizing (or at least understanding) the substantive issues that can derail a deal.

Key activities include:

- identifying and locating due diligence material, including board materials, company policies (for example, health care compliance and anti-corruption), significant contracts (including with licensors, licensees, CMOs and



CROs and for office, lab and manufacturing facilities), regulatory filings and related correspondence, relevant pre-clinical and clinical data, intellectual property registrations and listings, and employee benefit plans;

- reviewing exculpation, indemnification and expense advancement provisions in the company’s organizational documents and the company’s D&O insurance policies to ensure adequate coverage in the (likely) event of claims following announcement of a transaction;
- if needed, amending the company’s bylaws to add an exclusive forum clause;
- reviewing existing IP-related contracts for noncompetes, field or territory limitations, exclusivities and overly broad license grants that could reach through to an acquirer’s (or its affiliates’) pre-existing or future IP portfolio, and potentially renegotiating terms that an acquirer would view as problematic; and
- identifying issues that could impact deal structure, timing and feasibility, including product and pipeline overlaps with potential acquirers, third party consent issues in key contracts, timing for upcoming data releases and whether any of the company’s shareholders are potential activists.

Preparing for and completing a change of control transaction is an intensive process that requires significant effort from a target company, all while remaining focused on day-to-day operations.

Advanced planning and assistance from experienced outside legal counsel and financial advisors can help reduce the burden on the internal deal team, protect the board from liability and better prepare the team to navigate the complexities of an M&A exit.



Upstream Agreement Diligence

Acquirers will be focused on—and potentially wary of—restrictions and entanglements included in a target company’s existing license and collaboration agreements. In addition to noncompetes and license grant scope, companies should be prepared to address the following issues if identified by an acquirer in diligence:

- Termination of options and first rights (e.g., for additional programs or co-promotion rights) after a change of control
- Effect of a change of control on governance mechanisms and information sharing
- Limitations on granting sublicenses under third party IP
- Broadly or vaguely drafted financial terms, including whether the transaction will trigger a sublicense fee payment
- Onerous diligence or reporting obligations and third party review, comment or approval rights of development and commercialization plans
- Grant back licenses or reversion rights on termination, including technology transfer obligations and other burdensome transition assistance

Authors



Michael Labson
+1 617 603 8808
mlabson@cov.com



Michael Riella
+1 202 662 5168
mriella@cov.com



Megan Woodford
+1 202 662 5192
mwoodford@cov.com



Jenna Wallace
+1 212 841 1093
jwallace@cov.com



Sara Needles
+1 202 662 5634
sneedles@cov.com