McGuireWoods

THE CORNER SERIES

Episode 132: Navigating Nuances of Life Sciences Post-Closing, With Amy Cassalia

Episode Summary

McGuireWoods partner and host Geoff Cockrell invites colleague Amy Cassalia — whose practice is heavily weighted on life sciences transactions — to share insights about the post-closing period of these complex deals. The wide-ranging conversation covers the dynamics of "contingent consideration," investor risk and buyers' leverage.

Amy explains why she sees high-level use of contingent payments in life sciences deals and why the term "commercially reasonable" often becomes critical when a deal spirals into litigation. Stay tuned as she unpacks leading trends. Top among them? The increasing use of earn-outs.

Transcript

Voice over (00:00):
This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods partner, Geoff Cockrell, as he and specialists share real-world insight to help enhance your knowledge.

Geoff Cockrell (00:20):
Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell, a partner at McGuireWoods. Here at The Corner Series we've tried to bring together deal makers and thought leaders at the intersection of private equity and healthcare investing. Today, we're going to take an interesting stroll down some topics that surround investing in the broader life science arena. I'm joined by my partner, Amy Cassalia. Amy's a deal person like me and we both do deals across all of the spectrum of healthcare, but her practice is much more heavily weighted in life science transactions than mine is. And we're going to explore some of the particular nuances that come up in life science deals.

(01:01):
Amy, maybe give a quick introduction of yourself and your practice and then we can jump into a discussion.

Amy Cassalia (01:06):
Sure. Thank you so much, Geoff, and thank you for having me on your podcast. As you said, I'm an M&A partner. I'm in our Raleigh office and probably partly because of where I sit geographically, I've had the opportunity to work with a lot of companies in the life sciences industry. So I do a lot of deals in that sector. One thing that's very unique to those deals is some of the structuring, including that a lot of the consideration is often pushed to the post-closing period. And so that's what I thought we would talk about today.

Geoff Cockrell (01:34):
The whole idea of contingent consideration is super interesting and supercharged. And in sectors within healthcare where there's kind of direct reimbursement from the government, that sort of contingent consideration can be difficult to pull off within regulatory constraints. But in your arena, Amy, there's some greater freedom in that and there's also some kind of greater focus on binary outcomes of what can happen with a company after the point of investment. Before we delve into some of the kind of nuances of how that contingent consideration gets figured out, can you give a little bit of color of some of the business dynamics that cause people to really focus on trying to utilize contingent consideration and purchase agreements?

Amy Cassalia (02:18):
Yes, certainly. And the reason we see it so much in life sciences is because the acquisitions that you're making in that sector come at a time when there is still so much uncertainty. And so it's very hard to determine the value of the asset that you're buying because you don't have, for example, an established EBITDA that you can apply a multiple to. You're really more buying a probability curve. And so there are going to be points along that curve where value is created and the idea is to provide some of that value to your sellers at those points in time in the future. These are going to be tied to things like outcomes in clinical trials, FDA decisions, commercial adoption. These are things that are inherently uncertain and often binary and often determined by external factors. And so it's really a matter of using that to come to an agreement on value between a buyer and a seller at a point in time when really nobody knows what the future is going to hold for this asset.

Geoff Cockrell (03:21):
Parsing a little bit some of the binary aspects of it. How often are the trigger points for that contingent consideration kind of life or death questions for the company versus incremental value questions? I would think the bigger the binary outcome risk, the harder it is to deal with in a purchase agreement.

Amy Cassalia (03:39):
No, that's exactly right. And it's really both and it's often dependent on the point in the life cycle for the drug or medical device. So some of those early stages are going to be possibly a make or break. If you do not complete your clinical trial with success in the endpoint, or you do not prove safety and efficacy, or if you do not then get FDA approval, or if you get FDA approval but it's got some significant limitations, then those could all significantly change the value or even the viability of this asset.

Geoff Cockrell (04:15):
You in those sentences I think is significant in the sense of if an investor is making a minority investment, then the you in that sentence is still the company and management of the company. If on the other hand, an investor is making a control investment, the idea of who's responsible for achieving those outcomes can get a little squishier. How significant rather is it that the investor is making a minority versus a control investment in parsing some of these calculations?

Amy Cassalia (04:45):
Yeah, really a great question and very critical because you've just put your finger on one of the biggest sort of risk factors of using post-closing milestone or earn-out payments. And that creates a lot of potential for dispute on what happens after closing in terms of continued operations, continued drivers of the program. And so you're exactly right. This becomes really critical when you have majority acquisition, your buyer wants the right to take over the program, make all the decisions about it, decide if it should continue to even be pushed forward, but your sellers who have sold it probably for a small upfront payment have a keen interest in hitting those post-closing milestones. And so they will want to ensure that there is a continued push for the program that the right decisions are being made.

(05:35):
And so a lot of the thought that needs to go into putting these deals together is about that very thing. It's a little bit about the actual price points, but it's more about these governance matters that will happen after closing, and who's going to be able to control how much say so the other party has, how much insight they're able to have? And there's a real kind of friction between wanting to put a lot more clarity on a lot of these things, which can be helpful, especially post-closing when you're trying to have clear guidance, but it can also be limiting for whichever side is continuing to push forward the program. The more things that you've put into specifics, how much money needs to be spent on the program? How many people need to be working on it? What are the retention and hiring obligations? When can you make a decision that this isn't commercially reasonable anymore? The more restrictions you put on that, then the harder it is to be nimble and continue to make good decisions post-closing.

Geoff Cockrell (06:33):
How receptive are buyers to those sorts of obligations? I totally see it from the seller's perspective of like, "Hey, you bought this company on an expectation that they were going to achieve these things. Now you have to really try." But the covenants around trying seem to be fraught with exposure that a buyer has surrounding decisions that they maybe in complete good faith are well within the proper business judgment that they have to make course corrections or different decisions about where to go. How receptive are buyers to being bound by those sorts of covenants?

Amy Cassalia (07:09):
Geoff, as you would expect, they are not very. And this is another thing about these deals, often the buyer's going to have just more leverage in the deal making in setting the terms of the transaction and buyers typically don't want to have any constraints or few constraints. What we most typically will see as an outcome is an obligation of the buyer to use commercially reasonable efforts and then you have to sometimes negotiate what exactly do we mean by commercially reasonable efforts. Sometimes sellers who have a lot of leverage are able to get more than that from buyers so they can get actual commitments.

(07:44):
I've done deals where we've had actual schedules attached that describe the post-closing obligations of the buyer, and they can be specific as to the retention of certain scientists that will remain involved in the program and spending obligations and timeframes, but that's really very uncommon. I would say most typically buyers are going to ... Sometimes they'll even have covenants that say, "We have no obligations to you post-closing other than to not do anything that's intentionally disruptive of your ability to earn this earn out. But we are going to have the freedom to run the business in our judgment in a commercially reasonable manner."

Geoff Cockrell (08:25):
In a context where an earn-out is based on, let's say, hitting some EBITDA number, one of the dynamics that I encounter is kind of a point-blank misalignment around what is happening in a narrow period of time. Meaning if the deal is, "Hey, if we get another $100 of EBITDA, I'm going to owe you $400." There's a level where as an investor, yes, I want the company to grow and over a long period of time be super successful. But on the very narrow timeframe, that extra $100 costing me 400 can be a point-blank disalignment of what I'm trying to achieve versus what the seller is wanting to achieve.

(09:06):
How often with these kind of milestone-based metrics do you find that there's kind of point-blank misalignment of what they're trying to accomplish either from overall direction or from timing, meaning if I as a buyer achieve something in this time period, I owe a ton of money. If I achieve it in a little bit

later time period, I don't owe them anything, to what extent do you encounter and have to police against point-blank misalignment in near-term activities?

Amy Cassalia (09:36):
I would say certainly there's a potential for that, but I would say it is much more aligned in this sector than you would see outside of the life sciences industry. I think that's why we see such a high level of use of contingent payments in life sciences because there is, I believe, better alignment toward, as I said, a lot of these points in time along the creation of value are binary. And so if the buyer's going to end up with anything, they are going to want to have success in clinical trials. They are going to want to have FDA approval. They're going to want to have a first sale. They're going to want to have more widespread commercial adoption. And so there tends to be, I think, fairly good joint agreement on the path forward and the desire to achieve those points of additional value.

Geoff Cockrell (10:29):
Every transaction has kind of leverage built into it, meaning somebody's more interested in selling than someone's more interested in buying. There's a lot of leverage points in life science deals compared to other ones. Well, let me start with the other ones. An earn-out is often a bridge to valuation questions that the buyer's just not really willing to get to. How often in life science deals is the heavier use of contingent consideration reflective of a lack of leverage of the seller, or is it really a seller leaning into wanting to grab more of the upside than what they would be able to grab if they had less leverage? How does leverage factor into the use of these tools?

Amy Cassalia (11:12):
Well, I think certainly there is an aspect of leverage coming into play, but I think it's less so in this part of the M&A market, Geoff, than what you would see outside of life sciences because, again, the use of these outside of life science is often because sellers believe their company is worth more than the buyer believes. And so they sort of push that difference in opinion about value down the road by saying, "Okay, prove out certain things and we'll pay you more." It's really different in life sciences in that there's a belief at the time of acquisition in the potential incredible value of this drug or medical device, but it needs to still be proven out.

(11:50):
So I think it's less about the sellers not having as much leverage to grab more in the front end as it is about there's just an equal and mutually agreed uncertainty about whether or not this company is going to end up with the incredible value. And so I believe that, as I say, leverage certainly comes into play. And one of the reasons we're seeing an increase in contingent consideration in life sciences in the last couple of years I think is because we have a lot of earlier stage biotech companies that because of the uncertainty in the industry, because of some of the pressures in the market, they are in need of capital and so they're taking deals maybe sooner than they maybe otherwise would've

wanted to do that and because of that they have less leverage. So they are having to push more of the consideration into the post-closing period.

(12:43):
And to give you some numbers around that. The sort of historical size of the median earn-out payment in life sciences is about 60% of the total consideration. While outside of the life sciences sector, the median earn out size is more like 25 to 30% of total consideration. And then over the last year and a half, we've really seen even more get pushed that post-closing period.

Geoff Cockrell (13:07):
In deals where the contingencies surrounding EBITDA or income, there are a lot of questions that can arise over time that lead to disputes between buyers and sellers on various aspects, either some embedded accounting issues, frustration with how the buyer behaved or the efforts they put forward or structural changes they made after closing that kind of create friction and often lead to litigation. And I would say in general, earn-outs are probably one of the main sources of litigation post-closing if an earn-out is present. How litigious are these earn-out or contingency mechanisms in life science compared to your experience in non-life science?

Amy Cassalia (13:51):
Yes, I would say vary. There's sort of a famous quote by a Delaware justice who said, earn-outs convert today's disagreement over price into tomorrow's litigation over the outcome. And that's true in life sciences equally to outside the sector.

(14:05):
The challenge that comes is typically around the efforts that are used. So again, these are often sort of outcomes, either a yes or no. We've had success in the clinic or we haven't. We've gotten FDA approval or we didn't. And so when that decision or contingency happens, if it's not favorable to the sellers, they absolutely will look for a reason to blame it on the buyer. You didn't do what was needed to reach the success in the clinical trial or with the FDA. And so that's where they will point to, I talked earlier about the earn out covenants and typically those will look like the buyer agreeing to use commercially reasonable efforts.

(14:45):
And so the litigation is around, did you use commercially reasonable efforts? And that there are many, many cases including a handful just very recently with courts looking at what does commercially reasonable works mean? How was it defined in the agreement? And then it's a specific review of whether or not the buyer did meet the obligations that it had put in place for itself.

Geoff Cockrell (15:10):
One of the drivers of litigation in my mind in kind of earn out or contingency situations is the kind of binary aspect of if X happened, then this very large Y check gets paid. And if X is binary yes or no, it puts tons of pressure on how everything went down in that post-closing period. Whereas if you can massage a little bit the binary aspect of it, you can take some pressure off of there being litigation or somebody feeling like they truly got job. And I'm thinking of situations where it is not if X happens, you get Y, but if X happens, you get most of Y or something that is a little bit more scalable or timelines that can affect the amount of a payout, but not necessarily be an on/off switch on whether or not the payment's happening at all.

(16:00):
To what extent do you think that those can be useful tools? And when you're advising sellers, how do you think about trying to minimize the situation or sensation on a post-closing basis that they're going to feel like they got jobed by how the earn-out or contingency was framed?

Amy Cassalia (16:15):
The work I do in life sciences, I see those kind of less all or nothing situations than I would see outside of life sciences sector. I think that, again, is just given the nature of the post-closing lifecycle. What I do see though is renegotiation of these terms. I have worked with a number of parties who after closing, for whatever reason, either reached or were about to reach a milestone point in time where it was clear that it was not going to be payable and so they took that opportunity to renegotiate. So we'll push out maybe the timeframe for getting this approval, but we're going to pay you only two-thirds of what we are going to pay. Or we now need to do another phase three clinical trial that we were not expecting. And so that's going to mean you haven't met the goals that were outlined in our agreement, it's going to cost us much more. And so we're going to reduce your milestone payment by the additional expense of the additional work that'll need to be done to reach that endpoint.

(17:16):
So that is an opportunity sometimes for sellers when it's clear that an objective is not going to be met to be able to still get some value. But I see it a little less in the actual negotiation of the terms. Those tend to be fairly straightforward, it's a yes or no and you get paid or not.

Geoff Cockrell (17:34):
How does that play out? I mean, I'm assuming buyers are not just extending grace on these terms. Well, maybe they are. That with the benefit of seeing how things played out post closing, they have a sense that a modification of what was originally agreed is the, quote-unquote, right answer versus the seller has kind of structurally or on a go forward basis maintained some lever of leverage in the situation such that they can make a demand in that context where they've missed something that was kind of point blank contractually agreed before. How does that play out? Is it more sense of fairness or more sense that the seller still has leverage in the negotiation?

Amy Cassalia (18:13):
And so I do want to say that what I just described in terms of post-closing renegotiation is going to be in some of the, certainly on the private transaction side. Contingent consideration in life sciences deals is used in public company deals and that's through a contingent value right, we call that a CVR, and those are issued to the public at the closing of the transaction and an amount will be paid out on those when these particular milestones are met. I don't tend to see those getting renegotiated.

(18:42):
But in these private transactions, it is often the case that the sellers still have some leverage in that they may be still the scientific team that are working on the program. They may be the C-suite of the company that was acquired that has all of the knowledge and the relationships and the scientific connections that are going to move this program forward. So in order to keep them incentivized, if it's clear that the first milestone's not going to be met and maybe that's going to cause them to get discouraged about later milestones, it may be worthwhile, as they say, to come up with a solution where they get maybe paid a little less, but push out the milestone and then keep them incentivized to continue to work towards the later milestones.

Geoff Cockrell (19:22):
Amy, maybe we'll kind of end this discussion with stepping back from the specifics of contingent consideration into broader trends in the life science deals. What would you say are two or three of the leading trends that you're seeing in the market or hearing in transactions? What are some of the two or three trends that you see?

Amy Cassalia (19:39):
Well, first of all, I'd say just the use of earn-outs in life sciences deals is trending up. So even though I started by saying it's very common in this sector of the market, it's actually also increasing. So over the last, say, 18 months, we've seen earn-outs used in about 90% of the deals, that compares to a historical average of more like 70%. In addition to that, the use of CVRs in the public market has really increased. In 2025, there were 27 announced transactions with CVRs and that compares to only seven in the prior year, which was more similar to prior periods. So a lot more public company deals being done with contingent consideration.

(20:23):
And then the other thing I would say as a trend is just the creativity that's being used. We use sort of the typical milestone-based payments, but we're seeing those stretched into even later stages. So not just clinical results, not just FDA approval, but also extending into later commercial activities. We're also seeing other kinds of structures like staged investments where a slug of money is paid over certain of these milestones sometimes with an option to acquire at the end at some later endpoint. Even synthetic royalties as a way for deals like this to get done at a stage where the buyer still isn't

completely convinced of the complete value of the program. So I would say some of the creativity and deal structuring has been something that is evolving and is exciting.

Geoff Cockrell (21:09):
Amy, I think we'll wrap it there. Certainly an evolving area of the market, an area where we're seeing a lot of healthcare investors migrate more heavily into. So this is a good reminder of some of the key deal dynamics, but thank you a ton for joining. This has been a ton of fun.

Amy Cassalia (21:26):
Thank you so much for having me.

Voice over (21:30):
Thank you for joining us on this installment of The Corner Series. To learn more about today's discussion, please email host Geoff Cockrell at gcockrell@McGuireWoods.com. We look forward to hearing from you.

(21:43):