LEGAL OPTIONS OF STRUCTURING M&A DEALS

STRATEGICALLY

(FROM AN U.S. PERSPECTIVE)

by

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“The ringing will be good and strong.
So test therefore, who join forever,
If heart to heart be found together!
Delusion is short, remorse is long.”
Friedrich Schiller - Song of the Bell

Executive Summary:

This article explores different ways how businesses of nonaffiliated companies can be combined by taking a legal perspective. The answer to the question which option fits best shall be driven by strategic considerations during the mergers and acquisitions (M&A) process that include multiple factors such as current and future shareholder structure, the acquisition vehicle (direct or subsidiary merger, forward and reverse triangular merger), postclosing organization (division, holding company structure), legal form of the selling entity (corporation, limited liability company, limited liability partnership), liabilities, tax considerations, form of payment, and the form of the acquisition (statutory merger, statutory consolidation, stock or asset deal). Each option to structure a deal legally provides specific advantages and disadvantages. However, depending on the degree of required control strategic alliances (partnerships, joint ventures) provide alternatives to mergers and acquisitions. The optimum structure of M&A deals depends on interrelated factors that change from case to case and require a thorough analysis of the different and partially conflicting interests involved in M&A negotiations.

Mergers and acquisitions (M&A) can be seen as one of the most complex challenges business executives may face. Along the numerous steps to be taken from screening potential targets to closing and post-transaction integration, M&A require a multi-disciplinary expertise ranging from strategy, finance, legal, and human resources to engineering. This article spotlights the various strategic options of structuring a transaction legally, once a company that fits to the strategic business development plans of the acquirer has been identified; or, from a seller's perspective, the rationale of divesting a certain business aligns with its corporate strategy. The analysis of the available options should comprise considerations with regard to different interdependent components that include the legal structure used to acquire the target (acquisition vehicle), the organizational and legal framework used to manage the acquired business after the closing of the deal (postclosing organization), the legal form of the selling entity, form of payment, form of acquisition, and tax and accounting considerations.

Before looking at the strategic advantages and disadvantages of using a certain deal structure, the most important terms used need to be defined and distinguished from each other, because they have very diverging legal impacts on the way of obtaining control over another company. In contrast hereto, the terms "merger", "consolidation", "acquisition", "takeover" etc. are often used interchangeably in business context –sometimes not least to dilute the true nature of a deal for political reasons.

Merger and Consolidation

A merger is a combination of at least two independent legal entities, in which all but one legally cease to exist. The combined organization continues under the name of the surviving firm. Technically, a merger agreement needs the approval of the acquirer's and the target's boards of directors and the subsequent submission of the proposal to the shareholders of both firms (**statutory merger**). The bylaws of the companies often require a greater approval than a simple majority of the outstanding shares (qualified majority) in order to equitably take account of minority shareholder interests. In doing so, the buyer automatically assumes all assets and liabilities of the seller's company (universal succession). This includes the contractual relationships of the ceasing company with its suppliers and customers. As an exception to the statutory merger, no approval by the shareholders of the acquirer is necessary when the transaction is structured as a **subsidiary merger**. In this case the buyer creates a new corporate subsidiary or designates an existing subsidiary that merges with the target company. A **statutory consolidation** can be viewed as a special form of a merger: All legal entities that are consolidated are dissolved as the new company is formed. The emerging company assumes ownership of all assets and liabilities of the consolidated organizations. The owners of the consolidated companies exchange their shares against shares of the new company according to the consolidation agreement between the parties.

Acquisition

An acquisition occurs when one company takes a controlling ownership interest in another firm or selected assets of another firm, with the acquired firm continuing to exist independently in the case of only acquiring assets or as a legally owned subsidiary of the acquirer when the outstanding stock is subject to the purchase. Accordingly, such acquisitions are either called **asset deal** or **share deal**.

Business Alliance

In contrast to the above-mentioned forms of obtaining control in another company, a **business alliance** describes various forms of cooperative relationships that are not aimed at fundamentally changing the target company or its ownership structure. Such co-operations include joint ventures, partnerships, strategic alliances, equity partnerships, licensing agreements, and franchise agreements. A **joint venture** is formed by two or more independent companies, mostly as a distinct legal entity, to achieve common strategic objectives. The equity interest is often distributed equally among the partners in order to provide equal influence on the pursued strategy, but may diverge significantly depending on each party's contribution in capital, in kind or in intangibles (e.g. know-how, patents). A **partnership** is the general understanding of two or more parties to pursue a common goal. The law provides legal structures of unlimited liability (general partnership) and limited liability (limited liability partnership). A partnership is not a distinct legal entity as profits and losses are directly allocated to the partners, and thus not subject to tax by itself. **Equity partnerships** involve a minority purchase of another company's stocks, often in form of a two-way exchange of stock by the two companies. Equity partnerships do not create a legal organization such as general and limited liability partnerships. A **strategic alliance** is considered as a legally binding or largely informal agreement to cooperate in a specified way over a certain period of time, e.g. to buy each other's products or to co-develop certain technologies or standards. **Licensing agreements** provide access to proprietary technology or allow others to use intangible assets, such as patents and trademarks, in a certain territory in exchange for royalty payments. A **franchise** is a complex agreement that grants certain privileges from a manufacturer or service organization to a dealer to sell the franchiser's products or services. Such agreements involve among other aspects licenses of trademarks, trade dress rights, business concepts and know-how, and the purchase and reselling of goods. Business alliances are the preferable form of aligning businesses, if different market players are involved and only a little amount of control on another business is required. Such alliances, especially if a joint venture, are frequently a precursor to a later acquisition or merger, because it gives both parties time to assess the compatibility of their respective corporate cultures and strategic objectives.[1]

Acquisition forms

As noted above, there are three major forms of acquisition: the asset purchase, the share deal and the statutory merger. All of these acquisitions can be paid in exchange for buyer stock, cash, debt, or some combination; however, specific advantages and disadvantages identify the strategically best option to use under certain circumstances.

An **asset deal** should be considered, when the acquirer is only interested in certain tangible or intangible assets that can be delimited from others, because only assets and liabilities specifically identified in the purchase agreement are transferred to the buyer. For example certain machinery, a manufacturing plant, a product line or a patent family can be subject to the asset deal. From the buyer's perspective the advantage of a purchase of assets is to be selective as to which assets of the target to purchase. This includes to only paying current market value for the designated goods, and to limit the liabilities attached to certain assets as assumed under the contract. However, it is usual to insist on indemnification clauses, because the buyer can be held liable by third parties even for risks excluded in the purchase agreement, which is only effective between the parties of the agreement.[2] Indemnification holds the seller responsible for payment of damages resulting from third party claims. Notwithstanding, in cases in which a buyer purchased a substantial portion of the target's assets, there where court rulings that the buyer is responsible for the seller's liabilities

[1] Donald M. DePamphilis, *Mergers, acquisitions, and other restructuring activities* (San Diego, CA: Elsevier Academic Press, 2012), p. 150.

[2] Donald M. DePamphilis, p. 435.

according to the “trust funds doctrine”[3], especially applicable on the grounds that an acquisition is a de facto merger[4]. Another advantage from the buyer’s perspective might be that asset deals usually do not require the approval of its shareholders, except if the assets shall be paid in shares of the buyer that haven’t been already approved for this purpose.[5] Buying assets rather than stock also excludes undesired contracts, such as agreements with labor unions, social benefit plans, leases etc.[6] On the other hand, it should be taken into consideration that there are assets that cannot be transferred by an asset purchase agreement. These include the seller’s workforce, know-how and client relationships. Another disadvantage is that it can be very difficult and costly to list all acquired assets in the appendices of the agreement, the sale of titles to each asset transferred must be recorded, and state title transfer taxes must be paid. Moreover, a lender’s consent may be required if the asset is being used as collateral for loans.[7]

From a seller’s perspective an asset deal has the advantage of maintaining its corporate existence and ownership of all tangible and intangible assets not being part of the transaction. This includes the use of the corporate identity and all tax credits and accumulated net operating losses, which can be used to shelter future income from taxes.[8] On the negative side, the seller may face serious tax claims, because of differences between the book value and the price actually realized. Anyhow, it should be noted that whether the seller or the buyer pays transfer taxes or if they are shared is negotiable. Another tax-related issue is that if the target is subsequently liquidated, the seller may be responsible for the recapture of taxes

[3] Patrick A. Gaughan, *Mergers, acquisitions, and corporate restructurings* (Hoboken, NJ: John Wiley & Sons, 2011), p. 28.

[4] Edwin L. Miller Jr., *Mergers and acquisitions: a step-by-step-legal and practical guide* (Hoboken, NJ: John Wiley & Sons, 2008), pp. 116.

[5] Patrick A. Gaughan, p. 28.

[6] Joseph C. Krallinger, Mergers & acquisitions: managing the transaction (New York, NY: McGraw-Hill), pp. 205.

[7] Donald M. DePamphilis, p. 436.

[8] Donald M. DePamphilis, p. 436.

deferred as a result of the use of accelerated rather than straight-line depreciation.[9] Depending on the deal volume, the transaction may require the approval of the selling company's shareholders, whenever "substantially all" of the firm's assets shall be sold. The notion "substantially all" also refers to assets that are critical to the firm's operation of the business (e.g. core technologies or the company's brand name). The approval requirement can be equally stipulated by the bylaws of the company or by applicable state statutes.[10] The involvement of shareholders in transactions is always associated with administrative efforts, and may cause controversy among shareholders or between shareholders and the board of directors. Finally, it can be said that a well-drafted asset purchase agreement can provide legal security for both parties, because it designates clearly what is sold and with which party remain certain liabilities.

The nearest alternative to an asset deal is the acquisition of the targeted company's stock. Such a **share deal** requires a target organized as a legal entity with outstanding shares or interest, and that can hold titles independently from its owners (e.g. corporation or limited liability company). In this case it is not necessary to document all acquired assets individually, because all assets are transferred automatically with the transfer of ownership of the acquired stock in the company, which continues to hold all assets.[11] This is also true for the target's intangibles assets like name, licenses, franchises, brands, patents, and permits, which use thereof is preserved.[12] Since the continuity of the target corporate identity is provided by a share purchase, there is no need to renegotiate contracts with clients of the sold entity.

[9] Donald M. DePamphilis, p. 436.

[10] Donald M. DePamphilis, p. 434.

[11] Robert J. Borghese and Paul F. Borghese, *M&A from planning to integration: executing acquisitions and increasing shareholder value* (New York, NY: McGraw-Hill, 2002), p. 86.

[12] Donald M. DePamphilis, p. 438.

However, change of control clauses in client and vendor contracts may require their approval prior to the transaction.[13] As for asset purchase deals, there is usually no requirement of the acquirer's shareholders to approve the deal as long as it is financed primarily with cash or debt.[14] Another advantage may be that the deal can be carried out without the consent of the target's board or management, as is the case in a hostile tender offer.[15] From a seller's perspective a share deal is preferable to an asset deal, because it allows them to step away from the business and become free of current liabilities as well as future obligations (with the restrictions stipulated in indemnification clauses).[16]

On the downside, the buyer is liable for all unknown, undisclosed, or contingent liabilities, and union agreements and employee benefit plans are not terminated.[17] Nevertheless, the liabilities remain associated with the target company after the transaction and do not subrogate to the acquirer that will not be directly responsible for such liabilities.[18] Though there is no express requirement to obtain the shareholders' approval, stockholders of the target may simply refuse to sell their participation. Dealing with minority shareholders creates significant administrative costs and practical issues, such as submitting annual reports, holding formal annual shareholder meetings, and conducting a formal board election process. Minority shareholders may also inhibit the implementation of strategic moves and restructuring of corporate assets and functions.[19]

The alternative to an acquisition to obtain full control of another company is a **statutory merger** where at least one of the involved entities will cease to exist (other than in a statutory

[13] Donald M. DePamphilis, p. 438.
[14] Donald M. DePamphilis, p. 438.
[15] Donald M. DePamphilis, p. 438.
[16] Donald M. DePamphilis, p. 439.
[17] Donald M. DePamphilis, pp. 438.
[18] Robert J. Borghese and Paul F. Borghese, p. 86.
[19] Donald M. DePamphilis, pp. 438.

consolidation where a new company emerges from the deal). The principal advantage of a merger transaction is that it is similar to a stock purchase in that it does not involve the transfer of specific assets or the assumption of specific liabilities. The acquiring company assumes all assets and liabilities of the target automatically by operation of law.[20] However, certain contracts, licenses, leases, and titles may need to be assigned or changed. In some cases, filings are required to make these changes effective.[21] For example, requests for change of ownership in patents and trademarks must be filed with the local Patent and Trademark Offices in order that these intellectual property (IP) rights can be used in court proceedings to support IP infringement suits.

Becoming responsible for all liabilities disclosed, undisclosed, known or unknown is certainly the main disadvantage of a direct merger. Further, a merger requires the approval and commitment of both the buyer's and the target's board of directors and their respective shareholders (except for small-scale mergers and certain mergers of or with subsidiaries[22]). Notwithstanding, this is not exactly the case, because only a majority vote of the shareholders is required. This implicates that other than in the case of a share deal a complete transfer of the target's assets can be effected against the vote of its minority shareholders, and no squeeze out of minority shareholders is needed ("minority freeze-out").[23] Minority shareholders of both companies have of course the opportunity to contest the deal in legal proceedings if necessary and claim an equitable compensation according to the fair value of the company in exchange of their loss of rights. Such appraisal rights afford dissenting shareholders the right to receive cash for their stock instead of participating in the merger

[20] Robert J. Borghese and Paul F. Borghese, p. 87.

[21] Michael E. S. Frankel, Mergers and acquisitions basics: the key steps of acquisitions, divestures, and investments (Hoboken, NJ: John Wiley & Sons, 2005), p. 272.

[22] Donald M. DePamphilis, p. 441.

[23] Patrick A. Gaughan, p. 27.

transaction.[24] Furthermore, clients' and vendors' consent are required if stipulated in change of control clauses as contingency risks may change in connection with the merger.[25] Similarly, the transfer of licenses and permissions may require the approval of private third parties or state authorities.[26] The compensation of the dissolving company's shareholders can be structured in a flexible way in form of cash, debt or stock in the surviving entity. Under certain conditions stock-for-stock mergers are even tax-free transactions, if the target's shareholders maintain an ongoing interest in the combined company post transaction ("continuity of interest"), the target's business is continued in the acquirers ongoing operations ("continuity of business), the business purpose is not the avoidance of taxes ("valid business purpose"), and one of the reorganization types proscribed by Section 368 of the Internal Revenue Code is used. Finally, the compensation in stock must constitute at least 50% of the total consideration (while other payment components remain taxable).[27]

Acquisition vehicles

Making use of certain legal structures or special purpose companies, the so-called **acquisition vehicles**, can mitigate some disadvantages of merger transactions. The basic concept is to create a distinct legal entity as a wholly owned subsidiary of the acquirer, which consummates the merger. But this structure is also used for acquisitions, because it allows for a greater flexibility in terms of legal, tax and financing considerations. For example, if a corporate subsidiary acquires the target company, only the subsidiary is the debtor for the purchase price and liabilities are insulated from the parent company. If the subsidiary is

[24] Robert J. Borghese and Paul F. Borghese, p. 87.
[25] Donald M. DePamphilis, p. 441.
[26] Robert J. Borghese and Paul F. Borghese, p. 87.
[27] Peter A. Hunt, *Structuring mergers & acquisitions: a guide to creating shareholder value* (New York, NY: Aspen Publishers, 2004), pp. 224.

established as a limited liability company (LLC) it will not only limit liabilities, but may be exempt also from paying tax itself if it fulfills certain conditions, because then the LLC passes through all profits and losses of the entity to its owners (avoidance of double taxation).[28] The subsidiary is often organized as a holding company that holds several participations in companies with the effect that gains of one company can be offset against losses of another; a construction especially used by foreign acquirers that pay tax outside the U.S.[29]

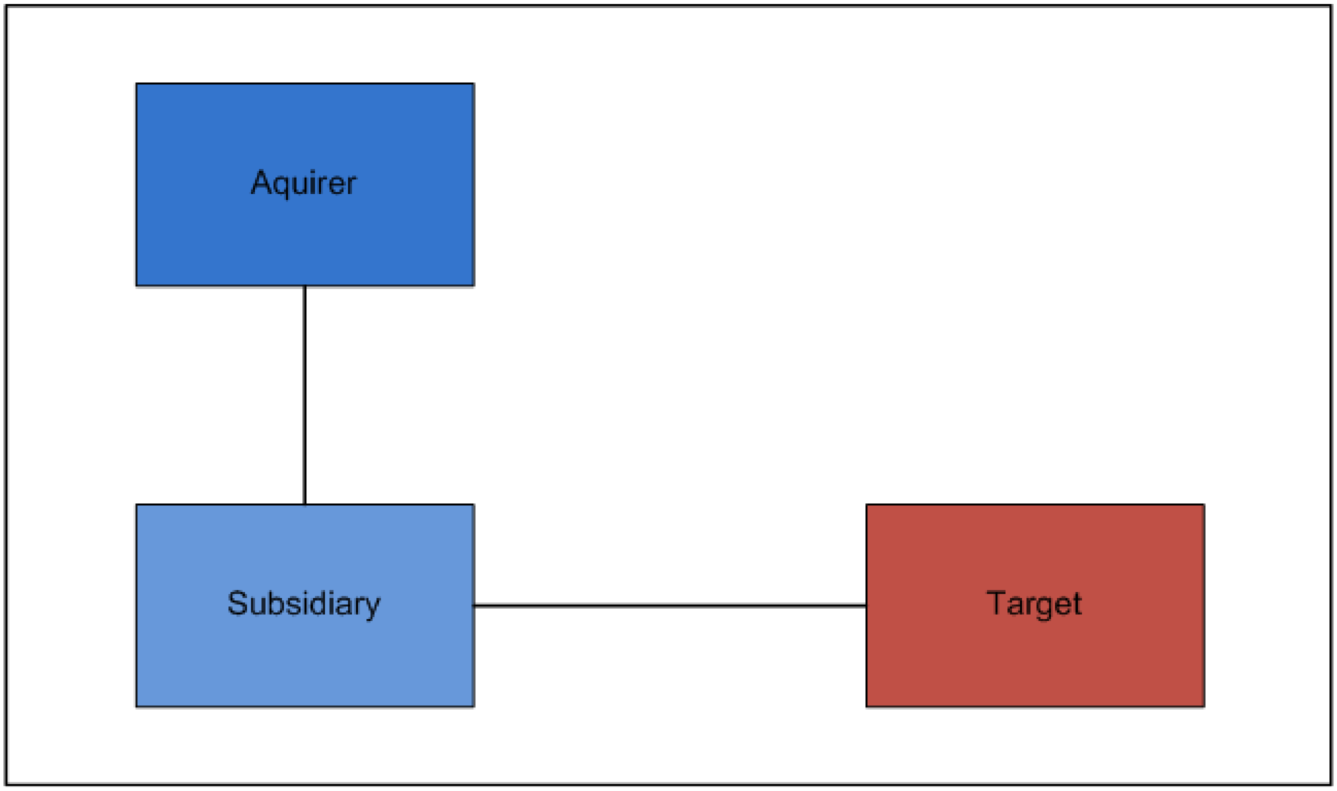

Figure 1: Subsidiary Acquisition Structure

With regard to financing an acquisition a subsidiary maximizes flexibility, because cash, debt or stock either from the parent company or the subsidiary can finance the acquisition. A subsidiary also facilitates the monitoring of the operation's performance of an acquired company during an earn-out period, abates the managerial influence of the parent, and

[28] Donald M. DePamphilis, pp. 549.
[29] Donald M. DePamphilis, p. 665.

therefore minimizes the potential for post-earn-out litigation.[30] Finally, this acquisition form does neither require the express approval of the parent's board nor shareholders, because it is the management of the subsidiary that is responsible for the acquisition.

The acquisition vehicle plays an even more important role in merger transactions, because in the case of a direct merger between the target and the acquirer, the buyer assumes all liabilities of the merged entity by operation of law, regardless whether such liabilities have been disclosed, undisclosed, known or unknown.[31] In contrast, a subsidiary of the parent consummating the merger can insulate these liability risks from the parent company. Further, the approval of shareholders and boards of both merging companies is required, but the shareholder of the subsidiary is the parent company and therefore approval can be obtained easily.[32]

The deal structure of a subsidiary merger is often used in leveraged buyouts (LBOs). This term refers to a financing technique in which the equity of a public corporation is purchased mostly with debt and the public company is taken private.[33] In addition, the subsidiary of a financial investor may raise capital in an initial public offering (IPO) before the merger or acquisition that is placed in a trust and invested in government securities between the IPO and the completion of the transaction.[34] If the transaction is effected as a merger, the company to be taken private merges with a company controlled by the investors, the so-called financial sponsors. If the LBO is structured as cash-for-stock transaction, the lender of debt capital will make the loan to the buyer once the security agreements are in place and the target's stock has been pledged against the loan. The target is then merged into the acquiring

[30] Donald M. DePamphilis, p. 417.
[31] Patrick A. Gaughan, p. 226.
[32] Donald M. DePamphilis, pp. 439.
[33] Patrick A. Gaughan, p. 333.
[34] Patrick A. Gaughan, p. 31.

company, which is the surviving corporation. While the loan proceeds are usually paid directly to the seller, the acquired company will be responsible for the repayment of the loan.[35] Companies with undervalued assets, high cash or working capital positions are favored targets, because they often have unused borrowing capacity that can be used as collaterals for loans and may accelerate the payoff for investors.[36]

In addition, a subsidiary merger or triangular merger provides further advantages: it provides options whether the subsidiary merges with the target, or the target merges with the subsidiary. What sounds one and the same at first glance has very significant effects in practice. In a **forward triangular merger** the acquired target merges with and into the subsidiary of the acquirer, which is often solely created for the single purpose of the merger. As a consequence the target formally ceases to exist. This can have undesirable effects on certain contractual rights and relationships that depend on the target's legal integrity.[37] For example, non-assignable franchises, long-term debt covenants, patent license-agreements cannot be transferred without third-party approval. This consent may be particularly difficult to secure, because a third party could use this opportunity to make the consent dependent on additional consideration or improved contractual terms and conditions.[38] Therefore, a considerable amount of attention should be drawn on non-assignment clauses during the legal due diligence.

[35] Donald M. DePamphilis, p. 500.

[36] Donald M. DePamphilis, p. 492.

[37] Robert J. Borghese and Paul F. Borghese, p. 90.

[38] Shannon D. Kung, "The reverse triangular merger loophole and enforcing anti-assignment clauses" *Northwestern University Law Review*, 2009, pp. 1045.

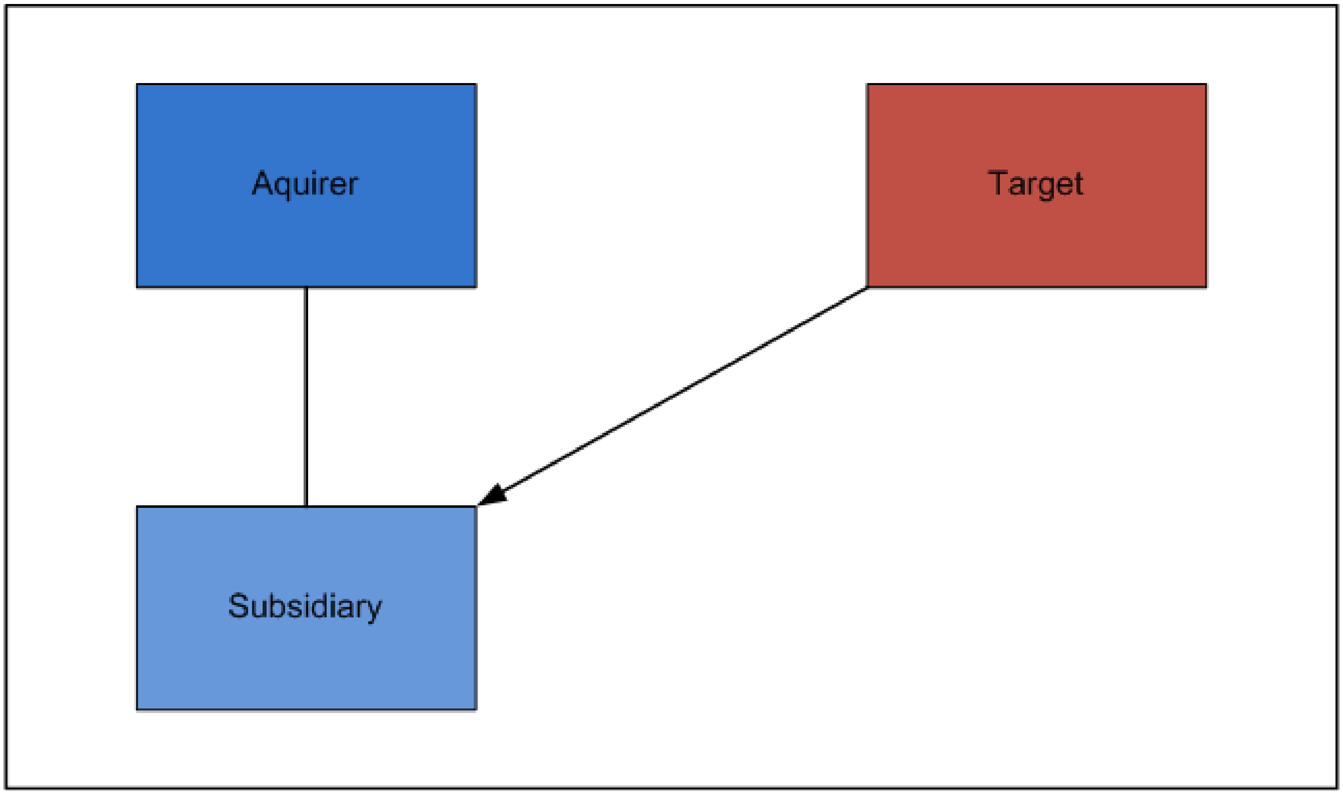

Figure 2: Forward Triangular Merger Structure

This pitfall can be avoided if the form of a **reverse triangular merger** is chosen. In this case the acquirer's subsidiary merges into the target company and only the target survives the transaction while the acquisition vehicle disappears.[39] Despite the acquirer's subsidiary disappearing, the target company becomes a subsidiary of the buyer. Thus, only the ownership of the target changes but not its legal identity.[40]

[39] Peter A. Hunt, pp. 227.
[40] Shannon D. Kung, p. 1046.

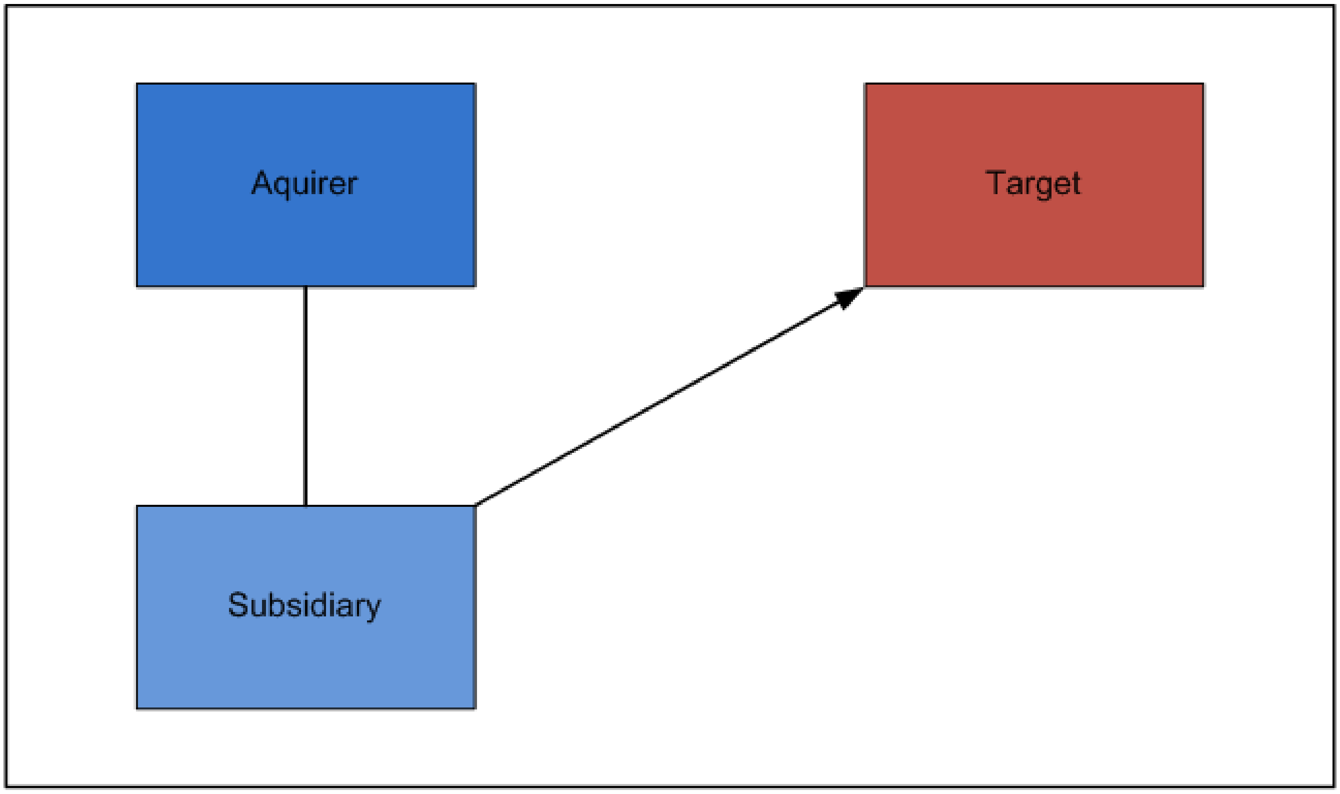

Figure 3: Reverse Triangular Merger Structure

Unfortunately, it has to be pointed out, that inconsistent interpretations of the relevant state laws and sparse and ambiguous court rulings have fostered continued confusion and uncertainty regarding the efficacy of anti-assignment clauses and the reverse triangular merger model.[41] The interests of the affected parties are controversial and make a balanced solution difficult.[42] For example, if a Company A has licensed a patented technology to a Company B, and Company B is acquired by (a subsidiary) of Company C which is a competitor of Company A. Company A has a vested interest not to make its proprietary technology accessible to its competitor. A reverse triangular merger could be an instrument to acquire rights through the backdoor that would otherwise not be up for sale.[43] This set of problems cannot be covered in detail in the present article, but it should be mentioned that the

[41] Shannon D. Kung, p. 1048.

[42] James Meade, “Reverse Triangular Mergers: Mere Change of Ownership? Maybe Not” *Mergers & Acquisitions: The Dealmaker’s Journal*, October 2011, p. 38.

[43] Shannon D. Kung, p. 1062.

term “reverse merger” is also used in a different context. Sometimes a private company wishes to go public by merging with an already public company that often is inactive or a corporate shell. This may avoid some of the costs and scrutiny that normally would be associated with an IPO and may take place quickly. Further, shares of a public company are more liquid and can be more easily used to purchase other target-companies.[44] But this option does not release the private company from performing due diligence on the target and communicate information on the shell corporation to the exchange on which its stock will be traded and prepare a prospectus.[45]

The postclosing organization

The organization in which an acquired business shall be operated after the closing of the deal is often determining for the form chosen for the acquisition vehicle: corporate, general partnership, limited partnership, and the limited liability company. Common organizational business structures include divisional and holding company arrangements.[46] Since an operating division is generally not a separate legal entity but rather an organizational unit, it will not have its own stock or board of directors. If the buyer is interested in integrating the target business immediately following the closing, the divisional structure may be most desirable because it allows gaining the greatest control.[47] The acquisition could then be structured as a direct or subsidiary merger or a two-step acquisition, where the target’s shares are acquired first, and the new business is then merged into the appropriate entity becoming part of the relevant division of the acquirer. If a more independent unit is desired, the target can be acquired through a share deal and managed as a direct subsidiary or as a

[44] Patrick A. Gaughan, pp. 29.

[45] Donald M. DePamphilis, p. 396.

[46] Donald M. DePamphilis, p. 417.

[47] Donald M. DePamphilis, p. 418.

subsidiary of a holding company, which may have several shareholders, as is the case in a joint venture. This form is also preferable if the target has significant known or unknown liabilities, an earn-out is involved, the target is a foreign firm, or the acquirer is a financial investor.[48] Finally, the postclosing organization is often chosen depending on tax effects that are associated with certain legal forms (e.g. partnership, LLC, Subchapter S cooperation).

The legal form of the selling entity

The legal form of the seller will have an impact on the tax payment obligations activated by the selling of the target company. For example, corporate legal structures, also referred to as "C-type corporations", are subject to double taxation (on the corporate level and on the level of its shareholders if dividends are paid), while Subchapter S corporations ("S-type corporations"), LLCs and partnerships (e.g. LLPs) are not, because the company's income passes through untaxed to the owners, who are subject to their personal tax rates. Therefore, the seller will care about the form of the transaction depending on its legal form, preferring acquirer stock if organized as a C-type corporation, while LLC owners may be indifferent to an asset or stock deal. Nevertheless, also LLC owners may be interested in receiving acquirer stock as a compensation in order to defer their tax liabilities or to participate in the long-term growth potential of the acquiring company. [49]

Forms of payment and tax and accounting considerations

The forms of payment are multiple (stock-for-asset, stock-for-stock, cash-for-asset, cash-for-stock) and mostly go along with tax considerations and the current market value of both the acquirer's and the target's stock. If a subsidiary merger is the chosen deal structure, shares of

[48] Donald M. DePamphilis, p. 418.
[49] Donald M. DePamphilis, p. 419.

the subsidiary and the parent come into consideration as a compensation for the purchased assets or shares. Often, a combination of different payment forms is chosen to meet the seller's and the buyer's interests and to distribute the financial risks that are associated with merger and acquisition transactions.

As stated at the beginning, the factors that impact the deal structure of mergers and acquisitions are multiple and interdependent. Each deal is different and has diverging underlying interests of the involved parties. Therefore, it is not possible to suggest a certain organizational form or form of consideration as the favorable deal structure. However, assuming well-informed players and a free play of market forces will lead to the appropriate combination of deal structure elements during the negotiation process.

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