Reverse and Forward Triangular Mergers
Alternative Approaches to Structure M&A Transactions,
Implications for Anti-Assignment Clauses

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Today’s faculty features:
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Reverse and Forward Triangular Mergers

I. Corporate Law Requirements

- Overview of Structure of Triangular Mergers
- Legal Requirements
- Advantages and Disadvantages

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This presentation should not be considered legal advice.
Reverse and Forward Triangular Mergers: Corporate Law Requirements
Overview of Structure of Triangular Mergers

Essential Steps
- Formation of Acquisition Subsidiary (capitalization with merger consideration)
- Agreement and Plan of Merger and Articles of Merger
- Board and Shareholder Approvals of constituent corporations (Acquisition Subsidiary and Target Company)
Reverse and Forward Triangular Mergers: Corporate Law Requirements
Overview of Structure of Triangular Mergers

**Forward Triangular Merger**
- Target Company Shareholders receive Merger Consideration and Target Company shares are cancelled
- Target Company merges with and into Acquisition Subsidiary, with Acquisition Subsidiary as the surviving corporation (with all of the assets and liabilities of Target Company)
Reverse and Forward Triangular Mergers: Corporate Law Requirements
Overview of Structure of Triangular Mergers

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Reverse and Forward Triangular Mergers: Corporate Law Requirements

Legal Requirements

- Agreement and Plan of Merger
- Approval of Board of Directors of Acquisition Subsidiary
- Approval of Board of Directors of Acquiring Company (as sole shareholder of Acquisition Subsidiary)
- Approval of Board of Directors of Target Company
- Approval of Target Company Shareholders
- Filing of Certificate of Merger
- Additional Considerations for Public Companies
- Regulatory Approvals
Reverse and Forward Triangular Mergers: Corporate Law Requirements
Advantages and Disadvantages

**Advantages**
- Insulating Acquiring Company from Target Company’s liabilities
- No approval is required from Acquiring Company Shareholders
- Maintaining Surviving Company as a separate legal entity from Acquiring Company will allow for an easier exit
- Fewer third party approvals
- Easier transition for employees
- Non-transferrable rights and assets are usually not affected

**Disadvantages**
- Statutory dissenters rights
- Necessity of shareholder approvals
- Necessity of board approvals
- No ability to leave behind liabilities of Target Company
- Ongoing maintenance of Surviving Company as a separate legal entity
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REVERSE AND FORWARD TRIANGULAR Mergers

II. Anti-Assignment Clauses

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DOES THE ACQUISITION/MERGER CONSTITUTE AN ASSIGNMENT?

Asset Acquisition

By definition, Target company’s assets (including contracts) are assigned or transferred

Direct Merger

Target Co. survives

Acquiring Co. survives

Triangular (Subsidiary) Merger

Forward Triangular Merger
• Acquiring Co.’s Merger
  Subsidiary survives

Reverse Triangular Merger
• Target Co. survives as a subsidiary of the Acquiring Co.
State Merger Statutes: “Vesting” Language

- Effect of Merger: Vesting Language in State Merger Statutes
  - Current ABA Model Business Corporation Act ("MBCA") “Vesting” Language:
    - “all property owned by, and every contract right possessed by, each corporation or other entity that merges into the survivor is vested in the survivor without reversion or impairment” (§ 11.07(a)(3))
    - Majority of states merger statutes include provisions similar to the effect of merger provision of the MBCA, but not necessarily from the current version of the MBCA
  - Vesting Language in Delaware Merger Statute:
    - “… the rights, privileges, powers and franchises of each of [the merged] corporations, and all property, real, personal and mixed, and all debts due to any of said constituent corporations on whatever account ... shall be vested in the corporation surviving or resulting from such merger or consolidation; ... and shall not revert or be in any way impaired by reason of this chapter...” (Del. Code § 18-259)
  - Vesting Language in California Merger Statute:
    - “… the surviving corporation shall succeed, without other transfer, to all the rights and property of each of the disappearing corporations and shall be subject to all the debts and liabilities of each in the same manner as if the surviving corporation had itself incurred them.” (Cal. Corp. Code § 11.07(a))
**Question:** Does an assignment or transfer by operation of law occur when “vesting” takes place in a merger, triggering anti-transfer or anti-assignment provisions?

- The official comment to the current MBCA provides that “a merger is not a conveyance, transfer or assignment” and that “it does not give rise to a claim that a contract with a party to the merger is no longer in effect on the ground of non-assignability, unless the contract specifically provides that it does not survive a merger;” but not all states have based their merger statutes on the current MBCA.
- The Texas and Georgia merger statutes expressly provide that vesting takes effect without any transfer or assignment.
- The Virginia merger statute expressly provides that vesting takes effect “except to the extent that assignment would violate a contractual prohibition on assignment by operation of law.”
- The Pennsylvania merger statute does not use “vesting” or “transfer” language but specifies that each party to the merger plan, except the resulting survivor, ceases to exist entirely, and the rights, privileges, properties, debts, powers etc. of the prior entities continues on within the new entity.
- Case law is confusing:
ASSIGNMENT/TRANSFER BY “OPERATION OF LAW” (CONT.)

• Practitioners traditionally assume that forward triangular mergers trigger anti-assignment contractual clauses because the Target Co. does not survive the merger

**Permaglass, Inc. v. Guardian Industries Corp.** *(597 F.2d 1090 (6th Cir. 1979))*

- Permaglass, Inc. merged with Guardian pursuant to Ohio and Delaware laws. Permaglass listed certain non-exclusive patent licenses granted to it by its competitor, PPG, to be vested with Guardian. PPG filed suit to enforce provisions that (i) specified that the agreement is non-assignable without PPG’s written consent and (ii) terminate the agreement if the majority of Permaglass’ common stock becomes owned/controlled by an automobile or glass manufacturer.
- The court interpreted the language, “deemed to be transferred to and vested in ... without further act or deed,” in the Ohio merger statute, to be a transfer by operation of law (and not an absence of transfer) and thereby held that the merger violated the Permaglass/PPG contract’s anti-assignment clause.

**TXO Production Co. v. M.D. Mark, Inc.** *(999 S.W.2d 137 (Tex. App.-Houston 1999))*

- TXO, a wholly owned subsidiary of Marathon Oil Co., merged with Marathon, whereupon certain data owned by PGI and held by TXO, was automatically transferred to Marathon. PGI’s contract with TXO prohibited the transfer of such data to third parties.
- The Texas Court of Appeals interpreting the Texas merger statute held that the merger was not an assignment or transfer that would violate contractual prohibitions on data transfer; but the court distinguished this case from other cases on the fact that the merger was with a related company. Note that the Texas merger statute makes no distinction based on related companies.


- Baton Rouge, the general partner of a partnership, merged with Star Cellular Tel. Co., a sister corporation. Other partners refused to recognize the surviving corporation as the general partner relying on a provision that required unanimous approval from the other partners for a transfer or assignment.
- The Delaware Chancery Court looking to the official comment to the Georgia merger statute that provides that a merger is not a conveyance or transfer held that a merger is neither a transfer or assignment and therefore, the anti-assignment provision was not violated and approval was not required.
ASSIGNMENT/TRANSFER BY “OPERATION OF LAW” (CONT.)

• Practitioners traditionally assume that reverse triangular mergers do not trigger anti-assignment contractual clauses (even clauses prohibiting assignments “by operation of law”) because the Target Co. survives the merger; limited case law on the point.


• In a reverse triangular merger, D&N Systems, Inc. merged with SybaseSub, Inc., and the surviving entity took the name SQL Solutions, Inc. Oracle Corporation sought to terminate its agreement with D&N Systems, which contained an anti-assignment clause requiring Oracle’s consent for any assignment or transfer of the agreement to a third party.

• The Northern California District Court held that an assignment or transfer of rights had occurred because there was a change in legal form of ownership – the merger of D&N Systems with SybaseSub and on this basis, held that the merger violated the anti-assignment clause in the Oracle/D&N Systems contract.

Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH (Del. Ch. Feb. 22, 2013)

• This case involved a reverse triangular merger where the question presented to the court was whether a reverse triangular merger is an assignment by operation of law, in which case the merger would result in a breach of the following anti-assignment clause in a Global Consent agreement at the center of the litigation: “Neither this Agreement nor any of the rights, interests or obligations under this Agreement shall be assigned, in whole or in part, by operation of law or otherwise by any of the parties without the prior written consent of the other parties ...”

• Initially, the Delaware Chancery Court in 2011 denied Roche’s motion to dismiss Meso’s claim. The court then, finding no Delaware case law on point, declined to rule that a reverse triangular merger does not, as a matter of law, constitute an assignment “by operation of law.” In summary judgment proceedings in 2013, however, the court affirmed that a reverse triangular merger does not constitute an assignment by operation of law or otherwise under Delaware law.
Default Assignment Rules

• Contracts are generally assignable without the consent of the other party
• Exceptions:
  • Certain IP licenses are not assignable without the licensor’s consent
    • Non-exclusive patent and copyright licenses are not assignable or delegable without the licensor’s express consent. *(Perlman v. Catapult Entertainment, 165 F.3d 747 (9th Cir. 1999)(patent context)); (Harris v. Emus Records Corp., 734 F.2d 1329 (9th Cir. 1984)(copyright context)).*
    • Trademark licenses are not assignable or delegable without the licensor’s express consent. *(N.C.P. Marketing Group, Inc. v. BG Star Prods. Inc., 279 Fed. Appx. 561 (9th Cir. 2008) & In re XMH Corp., 647 F.3d 690 (7th Cir. 2011) (trademark context)).* For purposes of assignability, courts have not distinguished between exclusive and non-exclusive trademark licenses.
  • Agreements for personal services
  • Other:
    • Statute, public policy, or contractual clauses prohibit assignment *(Restatement (Second) of Contracts § 317(2)(a) (1981))
    • Assignment is ineffective if it materially changes the obligor’s duty, increases materially the burden or risk imposed on obligor by the contract, or impairs materially obligor’s chance of obtaining return performance. *(U.C.C. § 2-210(2))
TRIANGULAR (SUBSIDIARY) MERGER

**Forward Triangular Merger**
- Merger Subsidiary survives
- Generally, an assignment or transfer by “operation of law”
- Anti-assignment & anti-transfer clauses may be triggered; watch out for contracts that are silent on assignment but contain IP licenses, relate to personal services, or otherwise materially change the obligor’s duty
- Change of control provisions may be triggered

**Reverse Triangular Merger**
- Target Co. survives
- Traditional practitioners’ view: no assignment. Exception: California-related reverse triangular merger may trigger anti-assignment and anti-transfer clauses in light of *SQL Solutions v. Oracle*
- Change of control provisions may be triggered
1. “[Target] may not assign its rights or obligations under this Agreement, in whole or in part.”

2. “[Target] may not assign its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent.”

3. “[Target] may not assign its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent (not to be unreasonably withheld or delayed).”

4. “[Target] may not assign or transfer its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent.”

5. “[Target] may not assign or transfer its rights or obligations under this Agreement, in whole or in part, whether by operation of law or otherwise, without [the other party’s] prior written consent.”

6. “[Target] may not assign or transfer its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent. A change of control of [Target] will be deemed an “assignment” by [Target].”

7. “[Target] may not assign or transfer its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent, and any attempted assignment without such consent shall be void and without effect.”
1. “[Target] may not assign its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent, except that it may, without such consent, assign this Agreement to its parent or subsidiary, or to any successor in interest by consolidation, reorganization, merger or acquisition of substantially all of its assets.”

2. “[Target] may not assign its rights or obligations under this Agreement, in whole or in part, without [the other party’s] prior written consent, except that it may, without such consent, assign this Agreement to its parent or subsidiary, or to any successor in interest by consolidation, reorganization, merger or acquisition of substantially all of its assets related to this Agreement.”
• Change of control
• Termination
• License restrictions (e.g., non-transferability, enterprise restrictions, etc.)
• Springing rights
PRACTITIONER’S TIPS

• Understand the transaction structure
• Carefully review Target’s commercial agreements:
  ➢ are there anti-assignment or anti-transfer clauses?
  ➢ does the agreement include any IP license grants to the Target Co. that will require consent for transfer purposes?
  ➢ is the agreement for the personal services of the Target Co. that will require consent for transfer purposes?
  ➢ does the assignment materially change the obligor’s duty?
  ➢ are there other clauses that would be triggered by a change of control?
• As part of your analysis, consider the state merger statute that would be applicable to the merger and the governing law of the commercial agreement
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REVERSE AND FORWARD TRIANGULAR MERGERS

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TRIANGULAR OR SUBSIDIARY MERGERS

Forward Subsidiary Merger

- **Target**
- **Acquiror**
- **Merger Sub**

**Tax Consequences**

- No gain to Acquiror or Target
- No gain to Target Shareholders except to extent of boot received

Reverse Subsidiary Merger

- **Target**
- **Acquiror**
- **Merger Sub**

- Transferee takes carryover basis in assets
- Target Shareholders take basis in Acquiror stock equal to basis in Target stock
TRIANGULAR OR SUBSIDIARY MERGERS

Section 368(a)(2)(D)
Forward Triangular Merger

- Statutory merger of Target into Merger Sub (at least 80% owned by Merger Sub)
- Substantially all of Target’s assets acquired by Merger Sub
- Would have been a good Type A merger if Target had merged into Merger Sub

Tax Consequences

- Merger Sub takes Target’s basis in assets increased by gain recognized by Target
- Acquiror takes “drop down” basis in stock of Merger Sub (same as asset basis)
TRIANGULAR OR SUBSIDIARY MERGERS

Section 368(a)(2)(E)
Reverse Triangular Merger

- Merger of Merger Sub into Target where
  - (i) Target shareholders surrender control (80% of voting and nonvoting classes of stock) for Acquirer voting stock and
  - (ii) Target holds substantially all the assets of Target and Merger Sub

Tax Consequences

- Non-taxable to Target and carryover basis
- No gain to Acquirer and Merger Sub under Sections 1032 and 361
- No gain to Target Shareholders except to the extent of boot
- Acquirer’s basis in Target stock generally is the asset basis, but Acquirer can choose to take Target Shareholders’ basis in stock (if it is also a B)
- If transaction is also a 351, Acquirer can use Target Shareholders’ basis plus gain

Diagram:

- Target Shareholders
- Acquirer Stock
- Target
- Acquirer
- Merger Sub
- Merger Survives
- 80%
Section 368(a)(1)(B) Type B Reorganization

- Acquisition of stock of Target, by Acquiror, in exchange for Acquiror voting stock
- Acquiror needs control of Target immediately after the acquisition
- Control = 80% by vote and 80% of each class

Tax Consequences

- Acquiror’s basis in Target stock is the same as the Shareholders’

- Solely for voting stock - No Boot in a B

- Reorganization Expenses – distinguish between Target expenses and Target Shareholder expenses (Rev. Rul. 73-54)

- Creeping B – old and cold stock purchased for cash should not be integrated with stock exchange
Section 368(a)(1)(C)
Stock for Assets

- Acquisition of substantially all of the assets of Target, by Sub, in exchange for Acquiror voting stock
- “Substantially All” = at least 90% of FMV of Net Assets and at least 70% of FMV of Gross Assets
- Target must liquidate in the reorganization
- 20% Boot Exception – Acquiror can pay boot (non-stock) for Target assets, up to 20% of total consideration; liabilities assumed are not considered boot unless other boot exists

Tax Consequences

- Reorganization Expenses – Acquiror may assume expenses (Rev. Rul. 73-54)
- Assumption of stock options not boot
- Bridge loans by Acquiror are boot
- Redemptions and Dividends – who pays and source of funds
Cash Reverse Triangular Merger

- Treated as Stock Sale
- Shareholders have gain or loss
- Acquiror takes cost basis in Target shares
S CORPORATIONS AND 338(h)(10)

- Character difference – ordinary income assets
- California 1.5% tax on S corporations
- All Target shareholders must consent on Form 8023
- Deemed 338 election for subsidiaries
- 1374 – BIG Tax
- Minority shareholders in rollover
- Hidden tax in liquidation or deemed liquidation in installment sale
Section 336(e)

Basic Model (for stock sales): Target is treated as selling all of its assets to an unrelated person while owned by its former shareholders and then reacquiring same upon acquisition by Acquiror.

![Diagram of Section 336(e)]

- **Acquiror** → **Target**
- **Assets** from **Target** to **3rd Party**
- **Cash** from **3rd Party** to **Acquiror**
- **Target Stock** from **Target** to **Shareholder**

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= Actual Component  = Deemed Component
CASH FORWARD MERGER

Asset Sale Followed by Liquidation of Target

- Target has gain on sale
- Target Shareholders have gain on liquidation (unless 332 applies)
- Acquiror takes cost basis in Target assets
**DOUBLE MERGER (REV. RUL. 2001-46)**

**Step 1: Reverse Triangular Merger**

- **Target Shareholders** ➔ **Target**
- **Acquiror Stock + Cash** ➔ **Acquiror**
- **Merger** ➔ **Sub 1**

**Sub 1 Survives**

**Step 2: A-type Forward Merger**

- **T + Sub 1** ➔ **Acquiror**
- **Merger Sub Survives** ➔ **Sub 2**

**Tax Benefit:** A taxable reverse merger has just one tax on the shareholders, while a taxable forward merger has two taxes (one on shareholders and one on corporation). The first step of this double merger disregarded so the transaction is a tax-free A-type merger (where 20% boot limitation does not exist). If the transaction fails to qualify, the tax is incurred on the first step (reverse merger) and avoids corporate level tax.
Mergers of corporation into single-member LLC may qualify as A reorganizations. Treas. Reg. § 1.368-2(b)(1).
Merger of Corporation into LLC

- Reg. 1.368-2(b)(1) – by operation of law, all assets and liabilities of Target become those of LLC, and Target ceases legal existence

- A Type Reorganization
USE OF WHOLLY OWNED LLC

Merger of Corporation with LLC where Corporation Survives

- Reg. 1.368-2(b)(1) – does not qualify as a statutory merger because Target does not cease to exist

- Possible Type B, C or D Reorganization or 351 transaction
Step 1

Target Shareholders → Target → LLC

Merger LLC Survives

Step 2

Former Target Shareholders

$ → LLC → Acquiror

Target
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