STRUCTURING AN M&A TRANSACTION

Aaron Harmon and Andy Western

Osborn Maledon, P.A.

This article provides a general overview of the three principal deal structures that a buyer might use to acquire an existing business and the most common legal considerations related to each structure. Treatises have been written on this topic and there is much more detail and nuance involved than is explored in this article. The basic guideposts are here, but deal-specific facts and circumstances always influence deal structure. Accordingly, it is always a good idea for the parties to involve experienced legal counsel, tax advisors, investment bankers and other M&A professionals to ensure the deal structure and its material terms are thoughtful and achieve the parties' respective objectives.[1]

Acquisition Structures

There are three principal deal structures that a buyer might use to acquire an existing business:

(1) Asset acquisition
(2) Stock acquisition
(3) Merger

Each structure has different benefits and drawbacks for the parties involved. Because it is uncommon in an acquisition for the interests of the buyer, the target company and its stockholders to be perfectly aligned, extensive negotiations determine the allocation of benefits, liabilities and risks among the parties and lead to a deal structure and terms designed to accomplish the agreed-upon allocation. Depending on the respective negotiating leverage of the parties, the agreed-upon allocation in a deal can be evenly balanced or one-sided.

Asset Acquisitions

Basic Structure

In an asset acquisition, the buyer purchases individual assets of the target company and usually agrees to assume specific liabilities of the target company. After closing, the target

[1] For simplicity, this article assumes that the buyer and the target company are corporations. The concepts outlined in this article generally apply regardless of the entity types involved in an acquisition, but if an alternative entity, such as a limited liability company, is involved this can influence choices related to deal structure and terms. Accordingly, one should always consider whether a corporation is affected differently by a particular deal structure or term than an alternative entity.

company continues to own any assets the buyer did not purchase and remains liable for any liabilities the buyer did not assume.[2]

The buyer may purchase any type of asset, including machinery, equipment, inventory, real estate, contract rights, accounts receivable, intellectual property, claims against third parties, employee relationships, etc. The buyer typically assumes liabilities associated with the purchased assets, such as accounts payable, contract obligations, employment-related liabilities, etc. but it is possible for the buyer not to assume any liabilities.

The buyer may enter into an asset acquisition to purchase the entire business of the target company, a particular operating division of the target company or specific assets owned by the target company.

If the buyer purchases the entire business of the target company, it will purchase all or substantially all of the target company's assets and, after closing, the target company will be a non-operating entity that holds the deal consideration (pending distribution to its stockholders) and any specific assets the buyer did not purchase (which are likely to be obsolete or unrelated to the purchased business). The target company will also remain obligated for any liabilities the buyer did not assume.

If the buyer only purchases an operating division of the target company or specific assets owned by the target company, then the target company will continue as a going concern after the closing and may distribute deal consideration to its stockholders and/or retain deal consideration for use in the business.

Benefits and Drawbacks

From the buyer's perspective, an asset acquisition may generally be the preferred deal structure because it allows the buyer to avoid spending funds on unwanted assets and avoid known and unknown liabilities of the target company that it does not want or need to assume. In addition, the buyer may realize better tax treatment in an asset acquisition relative to a stock acquisition. If the aggregate purchase price for the purchased assets exceeds the target company's cost basis in the purchased assets, the buyer gets a "stepped-up" basis in the purchased assets equal to the purchase price, which results in higher depreciation and amortization deductions for the buyer on future tax returns and reduces the taxable gain (or increases the tax loss) when the buyer sells the purchased assets. Of course, the buyer needs to ensure that it identifies and acquires all of the needed assets to achieve its purposes as failure to do so could result in an unwanted post-closing dispute with the target company or an unsuccessful acquisition.

[2] In certain circumstances, the buyer may be held liable for obligations it did not assume, such as when an asset sale is deemed a de facto merger under state law or if the buyer's relationship with the seller demonstrates that the buyer is a mere continuation of the seller, but this is unusual.

From the perspective of the target company and its stockholders, an asset acquisition may be the preferable structure if the target company is not selling its entire business because it is the simplest way to sell a subset of assets. In contrast, if the target company is selling its entire business, an asset acquisition may not be the preferred deal structure because it typically results in "double taxation." Double taxation occurs because the target company typically recognizes gain on the sale of assets and its stockholders also typically recognize gain on liquidating dividends when the target company distributes net proceeds from the asset acquisition to them.[3]

An asset acquisition may be more complicated than a stock acquisition or merger in the following respects:

(1) The parties must identify and value the specific assets to be purchased and the specific liabilities to be assumed.

(2) The target company must transfer the purchased assets to the buyer with separate instruments of transfer for each asset category, each of which are subject to different mechanics and formalities.

(3) An asset acquisition involving the purchase of a significant number of contracts can require the parties to obtain the written consent of numerous contract counterparties due to anti-assignment clauses.

(4) In certain states, the target company's stockholders who do not consent to the asset acquisition may be entitled to appraisal rights in connection with the target company's sale of all or substantially all of its assets (appraisal rights are also generally available to target company stockholders in a merger).[4]

(5) In certain states, bulk sales laws will apply which require the parties to provide notice to the target company's creditors before consummating the asset acquisition.

(6) Sales, use and other transfer taxes may be imposed on an asset acquisition, requiring the parties to negotiate responsibility for such taxes.

Approvals

---

[3] If the target company is an entity subject to pass-through tax treatment, such as an S-corporation or a limited liability company taxed as a partnership, then an asset acquisition will not result in "double taxation" because the target company does not pay tax. Also, "double taxation" may be avoided if the target company has sufficient net operating losses ("NOLs") for tax purposes to offset any gain realized on the sale of assets.

[4] *See, e.g.*, A.R.S. §10-1301 et al.

The target company's board of directors must approve a sale of all, substantially all or a material portion of the target company's assets.[5] In most states, applicable statutes require the holders of at least a majority of the outstanding shares of the target company's stock to approve a sale of all or substantially all of the target company's assets.[6]

The buyer's board of directors must approve an asset acquisition if the transaction is material to the buyer but the buyer's stockholders are not typically required to approve an asset acquisition.

In addition to these general requirements, the governing documents of the target company or the buyer (such as articles of incorporation or a stockholders agreement) may require specific approvals for an asset acquisition (such as the approval of a specific director or class or series of stock).

Stock Acquisitions

Basis Structure

In a typical stock acquisition, the buyer purchases all of the outstanding shares of the target company's stock directly from the target company's stockholders for cash or other consideration. After closing, the buyer owns 100% of the target company's shares and the target company becomes a subsidiary of the buyer. The target company owns the same assets and remains liable for the same obligations as before the transaction. From a legal perspective, nothing about the target company changes except for its owners.

So long as there are a manageable number of target company stockholders, a stock acquisition is generally a simpler deal structure than an asset acquisition or a merger. Because the target company remains a going concern, there is no need to transfer assets or assign liabilities to the buyer. Accordingly, the anti-assignment provisions in the target company's contracts are not triggered and there is no need to obtain third party consents to an assignment of the contracts. Most target companies have a few contracts that require the counterparty's consent to a change in control, but change in control provisions are far less common than anti-assignment provisions.

There are typically no sales, use or other transfer taxes imposed on the sale of target company stock (though a few states impose stock transfer taxes). Also, there is typically no need to make a filing with a government agency to effectuate a stock acquisition and there are generally few statutory requirements that apply to a stock acquisition.[7]

---

[5] *See, e.g.,* A.R.S. §10-1202.
[6] *Id.*
[7] The target company may be required to update its ownership information on file in its state of incorporation and should confirm that the stock acquisition does not affect any existing permits.

Stock acquisitions become less practical if there are a large number of target company stockholders. Because each stockholder independently decides whether to sell its shares, the chances of having holdouts or time-consuming individual negotiations are higher. Unlike an asset acquisition or a merger, there is no statutory mechanism that permits a stock acquisition to be approved by a vote of less than all of the target company's stockholders (though stockholders agreements frequently include drag-along provisions that contractually require stockholders to sell their shares to the buyer if a certain percentage of stockholders have approved the sale).

Benefits and Drawbacks

In a stock acquisition, unlike an asset acquisition, the buyer cannot selectively purchase assets or assume liabilities of the target company. All assets and liabilities remain with the target company and the buyer, indirectly, assumes ownership of and responsibility for those assets and liabilities. If the buyer properly maintains the target company as a subsidiary after the closing, the buyer itself should generally be shielded from the target company's liabilities but the buyer's investment in the target company is subject to the risks of the target company.

From the buyer's perspective, a stock acquisition may not be as tax efficient as an asset acquisition because the buyer does not get a "stepped-up" basis in the target company's assets that can be used for higher depreciation and amortization deductions.[8] Instead, the buyer receives a cost basis in the target company's stock equal to the purchase price for the stock. That cost basis determines the buyer's gain or loss when it subsequently sells the target company's stock.

From the perspective of the target company's stockholders, a stock acquisition is generally more tax efficient than an asset acquisition because any gain results in a single level of tax at the stockholder level.

Approvals

Unless the target company is a party to the stock purchase agreement, the approval of the target company's board of directors is generally not required for a stock acquisition. Approval of the target company's stockholders is generally not required as each stockholder makes an individual decision regarding whether to sell.

If the stock acquisition is material to the buyer, then the buyer's board of directors must approve the stock acquisition but the buyer's stockholders are not typically required to approve the transaction.

---

[8] In certain circumstances, a stock acquisition can be treated as an asset acquisition for tax purposes by making a special election under the Internal Revenue Code. Also, the buyer may prefer a stock acquisition if the transaction will not result in a "stepped-up" basis in the target company's assets.

The governing documents of the target company or the buyer may require specific approvals for a stock acquisition so it is important for the parties to review and comply with those documents.

Mergers

Basic Structure

In a merger, two companies combine into one legal entity, with the surviving entity succeeding to all of the assets and liabilities of both entities. Every state has statutory and case law that governs the merger process and the laws of each state of incorporation of each entity participating in the merger must be complied with. These statutes require the parties to make detailed filings with the applicable states to effectuate the merger.[9]

There are two basic merger structures: direct and indirect. A direct merger occurs when the target company and the buyer merge directly with either the buyer surviving the merger (forward merger) or the target company surviving the merger (reverse merger). An indirect merger occurs when the target company merges with a subsidiary of the buyer with either the buyer's subsidiary surviving the merger (forward triangular merger) or the target company surviving the merger (reverse triangular merger). An indirect merger allows the buyer to keep the assets and liabilities of the target company separate from the buyer in a subsidiary, whereas, in a direct merger, the assets and liabilities of the target company and the buyer are combined.

Benefits and Drawbacks

Forward direct mergers and forward triangular mergers result in an assignment of the target company's assets, including its contracts, to the buyer or the buyer's subsidiary by operation of law. Accordingly, any anti-assignment provisions in the target company's contracts are triggered by these transactions. In contrast, in most states, a reverse merger or a reverse triangular merger does not result in an assignment of the target company's contracts because the target company survives the merger. Any change of control provisions in the target company's contracts would be triggered by a reverse triangular merger.

Most states have appraisal statutes that permit target company stockholders who do not approve the merger to petition the court to require the buyer to pay them an appraised fair value for their shares, which the court may determine is more or less than the purchase price per share paid in the merger. A buyer always faces the risk of having to attend to an appraisal proceeding post-closing if there are minority stockholders who do not consent to the merger. As a practical matter, because of the complexity and considerable expense of an appraisal proceeding, a stockholder is unlikely to pursue an appraisal proceeding unless the stockholder believes that the target company was significantly undervalued by the parties in the merger.

[9] *See, e.g.*, A.R.S. §§29-2205 and 10-1105.

From a tax perspective, mergers are treated as either asset acquisitions or stock acquisitions, with forward mergers generally being treated as asset acquisitions and reverse mergers generally being treated as stock acquisitions.[10]

When a forward merger is treated as an asset acquisition, the purchase price is allocated to the target company's assets and the target company is taxed on any gains (which can be offset by NOLs or other tax attributes of the target company). In addition, the target company stockholders are treated as having sold their stock to the target company in exchange for the merger consideration and are separately taxed. So, as with an actual asset acquisition, there is the potential for double taxation with a forward merger.[11] After the closing, any unused NOLs or other tax attributes of the target company expire and are unavailable to the buyer.

When a reverse merger is treated as a stock acquisition, the target company stockholders are treated as having sold their target company stock to the buyer in exchange for the merger consideration and are taxed at the stockholder level. The target company is not taxed. Because the target company continues to exist after the merger, any NOLs or other tax attributes of the target company remain in place and can be used by the target company prospectively subject to certain limitations in the Internal Revenue Code.[12]

Approvals

The applicable state statutes dictate the director approvals and stockholder approvals necessary to consummate a merger. In all states, the board of directors of the buyer and the target company must approve any merger and the board of directors of the buyer's subsidiary must approve an indirect merger.[13] In addition, in most states, (1) holders of at least a majority of the target company's outstanding shares must approve any merger and (2) if either the buyer or its subsidiary are issuing shares greater than 20% of its fully diluted stock in a merger, holders of a majority of the outstanding shares of the buyer's stock or its subsidiary's stock, as applicable, must approve the merger.[14] As long as the approval of the requisite stockholder majorities is obtained, a merger may be consummated against the wishes of minority stockholders.

---

[10] This assumes that the merger is structured as a taxable transaction, which is generally the case if the buyer is not a publicly traded corporation. In some cases, a merger can be structured as a tax-free reorganization if the buyer's stock comprises a significant portion of the merger consideration.
[11] Under Section 332 of the Internal Revenue Code, a corporate stockholder who owns at least 80% of the target company is typically not taxed on a liquidating distribution. Accordingly, a forward merger of a target company that is a subsidiary in a larger corporate enterprise often avoids double taxation.
[12] In certain circumstances, the parties can elect to treat a reverse triangular merger as an asset acquisition for tax purposes under Section 338(h)(10) or Section 336(e) of the Internal Revenue Code. Such an election results in the merger being treated as a taxable sale of assets followed by a tax-free liquidation to the target company stockholders (i.e., a single level of tax at the target company level rather than the stockholder level). This election will generally be more favorable to one side or the other and so other concessions are generally made in the merger terms by the favored party to get the disfavored party to agree to make the election.
[13] *See, e.g.*, A.R.S. §10-1102.
[14] *See, e.g.*, A.R.S. §§10-1103.

In addition to these general requirements, the governing documents of the target company, the buyer or the buyer's subsidiary may require specific approvals for a merger so it is important for the parties to review and comply with those documents.

Determining Deal Structure

This article has touched on core principles in the most common deal structures. Complex business, legal, tax and other considerations must be considered in every deal to determine the "best" structure and these considerations are frequently in conflict. In addition, the interests of the parties are not always aligned when it comes to deal structure. Accordingly, the deal structure used will generally be agreed upon after extensive negotiations that take into account the competing considerations and conflicting interests involved.