

Mergers and Acquisitions Practice

Finkel Law Group has a thriving mergers and acquisitions (“M&A”) practice. In general, an M&A deal refers to one of three types of transactions: asset purchase, stock purchase, or merger. In M&A deals, one of the first and most important decisions facing an acquirer (“*Buyer*”) and its counsel is to identify and select the most appropriate form of the transaction. The Buyer often has a choice of effecting the acquisition by (1) purchasing all or a portion of the assets of the target corporation (“*Target*”), and usually assuming all or some portion of the Target’s liabilities; (2) purchasing all or a portion of the Target’s stock; or (3) merging with the Target.

Types of Transactions

Asset Purchase Transaction. In an asset purchase transaction, the Buyer identifies the specific assets of the Target that it wishes to purchase and carves out those assets from the Target’s portfolio of assets. In this type of transaction, frequently any liabilities associated with the purchased assets are assumed by the Buyer. These transactions can be extremely labor intensive because each desired asset must be specifically identified and evaluated. Some of the problems sometimes encountered in an asset purchase transaction include (1) identifying the assets that will be acquired by the Buyer and those that will remain with the Target; (2) identifying the liabilities that will be assumed by the Buyer and those that will remain with the Target; (3) determining who owns particular assets and whether those assets are in any way encumbered; (4) dealing with the possibility the transaction may generate taxes on either party upon consummation of the sale; (5) the need to recapture tax credits and depreciation associated with particular assets; (6) the need to comply with California’s bulk sales laws; (7) the possible non-transferability of certain licenses, franchises or permits; (8) the need to document properly the transfer of certain assets, such as real property, motor vehicles, vessels, and intellectual property; and (9) the need to examine each of the Target’s important contracts and, if required, obtain third party consents before transferring or assigning the contracts.

Purchase of Stock. In a stock purchase transaction, the Buyer purchases all or a portion of the outstanding shares of stock of the Target corporation. In a non-hostile stock purchase transaction, the Buyer typically must negotiate and execute an acquisition agreement with both the Target and the holders of the Target’s shares the Buyer wants to purchase. This process may be difficult, particularly in companies with many shareholders, (1) if some of the shareholders are reluctant to sell; (2) if any of the shareholders die, are divorced, or enter bankruptcy after negotiations start but before the transaction’s final closing date; or (3) if the Buyer needs meaningful warranties and indemnification obligations from the selling shareholders, but only some of them have been regularly involved in the Target company’s operations. Even with these complexities in mind, a stock purchase transaction is usually less complicated than an asset purchase transaction because the Target’s corporate form, business organization, and important relationships remain unchanged, and there is no transfer of particular assets or assumption of liabilities from one corporation to another.

Merger. A merger generally achieves the same result as a stock purchase transaction but is usually a simpler transaction. It avoids many of the obstacles incident to dealing with a large number of shareholders. Absent special supermajority voting requirements in either party's articles of incorporation, a merger that has the effect of selling 100 percent of the Target company requires only majority approval by its shareholders, which is easier to obtain than the 100 percent shareholder approval – or 90 percent shareholder approval if a “short-form” merger is contemplated – required to achieve the same result through a stock purchase. Depending on the structure of the merger, the Target's assets and contracts may not need to be assigned or otherwise transferred.

There are several types of mergers, including: (1) the Target merges into the Buyer with the Buyer continuing as the surviving corporation; (2) the Buyer merges into Target with the Target continuing as the surviving corporation; (3) the Buyer forms a subsidiary into which the Target merges and the Target disappears (i.e., a “forward triangular merger”); or (4) the Buyer forms a subsidiary which merges into the Target and the Target survives (i.e., a “reverse triangular merger”).

There are several advantages to the reverse triangular merger that make it a widely used form of merger transaction. The most important of these considerations is the fact the Target corporation remains intact, and thus its business, organization, contracts, franchises, licenses, permits and other assets normally do not need to be renewed with a third party or transferred from one entity to another entity. Similarly, it is usually not necessary to obtain the consent of third parties with whom the Target corporation has contracts, even though the third parties may have the a right of consent to transfers or assignments of the contracts, because no transfer or assignment takes place in this form of transaction.

Keep in mind, however, that some contracts, particularly loan agreements and leases, purport to require one party's consent to the other party's sale of a controlling interest or merger; generally known as a “change of control” of the seller corporation. It is important to be aware of each of the Target company's material contracts to determine whether the merger will trigger such a “consent” requirement. Absent this type of provision, however, the typical contract containing a covenant limiting or prohibiting transfer or assignment should not require consent in a reverse triangular merger in which the Target is the surviving corporation. A reverse triangular merger may also be desirable if the Buyer does not want to merge the Target company directly into its corporate structure because of the Target's actual or contingent liabilities, which the Buyer would prefer to keep in a subsidiary.

Major Factors Affecting Form of Transaction

While nowhere near comprehensive, the following table contains a short list of the most common factors affecting the form of an M&A transaction:

Factor Affecting Transaction Form	Merger	Asset Sale and Dissolution	Stock Sale
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Factor Affecting Transaction Form	Merger	Asset Sale and Dissolution	Stock Sale
Required corporate approvals, including dissenters' rights	Directors and shareholders ¹ of both parties	Seller's director and shareholders ¹ and, if a reorganization, Buyer's as well	Buyer's directors and, if a reorganization, its shareholders, ¹ but neither for Seller corporation
Tax-free reorganization (no step-up in basis)	Most tolerant of boot	Use of boot limited or unavailable	No boot permitted
Taxable transaction (step-up in basis)	Forward merger is treated as an asset transfer and a reverse merger is treated as a stock transfer	Tax burden generally on seller	Tax burden generally on buyer
Seller's liabilities and obligations assumed by buyer	All ²	None, but there may be some exceptions	All remain with acquired corporation ²
Non-assignable contracts, leases, and other rights ³	All rights assigned by statute	Most clearly violates non-assignment provisions	Rights remain with acquired corporation
Resulting minority interests	None, but dissenters' rights	None, but dissenters' rights if reorganization	Non-selling shareholders remain. Their elimination may require later freeze-out ⁴

1 Shareholder vote may not be required in a reorganization if the corporation, its shareholders or both, own more than five-sixths of the voting-power of the surviving business entity's stock (i.e., 20 percent or less stock dilution occurs).

2 Buyer may require protections concerning the assumed liabilities and obligations, including the possible use of a subsidiary to consummate the transaction and seller's indemnities.

3 A reverse merger often is viewed as the best transaction to solve non-assignment issues.

4 A reverse taxable merger (normally requiring approval of a simple majority of the shares) may achieve the tax results of a stock sale without leaving any remaining minority shareholders.

Factor Affecting Transaction Form	Merger	Asset Sale and Dissolution	Stock Sale
California sales tax	None	Imposed, but tangible personal property subject to exceptions.	None
Unwanted assets in tax-free reorganization	May be separated before a type A reorganization	Difficult to separate before a type C reorganization	May be separated before a type B reorganization
Application of federal and California corporate and securities laws	Rule 145 and Corp. Code 25103(c) and (h) are available	Rule 145 and Corp. Code 25103(c) and (h) are available	Corp. Code 25102(f) and 10 CCR 260.105.15 are available; Rule 145 and Corp. Code 25103(c) and (h) not available

Corporate Approvals

A shareholder vote may not be required if the corporation or its shareholders own more than 5/6 of the voting power of the relevant surviving, acquiring or parent corporation, or if 20 percent or less voting stock dilution occurs. The approval required by a board of directors may be delegated to a committee of the board unless shareholder approval also is required. Aside from the approvals of the board of directors and shareholders required by state corporate law, the relevant corporation's articles of incorporation, bylaws, agreements, and other documents have to be reviewed to determine if other approval requirements, including a supermajority vote, exist.

Tax Free Reorganizations

With respect to tax-free reorganizations and boot, in a transaction qualifying as a tax-free reorganization, the sale is tax-free to the selling corporation and its shareholders. The acquiring corporation, however, inherits the cost basis of the assets of the target corporation without any "step-up" in basis. If, in addition to the issuance of stock by the acquiring corporation, partial non-stock consideration (or "boot") is given to the sellers, the tax-free status of the stock issued will depend on the type of transaction selected and the degree of boot permitted under the tax law for that transaction. In general terms, a forward merger will permit up to at least 50, and possibly 60, percent boot (which may be taxable), while the stock consideration is tax free.

Of course, in a tax-free reorganization a major element of the consideration paid is stock of the acquiring corporation. When making the decision to issue stock, the Buyer should consider the dilutive effects of such issuance on existing shareholders as opposed to the cost of using other consideration to pay for the purchase.

Taxable Transactions

An asset purchase transaction is the usual method of achieving the acquirer's desire for a "stepped-up" tax basis in the target corporation's assets. This type of transaction, however, can trigger a double tax on the seller; one tax imposed on the selling corporation upon the sale of the assets and a second tax imposed on the shareholders of the selling corporation when that corporation liquidates. A higher acquired tax basis, which usually results from the purchase price, is beneficial to the buyer for purposes of amortization and depreciation. It also allows for lower gains or profits on subsequent sales.

A stock purchase transaction is advantageous to the selling shareholders because only one tax will be imposed at the shareholders' level, and usually it is imposed at long-term capital gains rates. The buying corporation, however, will inherit the historic tax basis of the assets in the target corporation without a step-up in basis.

Under certain circumstances, it is possible for the selling corporation to receive a step-up in basis and suffer only single level taxation if an IRC §338 election (to treat a purchase of stock as a purchase of assets) is available and made, and if the factual pattern indicates that the problems relating to the double tax will be minimal or non-existent.

Briefly, the buyer can make an IRC section 338 election if it purchases at least 80 percent of the seller's stock within a 12 month period and files timely election. The selling corporation is treated as selling its assets and then, as a new corporation, purchasing those same assets. This results in a tax at the buyer's tax rate following the stock purchase. If the selling corporation has operating losses or a net operating loss carry forward to offset the tax, IRC section 338 may be a very attractive election.

To determine the respective issues facing the seller and buyer in a taxable transaction, the buyer should pay close attention to the following: (1) the existing tax basis of the seller's assets, (2) the tax basis of the seller's stock, and (3) the purchase price and availability of an election under IRC section 338. The parties should thoroughly consider the respective tax benefits and detriments before determining the final price of the transaction. Finally, because a taxable transaction will usually require the buying corporation to depart with cash, it should analyze how that will affect its future operations and working capital requirements.

Seller's Liabilities and Obligations

In general, an asset purchase transaction avoids the assumption of the seller's liabilities and obligations. There are, however, certain exceptions to this general rule, including certain judicially and statutorily imposed obligations that must be assumed by the Buyer, dealing with issues ranging from tort liabilities to possible "de facto merger" holding, and collective bargaining agreements. It is also important for the Buyer to review the effects of the Uniform Fraudulent Transfer Act (Civil Code §§ 3429 to 3439.12), the Bulk Sales Law (Commercial Code §§ 6101 to 6111), the Comprehensive Environmental Response,

Compensation and Liability Act of 1980 (42 USC §§ 9601 to 9675), which pertains to hazardous waste clean-up and attendant liability, California Sales and Use Taxes (Revenue & Taxation Code §§ 6811 to 6812), and certain salary and tax withholding requirements (Revenue & Taxation Code § 18669).

In a merger, the Corporations Code requires the buyer to assume all of the seller's liabilities and obligations. In a stock purchase transaction, the acquired corporation continues to be responsible for its own liabilities and obligations. Regardless of the form of the transaction, a buyer can take other protective measures, including the following: (1) fully examine the continued vitality of the seller's insurance coverage, and the coverage protection accorded by the buyer's insurance; (2) use a separate subsidiary corporation to effect the purchase; (3) obtain indemnities from the selling shareholders or from the major selling shareholders; (4) escrow a portion of the purchase price to be applied against un-assumed liabilities or obligations if they arise over a given period of time (usually one or two years); and (5) obtain the right to offset future purchase price or promissory note payments against un-assumed liabilities or obligations.

Non-assignable Contracts, Leases and Other Rights

A seller's business may have various leases, franchises, contracts, licenses, real estate entitlements, and other valuable arrangements that contain clauses prohibiting assignments. Often, particularly in leases, the written consent of the other party is required for an assignment. In some provisions, the consent may not be unreasonably withheld or is otherwise conditioned. Other provisions may include specific exceptions to the assignment prohibition.

A reverse merger or a stock sale is generally viewed as the safest transaction to avoid disturbing non-assignment clauses because the selling corporation remains in place. One California case held that a sale of a corporation's stock did not violate a covenant that prohibited an assignment of a lease even though it contained no express provision about a stock sale.

Whether a given type of transaction will violate the assignment prohibition clause will usually turn on the language, or the interpretation of the language, used in the clause. Each clause should be reviewed to determine if it either explicitly or implicitly covers mergers, reverse mergers, stock sales, or other transactions in its assignment prohibition.

Resulting Minority Interests

In most instances, the buying corporation will want to acquire complete control of the selling corporation, without any minority owners. This may not be possible or practical to achieve in a stock purchase transaction if the target corporation has a large number of shareholders. On the other hand, in addition to the approval by the board of directors, and unless the seller's articles of incorporation require a higher percentage, the holders of a majority of seller's voting shares can approve a sale of assets, merger or reverse

merger, with no surviving minority interests. Dissenters' rights, however, may apply, and the parties must determine in advance how they should be handled.

Although unusual, a buying corporation may be content purchasing less than all of the stock of the target corporation, and then consider a later "freeze-out" of the minority interests by a merger or other transaction. If this is the case, the buyer should consider the following:

The privilege of filing consolidated returns with the target corporation requires an ownership of at least 80 percent of the voting stock and of the total value of all of the stock of the subsidiary;

To liquidate the acquired subsidiary on a tax-free basis under IRC §332, a similar 80-percent stock ownership test (of voting and value) must be met;

To use a "short-form merger" of the acquired subsidiary into the acquiring parent corporation, requiring the approval only of the parent's board of directors, the parent must own at least 90 percent of the shares of each class of the subsidiary's outstanding stock;

On any sale or transfer of the assets of the acquired subsidiary to the parent, if the parent owns more than 50 percent of the voting power of the subsidiary, the consideration must be the non-redeemable common shares or non-redeemable equity securities of the parent, unless the sale is approved by at least 90 percent of the voting power of the subsidiary; and

On a merger of the acquired subsidiary into or with the parent, if the parent owns more than 50 percent of the voting power of the subsidiary, the non-redeemable common shares of the subsidiary may be exchanged only for the non-redeemable common shares of the parent, unless the parent owns 90 percent or more of the voting power of the subsidiary, or unless all of the common shareholders consent. The 50-90 percent requirement and the non-redeemable common or equity shares requirement will not apply if a fairness determination about the transaction is made by the Commissioner of Corporations, the Commissioner of Financial Institutions, the Insurance Commissioner, or the Public Utilities Commission.

California Sales Tax

California sales tax is not imposed on a sale of stock transaction or merger, but may be imposed on the sale of tangible personal property in an asset sale transaction, with certain exceptions.

Unwanted Assets in Tax-Free Reorganization

A type A reorganization (merger) and a type B reorganization (stock for stock exchange) do not specifically require that the Target retain any of its assets. A type C reorganization (sale of assets) and a type E reorganization (reverse triangular merger) do

require that substantially all assets of the Target be acquired. In all situations, however, the parties and their counsel should be aware of the continuity-of-business requirement for any tax-free reorganization.

Securities Laws

Generally, requirements for compliance with securities laws are applied in a similar manner to a merger or sale of assets transaction. Each transaction involves the seller's corporate actions and approvals. Different requirements, however, are applied to a stock sale transaction, which involves an individual and voluntary action by each selling shareholder.

Contact Us For More Information

Finkel Law Group, P.C. has extensive experience representing clients in all of the aforementioned types of M&A transactions, and has represented clients in M&A transactions in the banking, Internet retail and wholesale, automobile, software, hardware, scientific instruments, energy, resorts, agricultural cooperative, and toys and paper products industries.

Please call Lonnie Finkel at (925) 274-9600 for more information on how Finkel Law Group can help your company position itself to maximize its value upon the sale of the company or certain of its assets, or identify and acquire complementary companies or assets to grow your business through acquisition.