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Reverse and Forward Triangular Mergers: Anti-Assignment Triggers, Tax Implications, Employment Considerations

WEDNESDAY, APRIL 15, 2020

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Today's faculty features:

Gilbert J. Bradshaw, Managing Partner, **Wilson Bradshaw LLP**, New York

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Reverse and Forward Triangular Mergers:

Anti-Assignment Triggers, Tax Implications, Employment Considerations, etc.

Gilbert J. Bradshaw, Managing Partner, Wilson Bradshaw LLP
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A live 90-minute premium CLE webinar with interactive Q&A

This Presentation Will Address the Following Questions:

- What are the advantages and disadvantages of structuring an acquisition as a forward or reverse triangular merger?
- What risks are associated with triangular mergers and what should counsel consider when structuring the acquisition?
- What are the tax costs and risks in a triangular merger?
- What is the impact of a triangular merger on employees, contracts, and certain tax considerations?

Presentation Overview

I. M&A Transactions
II. Corporate Law Requirements
III. Anti-assignment Clauses
IV. Tax Consequences and Issues
V. Employment Law Considerations

I. M&A Transactions

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April 15, 2020

I. M&A Transactions

General State of M&A Market in North America: 2019 Reviewed

- North America exhibited a strong first half but began to be affected by concerns of slowing global growth later in the year.
- While geopolitical uncertainty caused cross-border activity to decline, U.S. domestic M&A announced volume still reached record levels in 2019.
- PE fundraising activity has continued to be robust, particularly in North America, where 2019 well exceeded 2018.
- Low interest rates continue to hold borrowing costs down and bolster the leveraged buyout market.
- Meanwhile, the amount of dry powder (cash) held by private equity funds continues to set records, with nearly $1.5 trillion held in private equity funds in 2019.
- Valuations for platform deals remain elevated, add-ons to existing portfolio companies continue to be the largest of sponsor deal activity.

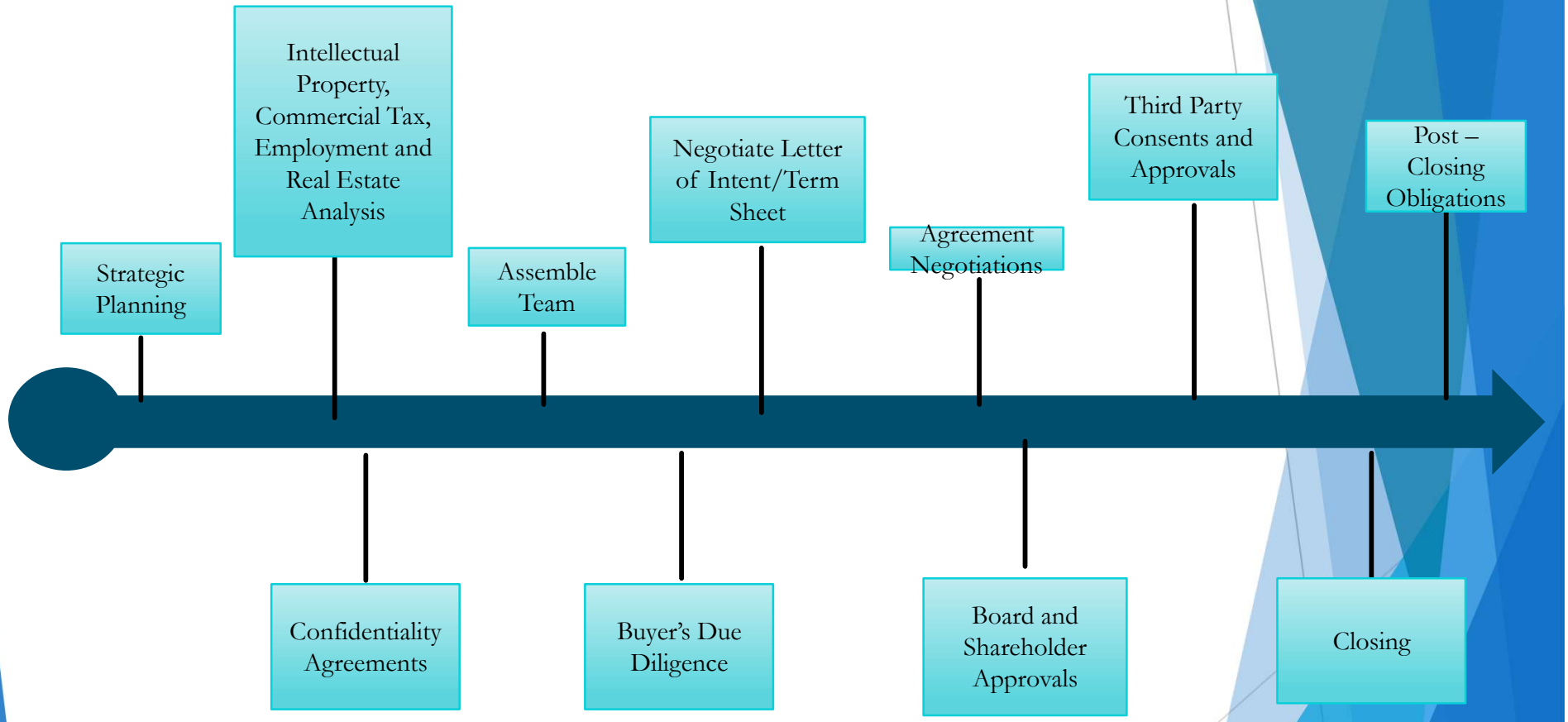
I. M&A Transactions

General State of M&A Market in North America: 2020 Outlook

- Coronavirus, Coronavirus, Coronavirus
- Middle market LBO transactions expected to take a hit because value of collateral is in question
- Get ready for pre-pack 363 sales in Chapter 11 bankruptcies
- Cash is king in 2020
- Number of deals will be up significantly in 2020, but for survival and not for value generation like in 2019
- Deals will close quickly

I. M&A Transactions

M&A Timeline:



I. M&A Transactions

The Letter of Intent ("LOI")

- Details the terms of the transaction, including how the transaction will be structured i.e. reverse triangular merger, forward triangular merger, etc.
- Is usually non-binding
- Facilitates negotiations
- Guides drafting of definitive documentation
- Helps to avoid costly litigation

I. M&A Transactions

The LOI

- Advantages and disadvantages from a seller/buyer perspective
- Ensures that buyer and seller agree on significant business points, legal terms, and obligations of parties
- Eliminates surprises and avoids significant delays in the transaction
- Impacts on negotiating strategy
- Binding vs. non-binding provisions
- Disclosure obligations

In most situations, address issues up front with a detailed LOI

I. M&A Transactions

The LOI Should Include:

- An exclusivity period
- A provision indicating or disclaiming that the parties will negotiate in good faith
- Confidentiality and non-disclosure provisions
- Key material terms, including definitions of key financial and performance metrics

I. M&A Transactions

Areas to Focus on in the LOI

- Stock vs. asset transaction
- Purchase price terms and adjustments to the purchase price
- Tax issues
- Commercial and regulatory issues
- Golden parachutes, employee stock options, and personnel turnover
- Management equity participation
- Intellectual property issues

I. M&A Transactions

Areas to Focus on in the LOI (cont.)

- Deal contingencies
- Quality of earnings/expectations
- Accounting issues
- Liability issues
- Scope of representations and warranties
- Indemnification and survival clauses
- Escrow holdbacks
- Third party consents and regulatory approvals

I. M&A Transactions

Areas to Focus on in the LOI (cont.)

- Creditors' rights issues
- Litigation issues
- Fixes assets
- Key customers
- Key suppliers
- Transaction milestones
- Cross-border compliance requirements and dispute resolution

I. M&A Transactions

The LOI: Binding vs. Non-binding Provisions

- Economic deal terms
- Nature and extent of representations and warranties
- Indemnification and survival provisions
- Continuing obligations and relationships
- Structure of the deal
- Purchase price
- Indemnification provisions
- Agreements with management
- Explanation of due diligence

I. M&A Transactions

The LOI: Common Binding Provisions

- Exclusivity period
- Confidentiality
- Allocations of transaction expenses
- Governing law
- Refundability of deposit

I. M&A Transactions

The LOI: Important Takeaways

- Keep the LOI unambiguous
- Include the key terms, but don't be too detailed

I. M&A Transactions

Methods to Acquire a Company:

- Stock Purchase
- Asset Purchase
- Employee Stock Ownership Plan
- Merger (non-exhaustive list)
  - Direct
  - Triangular

I. M&A Transactions

Transaction Structuring: Asset vs. Stock Deal

- Minimize tax (stock deal)
- A simpler transaction (stock deal)
- Cons of Asset Deal for Seller:
  - Asset deal can result in entity level tax and/or result in ordinary gain treatment (i.e., instead of capital gains)
  - Asset deal can compromise seller's ability to take certain transaction-related deductions
  - Generally, more complicated to execute (e.g., buyer and seller will have to agree on tax purchase price allocation)
  - Compliance becomes more complicated
  - Dealing with any unwanted assets and any liabilities not assumed
  - Harder to calculate gain, which would be asset by asset
- BUT what seller really wants is the most money
  - Though it can be less tax efficient, if properly negotiated (i.e., proper make-whole payment made to seller), an asset deal can result in, at a minimum, the same value delivered to seller and an overall higher deal value

I. M&A Transactions

Transaction Structuring: Asset Deal

- Stepped-up tax basis in the acquired Target's assets equal to value (asset deal)
  - This results in immediate and future tax savings through the depreciation of fixed assets and amortization of goodwill (straight line over a 15-year period). With the passage of the Tax Cut and the Jobs Acts, buyers now have the ability to deduct 100% of certain tangible property acquired in the first year, even if the property is used property.
- Ability to cherry pick what assets are purchased and what liabilities are going to be assumed in the transaction (asset deal)
  - This potentially limits the buyer's exposure to large, unknown or contingent liabilities

I. M&A Transactions

Transaction Structuring: Asset vs. Stock Deal

- Buyer and Seller often have opposing preferences
- For tax, stock purchase can be treated as asset purchases (various mechanisms/elections exist)
- Partial deemed asset sale/partial tax deferred roll-over possible in certain scenarios
- Certain tax profiles lend themselves better to asset sales
  - S corps
  - Partnerships
  - C Corps with losses or credits
  - Etc.

I. M&A Transactions

Transaction Structuring: Asset vs. Stock Deal Takeaways

- State Tax Implications
  - May want to relocate to a lower tax jurisdiction (S corps subject to 1.5% CA tax upon sale)
  - State residency of shareholders can have major tax implications
- 338(h)(10) Fiction only for Federal Income Tax
  - For all other legal and tax purposes, this is a stock sale
  - Buyer inherits target liabilities, some income tax liabilities, successor tax liabilities, etc.
- Section 338(h)(10)s, section 338(g)s, and section 336(e) transactions are all very similar in application
  - Requirements vary and should be considered before executing transaction agreements
  - Section 336(e) elections are more time sensitive than section 338(h)(10)

I. M&A Transactions

Due Diligence

- Relationship to reps and warranties, disclosure schedules, and indemnification
- Properly assess risks
- Identify assets
- Ongoing obligations
- Identity
- Tail liabilities and insurance coverage
- Transfer requirements
- Financial statements

I. M&A Transactions
During Due Diligence

- Commercial and regulatory issues
  - Change in control
  - Third party consents
  - Regulatory approvals
- Labor and employment issues
  - Stock vs. asset transaction
  - Plant closings/notices
  - Employee-related liabilities, including severance and benefit plans
  - Employee stock ownership
  - ERISA/Plan transfers and integration
  - Employment and labor contracts
  - WARN notice

I. M&A Transactions

During Due Diligence (cont.)

- Intangible capital and property rights (brand names, patents, etc.)
  - Preliminary IP audit
  - Confidentiality
  - Ownership
  - Transfers
  - Infringement
  - Indemnification
  - Retention of talent
  - Intangible capital management: brand names, leases, corporate names, patents, etc.
  - Production, logistics, and supply chain management
  - Information systems
  - Data privacy and compliance issues

I. M&A Transactions
During Due Diligence (cont.)

- Real estate
  - Title
  - Land use
  - Environmental
  - Leaseholds
  - Change in control
- Issues to consider
  - Deadlines and work plans
  - Acceleration of obligations due to change in control
  - Representations and warranties insurance

I. M&A Transactions

Integration is Key to Transaction Success

- The integration process must be managed through all stages of a transaction:
  - During due diligence
  - Definitive agreement to close
  - Post-acquisition

Integration: earlier is better

I. M&A Transactions

Seller Preparedness: New Tax Considerations

- No one size fits all/must customize approach
- Three common buckets
  - Tax benefit modeling
  - After tax proceeds
  - "Health check" tax due diligence
- Special projects…

I. M&A Transactions

Due Diligence Considerations: Transactional Risk Insurance

- Created to facilitate M&A transactions by addressing indemnification issues that arise during the negotiation of the transaction or during due diligence that may prevent the deal from closing:
  - Representations and warranties insurance
  - Tax indemnity insurance
  - Contingent liability insurance
- Transaction risk insurance is used to protect or mitigate two types of risks that typically arise in M&A transactions

I. M&A Transactions

Due Diligence Considerations: Reps & Warranties Insurance

- Provides coverage for financial losses resulting from breaches of representations and warranties made by target company or sellers contained in purchase agreement

Typical Uses:

Buyers	Sellers
• Increase maximum indemnity/extend survival period for breaches of reps & warranties	• Reduce contingent liabilities enabling distribution of sale proceeds
• Provide recourse when no seller indemnity possible	• Include R&W insurance as the sole remedy in draft agreements in auctions
• Distinguish bid in auction	• Attract best offers by maximizing indemnification
• Elimination of seller post-closing credit risk	• Protect passive sellers

I. M&A Transactions
COVID-19

- As a result of the pandemic, uncertainty in the marketplace has caused most deals to be put on pause.
  - Due diligence: take the time to do more diligence
  - Purchase price: consider using a "lock box" structure so that the company's capital position and cash position are locked in place until the company can resume business as usual
  - Negotiate for a simultaneous sign-and-close
  - "Material Adverse Effect" may include COVID-19

I. M&A Transactions
COVID-19 (cont.)

- Due diligence during the Covid-19 pandemic:
  - Insurance policies: look for business interruption policies and disability coverage for employees
  - Lease agreements: look at the rent abatement provisions, is the premises "untenantable" due to governmental emergency orders?
  - Are there increased supply chain risks?
  - Look at data privacy implications as a result of remote working arrangements

II. Corporate Law Requirements

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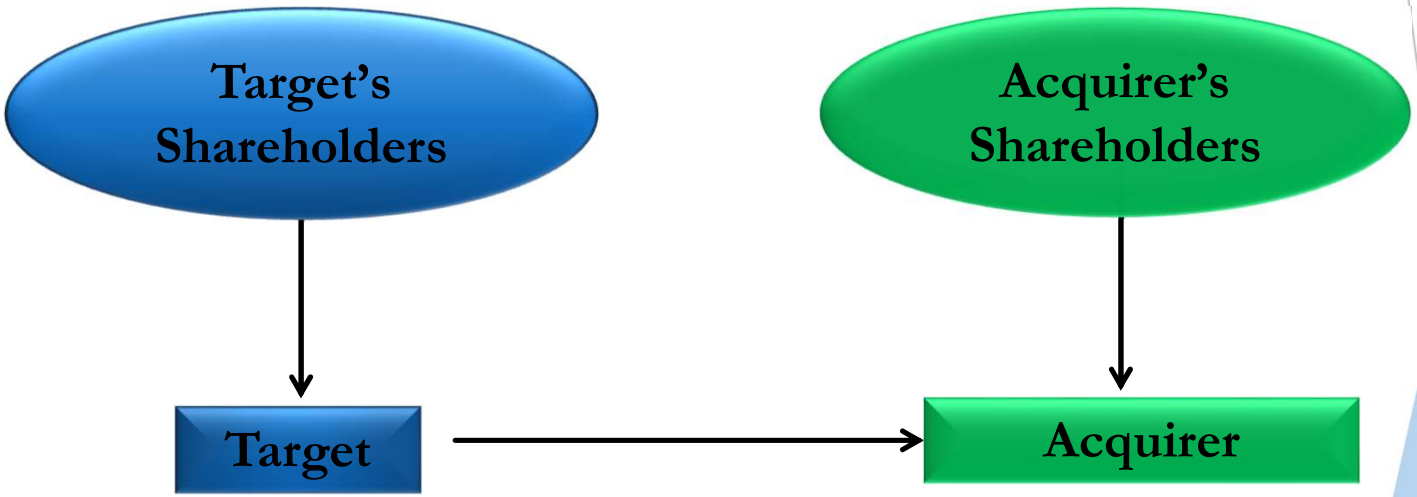
April 15, 2020

II. Corporate Law Requirements

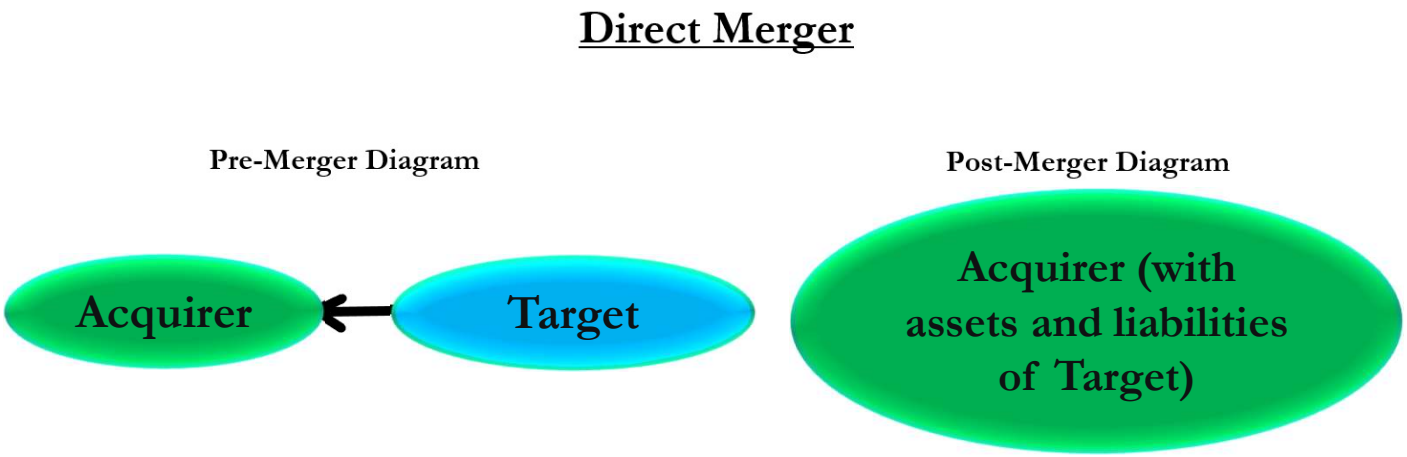
Merger Types:

- Direct Merger: the company being acquired ("Target") merges directly into the acquiring company



- Triangular Merger: the Acquirer uses a merger subsidiary ("Subsidiary") to acquire Target

II. Corporate Law Requirements
Direct Mergers

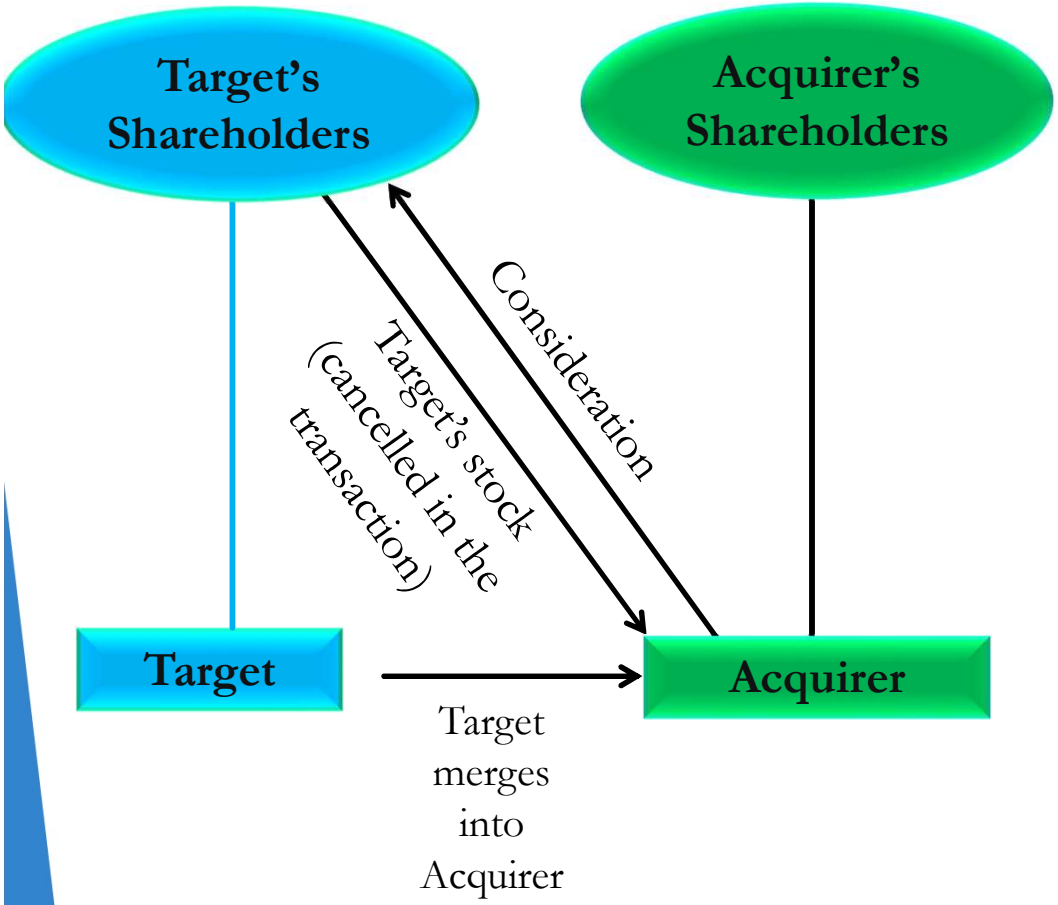


- Target merges directly into Acquirer and the Acquirer survives
- Shareholders of Target are compensated for their shares and Target ceases to exist

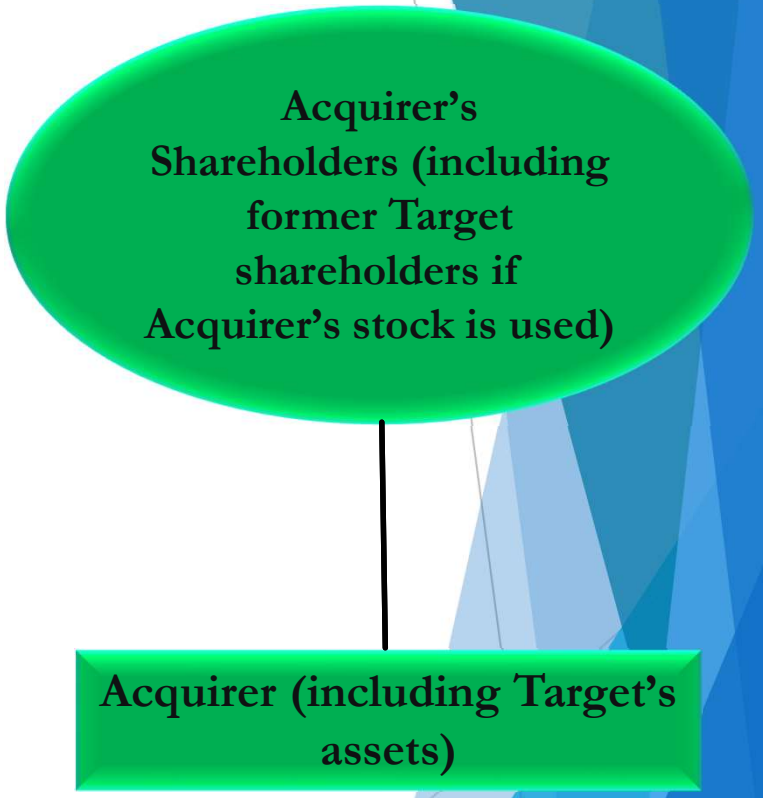
II. Corporate Law Requirements

Direct Mergers

The Transaction



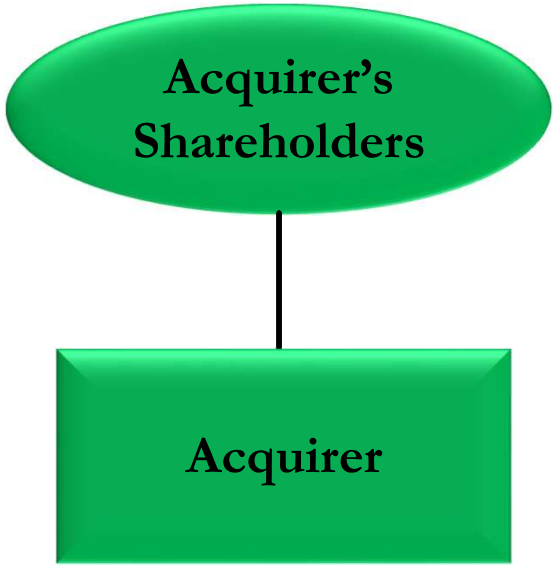
Post-Transaction Structure



II. Corporate Law Requirements

Direct Merger:

Post Merger Acquirer's Structure – Direct Merger



- All assets and liabilities of Target are held by Acquirer
- If stock is used as consideration, Target's shareholders are included with Acquirer's shareholders

II. Corporate Law Requirements

Pros and Cons of Direct Mergers:

- Pros:
  - Involve a direct action between two companies
  - Easier to integrate the companies without interrupting the Acquirer's business operations
- Cons:
  - Acquirer takes on Target's liabilities
  - Acquirer's shareholders must approve the transaction which can be difficult and could stall the closing

II. Corporate Law Requirements

What are the Benefits of Triangular Mergers?

- Acquirer doesn't take on Target's liabilities
- Usually less approvals from third parties
- Less disruption to Target's business operations
- No stockholder consent needed from Acquirer
- Can take advantage of a tax-free transaction

II. Corporate Law Requirements

What are the Downsides to Triangular Mergers?

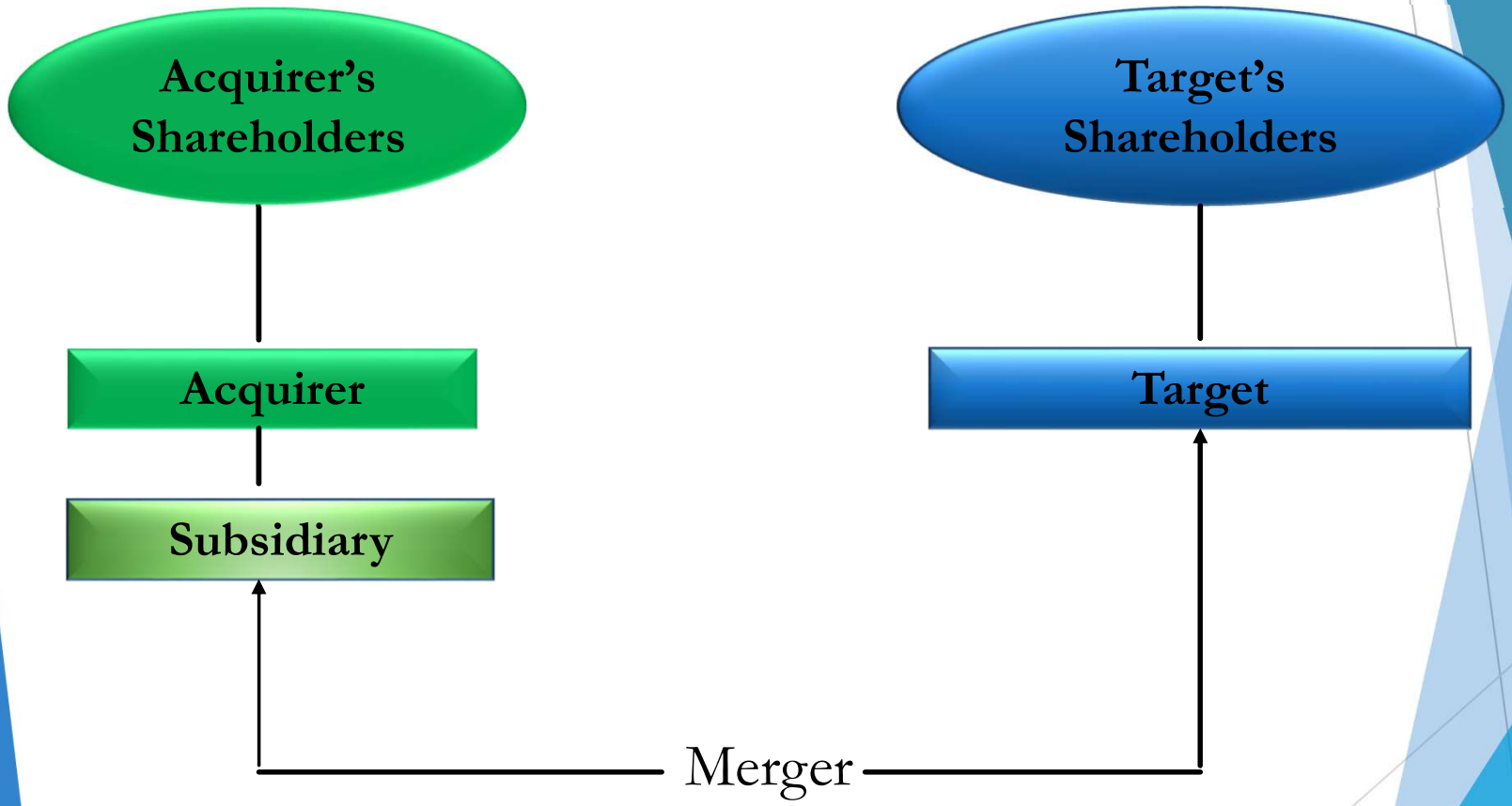
- Need stockholder approval from Target
- Dissenter rights issues
- Subsidiary absorbs Target's liabilities
- May impeded integration process of Target with Acquirer
- Ongoing corporate maintenance of the surviving company as a separate legal entity

II. Corporate Law Requirements
Triangular Mergers

- Types of Triangular Mergers
  - Reverse Triangular Mergers
  - Forward Triangular Mergers

II. Corporate Law Requirements

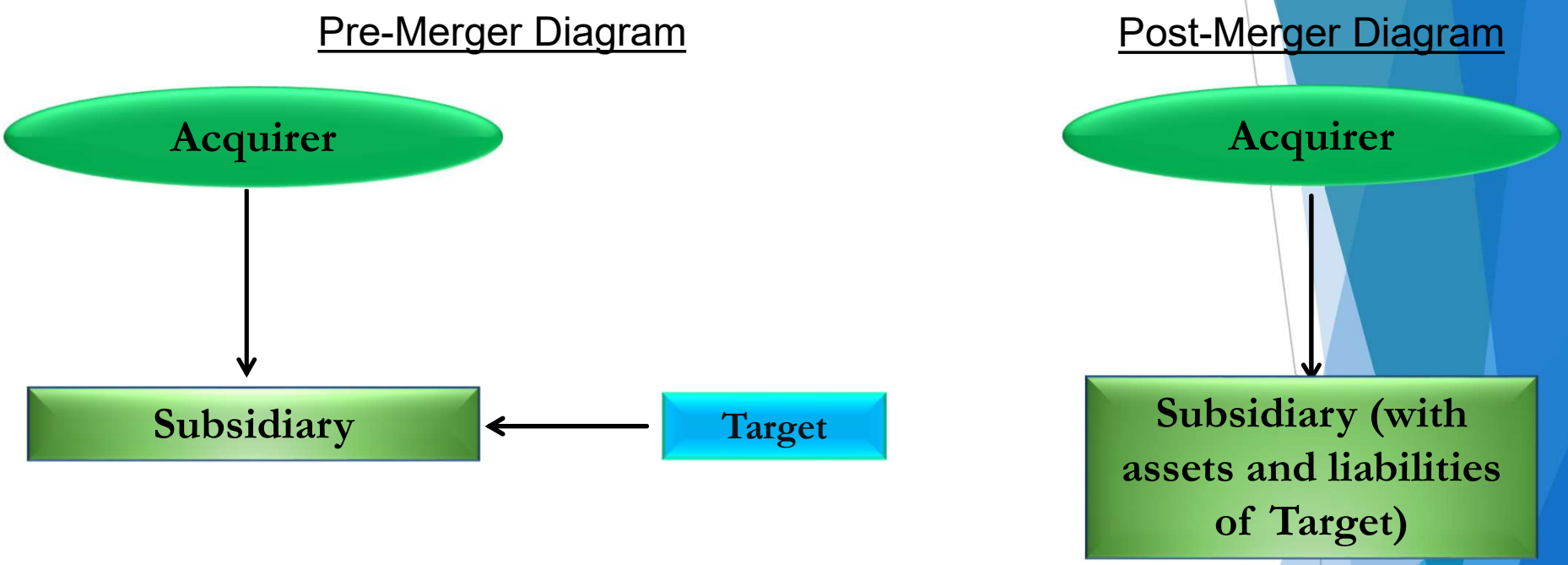
Parties Involved in a Triangular Merger:



- Subsidiary formed by Acquirer in order to effect the acquisition

II. Corporate Law Requirements

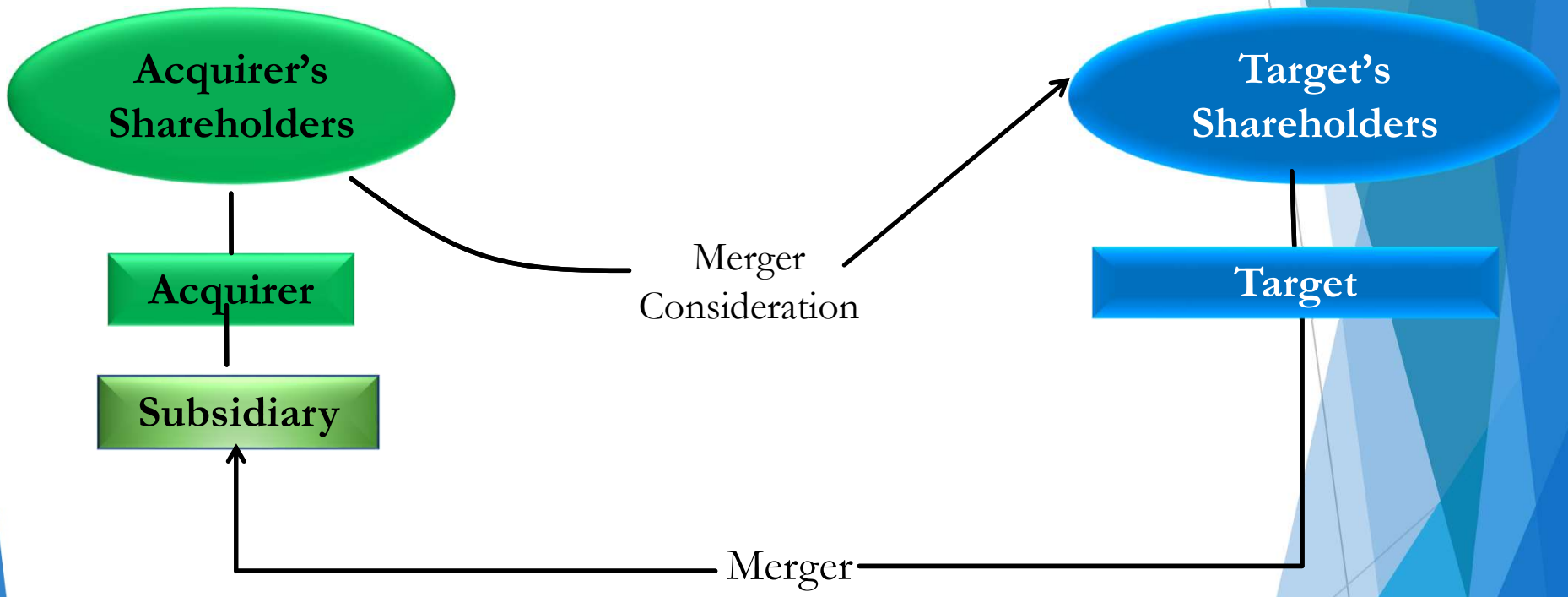
Forward Triangular Mergers



- Target merges directly with Subsidiary and the shareholders of Target are compensated for their shares
- The Subsidiary survives as the wholly-owned subsidiary of the Acquirer

II. Corporate Law Requirements

Forward Triangular Merger:

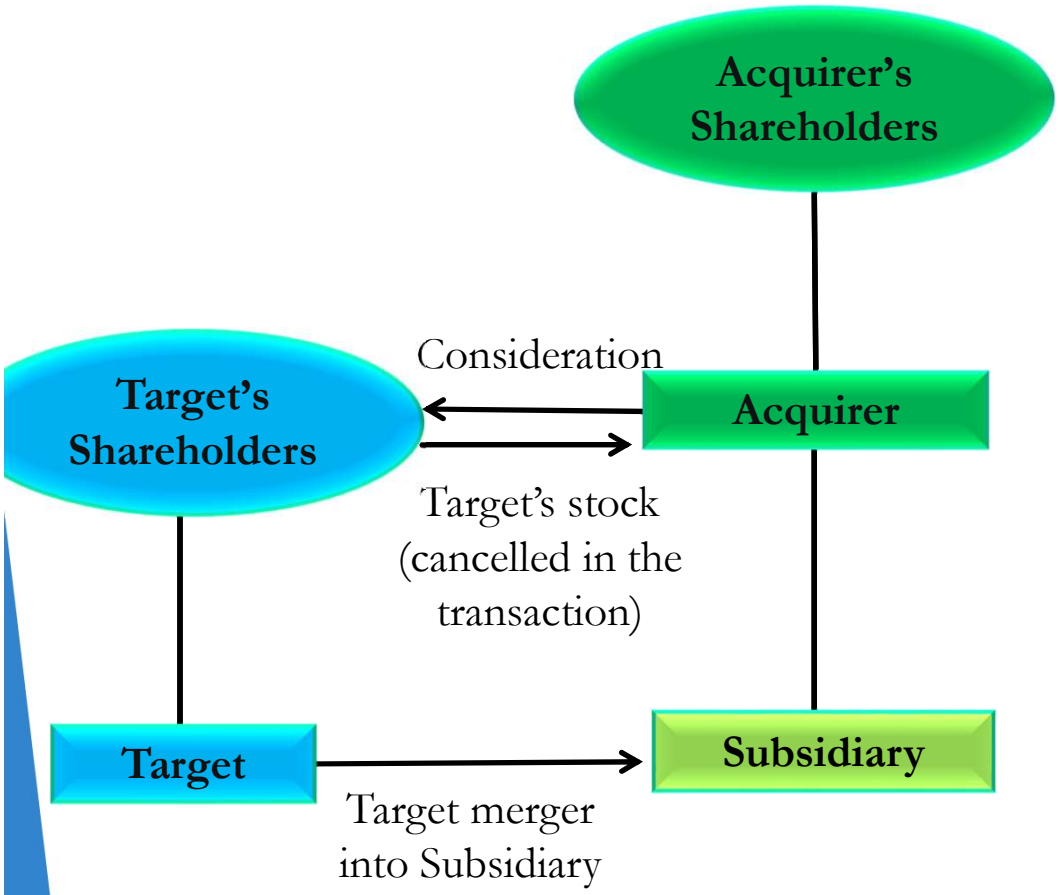


- Target merges directly with Subsidiary as surviving entity and Target ceases to exist as a separate entity
- Target stock is cancelled in the merger in exchange for the merger consideration (which may be in the form of cash and/or Acquirer's shares.

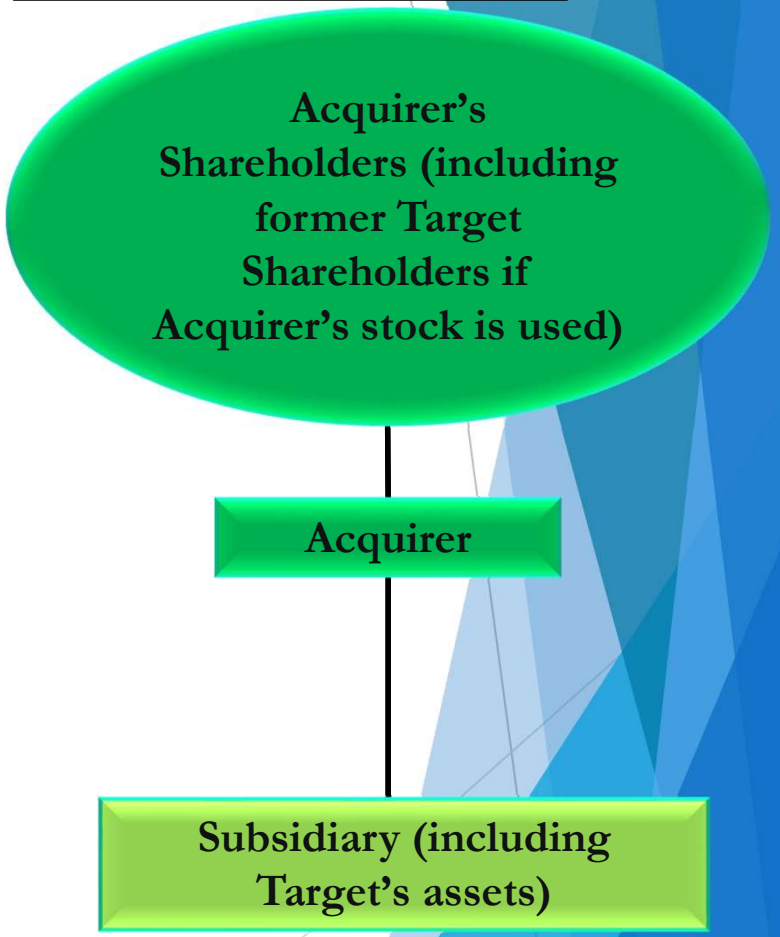
II. Corporate Law Requirements

Forward Triangular Mergers

The Transaction



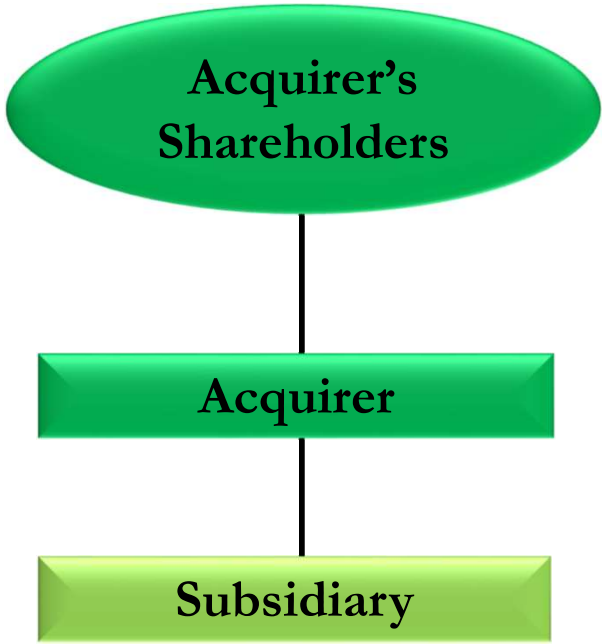
Post-Transaction Structure



I. Corporate Law Requirements

Forward Triangular Merger:

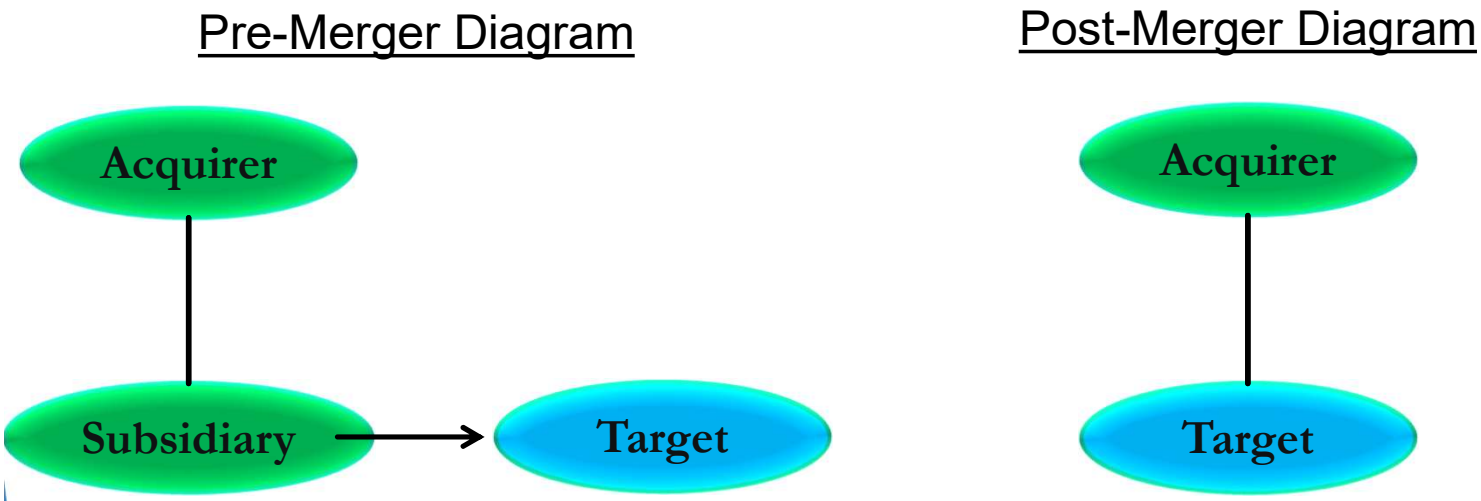
Post Merger Acquirer's Structure– Forward Triangular Merger



- All assets and liabilities of Target are held by Subsidiary

II. Corporate Law Requirements

Reverse Triangular Mergers

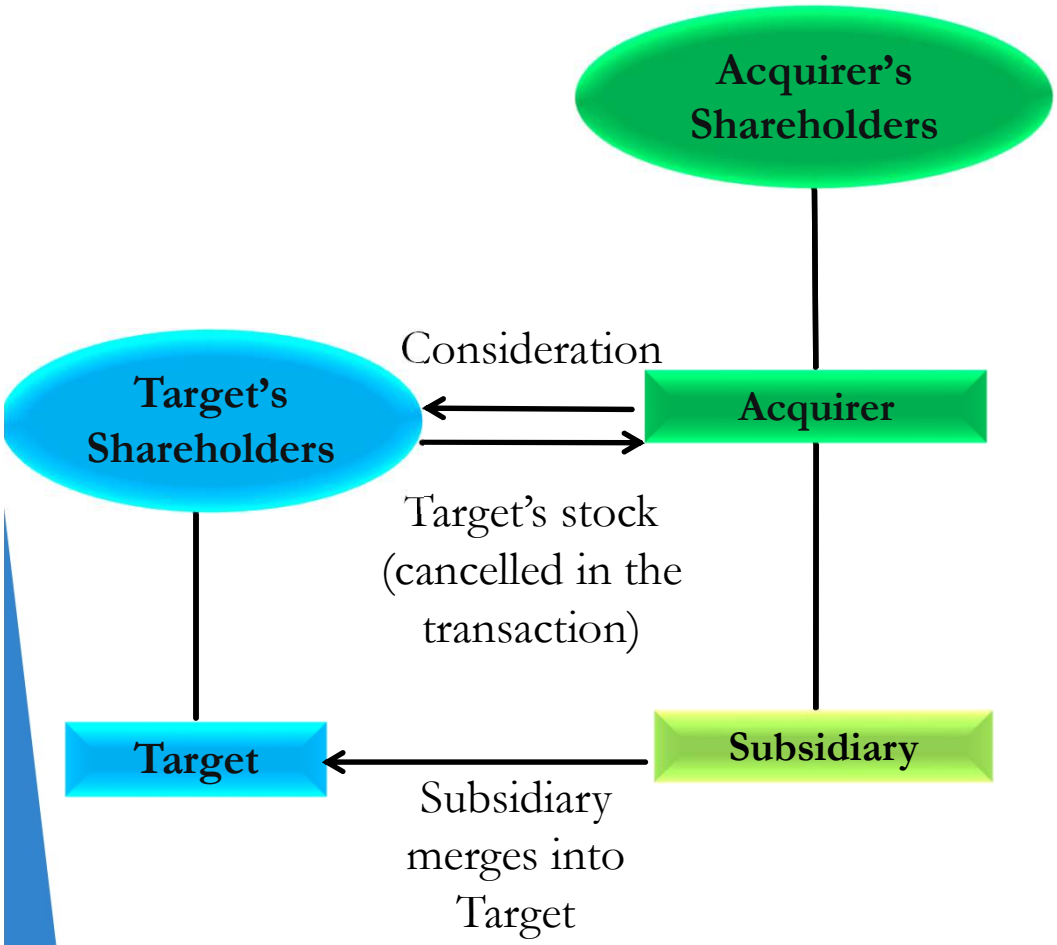


- Target merges directly with Subsidiary and the shareholders of Target are compensated for their shares
- Target survives as the wholly-owned subsidiary of Acquirer

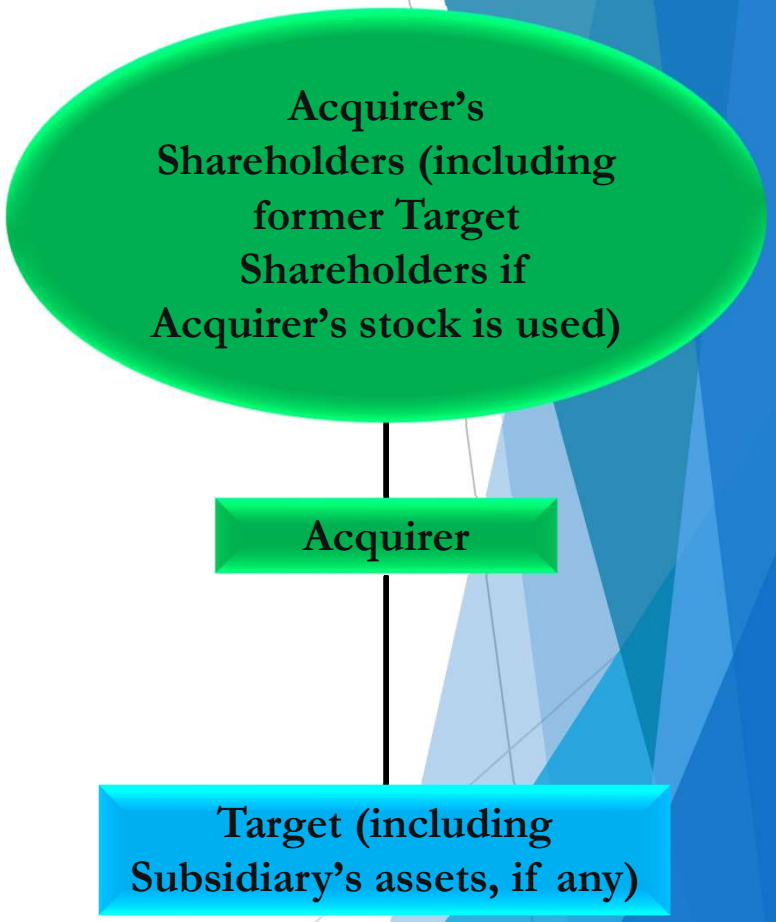
II. Corporate Law Requirements

Reverse Triangular Mergers

The Transaction



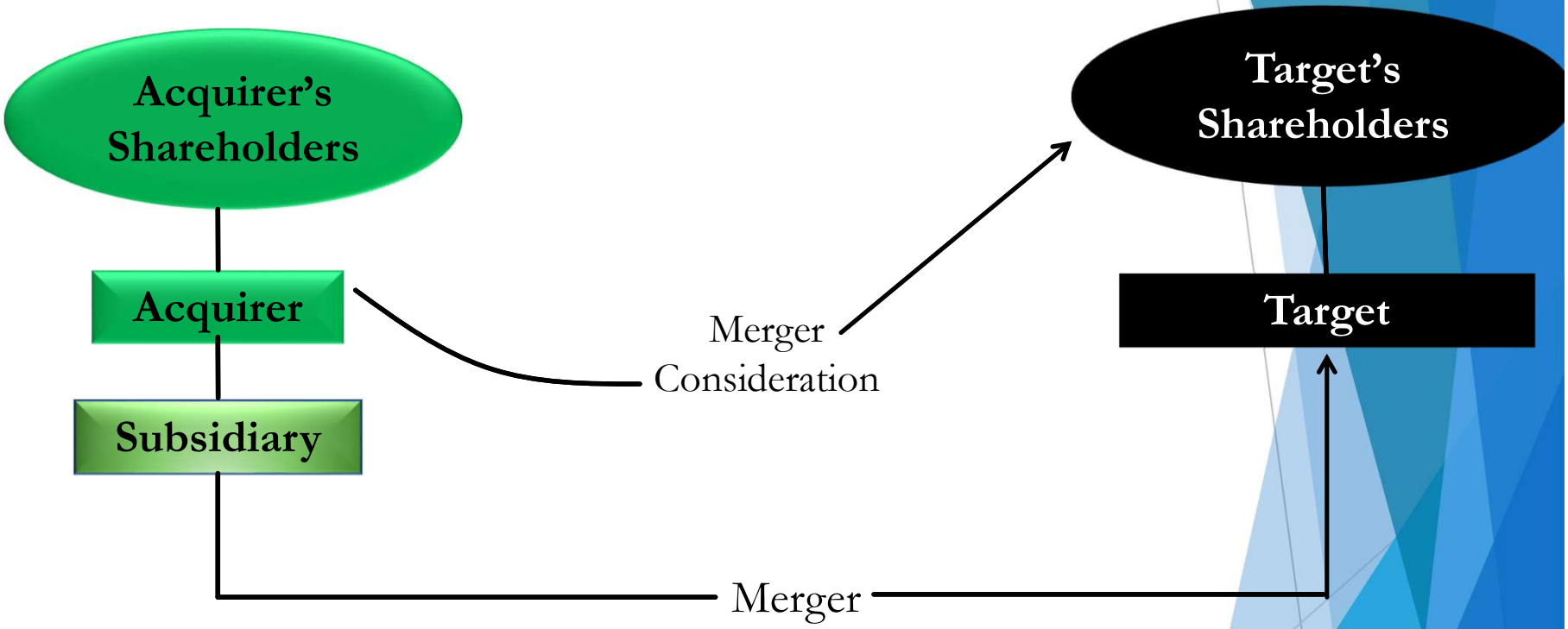
Post-Transaction Structure



I. Corporate Law Requirements

Reverse Triangular Merger:

Reverse Triangular Merger Diagram

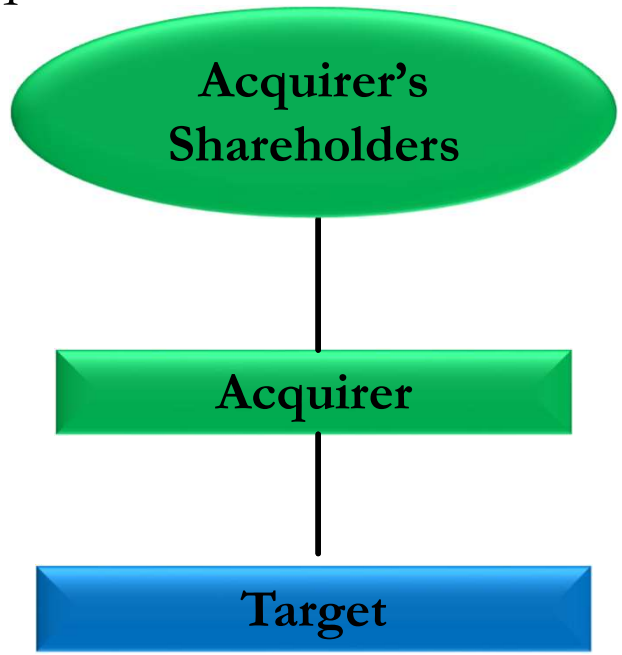


- Subsidiary merges directly with Target. Target survives as a subsidiary of Acquirer
- Target's stock is canceled in the merger and exchanged in the merger as consideration (in the form of cash or Acquirer's stock)

I. Corporate Law Requirements

Reverse Triangular Merger:

Post Merger Acquirer Structure – Reverse Triangular Merger



- All assets and liabilities of Subsidiary are held by Target

II. Corporate Law Requirements

Triangular Mergers: Most Tax Favorable

- Typically Most Tax Favorable Merger:
  - Forward Triangular Merger: If stockholders of Target can receive 50% of their compensation as shares of the Acquirer, this can be a non-taxable event

II. Corporate Law Requirements
Triangular Mergers: Most Practical

- Typically Most Practical Merger:
  - Reverse Triangular Merger: Licenses and contracts must be assigned to the Subsidiary, making it difficult to close

II. Corporate Law Requirements

Triangular Mergers: Requirements

- Acquirer
  - Form Subsidiary
  - Get board approvals from the Subsidiary and from the Acquirer (as the sole shareholder of Subsidiary)
  - Merger agreement
- Target
  - Get board approval from Target
  - Get stockholder approval from Target's stockholders (usually 50%+, mind the state notice provisions)
  - File certificate of merger in state
- Regulatory approvals (i.e. securities and antitrust)

II. Corporate Law Requirements

Triangular Mergers: Important Considerations

- What type of entity is the Acquirer and the Target?
- Where are the entities incorporated?
- Review the organizational documents
  - Depending on the entity type, bylaws, operating agreements, and partnership agreements control internal governance
- Is the Acquirer and/or Target a public company
- Regulatory requirements
- What's the size of the transaction? Will there need to be antitrust approvals?

II. Corporate Law Requirements

Triangular Mergers: Important Considerations

- Contractual obligations
- Tax considerations
- Employment considerations

II. Corporate Law Requirements
Target is a Public Company

- Transaction Structures:
  - Statutory Merger
    - Preliminary Communications (Schedule 14A/Rule 425
    - Proxy Materials/Registration Statement
    - Target Shareholders Meeting
  - Tender Offer (Exchange Offer) and "Back End" Merger
    - Preliminary Communications (Schedule TO/Rule 425)
    - Registration Statement and 14-9 Summary Advertisement
    - Mail Exchange/Mail Tender

II. Corporate Law Requirements

Acquirer is a Public Company: SEC Reporting

- Form 8-K
- Schedule 14C
- Form 10-K/10-Q
  - Target's financial statements

III. Anti-assignment Clauses

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April 15, 2020

III. Anti-assignment Clauses

No Anti-assignment Provision

- In the event than agreement does not contain an anti-assignment provision, a contract is generally assignable without the consent of the non-assigning party. *Peterson v. District of Columbia Lottery and Chartable Games Control Board*

III.Anti-assignment Clauses

Deal Structures

- If the Target has entered into agreements that contain an anti-assignment clause, whether an assignment has taken place will depend on the structure of the deal i.e. asset acquisition, stock acquisition, or merger

III.Anti-assignment Clauses

Asset Acquisitions

- The Asset Purchase Agreement details the assets that have been purchased
  - Any agreement that contains an anti-assignment clause will be triggered
    - These agreements must be assigned

III. Anti-assignment Clauses
Stock Acquisitions

- The Acquirer purchases shares directly from Target's shareholders. The Stock Purchase Agreement does not trigger any anti-assignment clause and Target continues as it existed before the shares were purchased. *Baxter Pharm v. ESI Lederle*

III.Anti-assignment Clauses
Direct Mergers

- Target merges into the Acquirer and the Acquirer continues as the surviving entity. This is similar to an asset acquisition; no anti-assignment clauses are triggered.

III.Anti-assignment Clauses
Forward Triangular Mergers

- Target merges into the Acquirer's Subsidiary and Subsidiary survives the merger, triggering anti-assignment clauses. *Tenneco Automotive Inc. v. El Paso Corporation and Star Cellular Telephone Company, Inc v. Baton Rouge CGSA, Inc.*

III.Anti-assignment Clauses
Reverse Triangular Mergers

- Acquirer's Subsidiary mergers into Target and Target survives as a wholly-owned subsidiary of Acquirer. Since Target continues to exist, most courts have held that anti-assignment clauses are not triggered. However, the court in *SQL Solutions, Inc. v. Oracle* held that a reverse triangular merger constituted an assignment by operation of law.

III.Anti-assignment Clauses

Deal Structures

Asset Acquisition

- Target's assets (including contracts) are assigned or transferred

Direct Merger

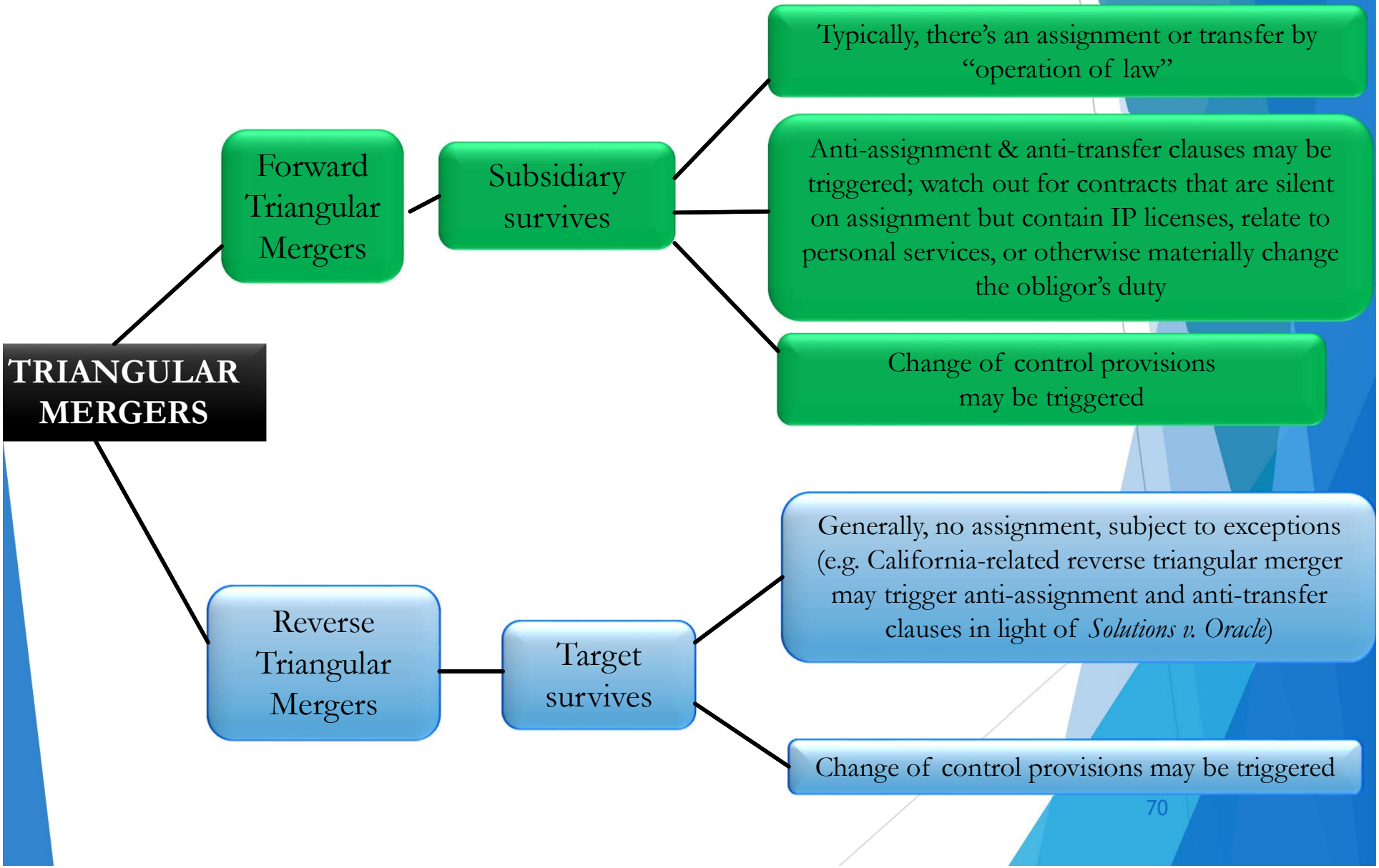
- Target survives
- Acquirer survives

Triangular Merger

- **Forward Triangular Merger**
  - Subsidiary survives
- **Reverse Triangular Merger**
  - Target survives as a subsidiary of the Acquirer

III.Anti-assignment Clauses

Triangular Mergers



III.Anti-assignment Clauses

Common Clauses

- Common anti-assignment clauses state:
  - 'Target may not assign or transfer'
  - 'Target may not assign without prior written consent [not be be unreasonably withheld or delayed]'
  - 'Target may not assign or transfer whether by operation of law or otherwise'
  - 'A change of in control is deemed an "assignment" by Target'
  - 'Any attempted assignment without consent shall be void and without effect'

III.Anti-assignment Clauses
Common Exception Clauses

- Common exceptions in anti-assignment clauses state:
  - '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]'

III.Anti-assignment Clauses

Other Clauses that are Commonly Triggered

- Change of control
- Termination
- License restrictions (e.g., non-transferability, enterprise restrictions, etc.)
- Springing rights

IV. Tax Consequences and Issues

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April 15, 2020

IV. Tax Consequences and Issues

Tax Implications of Triangular Mergers

- No gain to Acquirer or Target
- No gain to shareholders of Target except to the extent of boot received
- Transferee takes carryover basis in assets
- Stockholders of Target take basis in Acquirer's stock equal to basis in Target's stock

IV. Tax Consequences and Issues

Deal Structures

- "Asset" Acquisition
  - Asset purchase
  - Forward triangular merger
- "Stock" Acquisition
  - Stock purchase
  - Reverse triangular merger
- Hybrid: stock acquisitions treated as asset acquisitions
  - Section 338 and 338(h)(10) elections (and Section 336(e) elections)
  - Acquisitions of all of the membership interests in an LLC

IV. Tax Consequences and Issues

Corporate Target: "Asset" Acquisition

- Double taxation: corporate tax on asset sale and shareholder tax on ensuing liquidation
- Possible exception for corporate shareholder
- Acquirer has "stepped-up" tax basis in assets
- Tax attributes of Target are lost

IV. Tax Consequences and Issues

Corporate Target: "Stock" Acquisition

- Only the stockholders are taxed
- Target retains historic tax basis in assets
- Tax attributes of target retained (subject to limitations)

IV. Tax Consequences and Issues

Corporate Target: S Corporation

- No tax on the corporation if asset sale
  - Section 1374 "build-in gains" tax
  - State level S corporation tax
  - Acquirer still gets stepped-up basis
- Character of "pass-through" income on asset sale determined at corporate level:
  - Capital gains may be treated as ordinary income
  - State and local tax consequences
- Can make 338(h)(10)/Section 336(e) election to treat stock purchase like an asset purchase

IV. Tax Consequences and Issues

Corporate Target: Pass-Through Entity (Partnership or LLC): "Asset" Purchase

- Gain or loss calculated at the partnership/LLC level and passes through to the partners/members
  - Capital gain vs. ordinary income
- Generally no gain or loss on liquidation
  - Basis in partnership/member interests reflects asset sale gain/loss
- Acquirer gets stepped-up tax basis in assets

IV. Tax Consequences and Issues

Corporate Target: Pass-Through Entity (Partnership or LLC): "Stock" Purchase

- Gain or loss calculated based on sale of interests
  - Ordinary income treatment for Section 751 "hot assets" i.e. unrealized receivables and inventory items
- If Acquirer is a single buyer, then they'll have a stepped-up asset basis
- If Acquirer is two or more buyers, then they'll retain historic tax basis in assets
  - Section 754 election may permit buyers to have a stepped-up asset basis

IV. Tax Consequences and Issues

Tax-Free Transactions through Section 368

- Transactions can be partially or wholly "tax-free"
  - Neither party can be an individual
    - Make sure they're incorporated
  - Definitional, not elective
- Deferral of tax at both corporate and stockholder level
  - Resulting tax basis carryover
- Varying requirements depending on form, but all require Acquirer to offer stock as consideration making there a tradeoff between tax-free and liquidity

IV. Tax Consequences and Issues

Tax-Free Transaction Requirements

- Continuity of proprietary interest
  - Target's shareholders must continue their interest through receipt of stock of Acquirer
  - Focuses on percentage of consideration received in exchange for stock
  - Aggregate calculation - no requirement for proportionality among shareholders

IV. Tax Consequences and Issues

Tax-Free Transaction Requirements (cont.)

- Amount of consideration must be stock of Acquirer
  - IRS says 50%
  - Regulations give the example of 40%
  - Private Letter Rulings say 40%
- Amount of consideration calculate once the merger agreement is executed
  - This avoids the value fluctuating until the closing date

IV. Tax Consequences and Issues

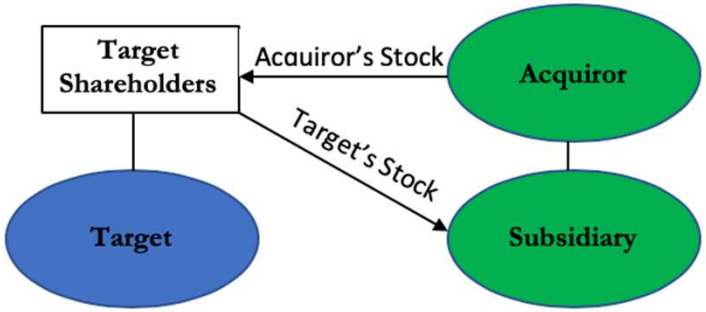
A Reorganization: Section 368(a)(1)(A)

- Must be structured as a statutory merger or consolidation of corporations
  - Recent regulations permit foreign law mergers and mergers into disregarded entities owned by Acquirer
- All of target's assets and liabilities must be transferred to acquiring corporation
- Usually the least restrictive form of reorganization

IV. Tax Consequences and Issues

B Reorganization: Section 368(a)(1)(B)

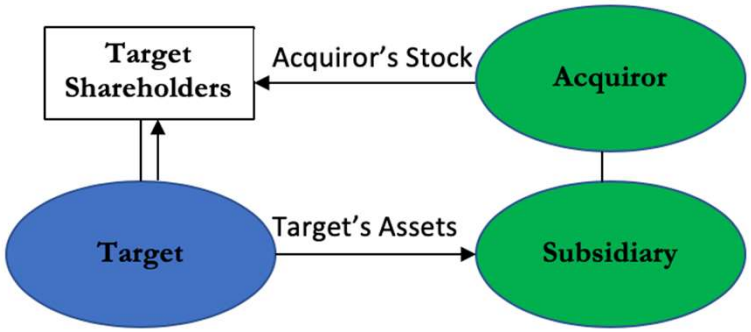
- Target must transfer stock to Acquirer
- Stockholders of Target must give up "control" of Target and receive Acquirer's voting stock in return
- "Control" of target means: 80% of voting power and 80% of the total number of shares of all other classes



IV. Tax Consequences and Issues

C Reorganization: Section 368(a)(1)(C)

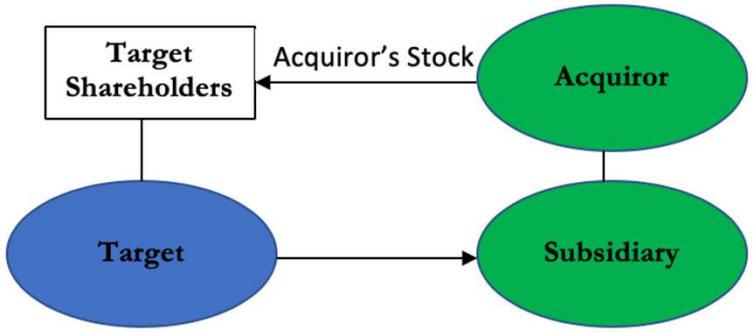
- Acquirer must Acquirer "substantially all" of Target's assets in exchange solely for Acquirer's voting stock
- Subsidiary can acquire Target's assets
- 80% of the consideration must be voting stock of Acquirer
- Target must usually liquidate
- Reorganization expenses may be assumed by Acquirer (Rev. Rul. 73-54)



IV. Tax Consequences and Issues

D Reorganization: Section 368(a)(2)(D)

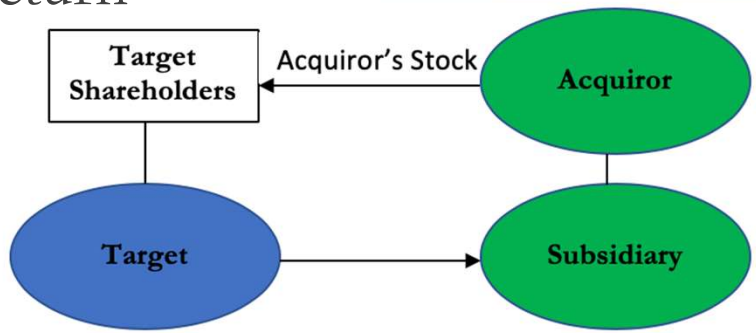
- Must be qualify under direct forward merger rules
- Subsidiary must acquire "substantially all" of target's property
  - Can be adversely affected by pre-acquisition and post-acquisition dispositions
- Cannot use the stock of the Subsidiary or the Acquirer's parent corporation



IV. Tax Consequences and Issues

E Reorganization: Section 368(a)(2)(E)

- Transactions must also qualify for an A reorganization
- Target must continue to hold "substantially all" of its property and Subsidiary's property
  - Can be adversely affected by pre-acquisition and post-acquisition dispositions
- Non-taxable to Target and carryover basis
- Stockholders of Target must give up "control" of Target and receive Acquirer's voting stock in return
- 80% of vote and non-voting classes
- Cannot use "grandparent" stock



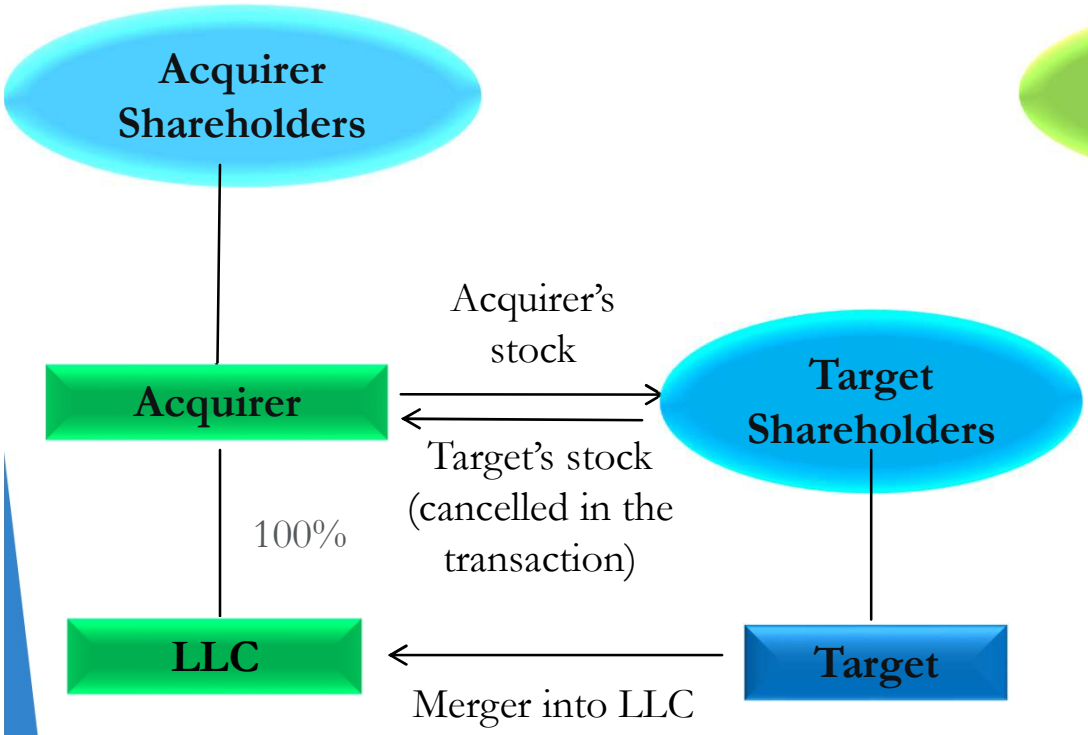
IV. Tax Consequences and Issues

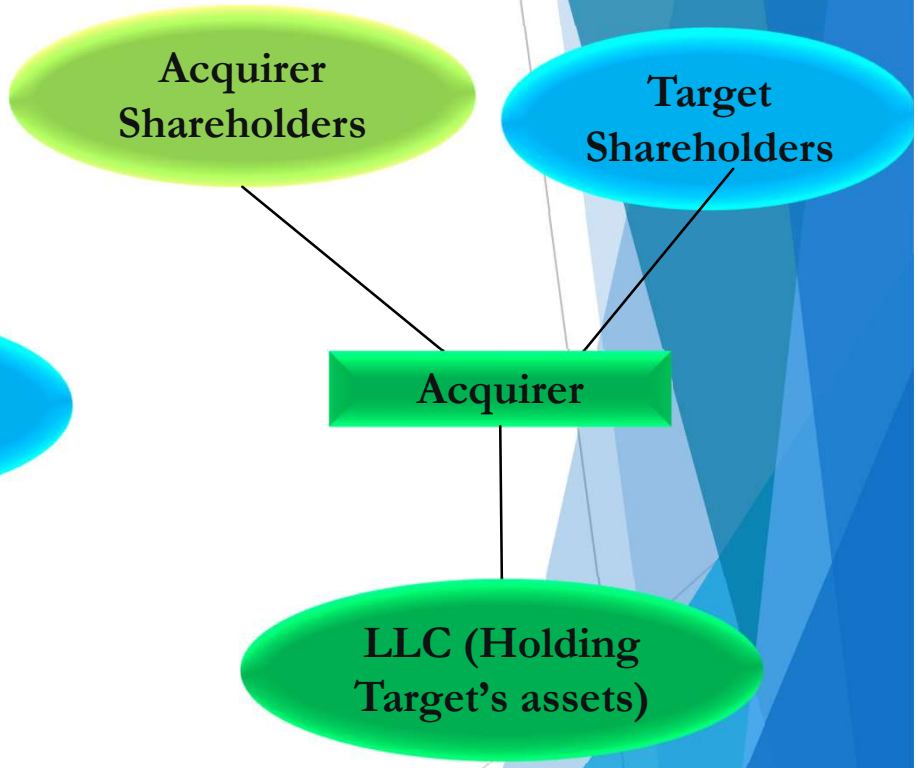
Single-member LLC in Place of Subsidiary

- Similar to a subsidiary merger, but treated as a direct merger for tax purposes
  - Forward merger where Target merges into LLC
  - If Target survives, the reorganization is treated as a stock acquisition
- Isolates Target's assets and liabilities
- Less stringent requirements for tax-free qualification
  - "A" reorganization v. "(a)(2)(D)" or "(a)(2)(E)"

IV. Tax Consequences and Issues

Single-member LLC in Place of Subsidiary





Tested as an "A" reorganization

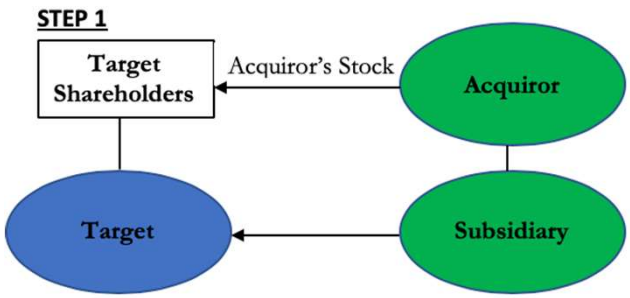
IV. Tax Consequences and Issues
Practice Tips

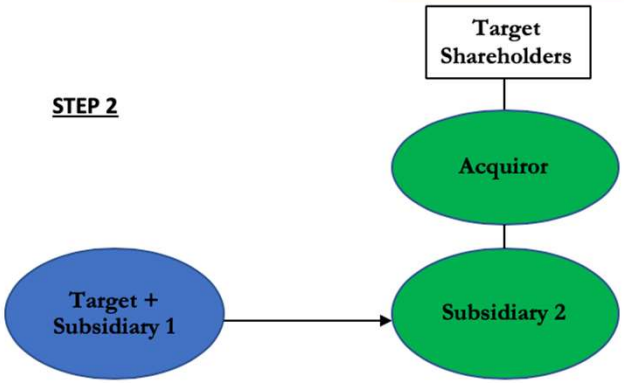
- Are two mergers better than one?
- Multi-step transactions can be used to achieve corporate and tax efficiency
  - Be sure to test overall transaction to make sure it qualifies as tax-free. If fails to qualify for tax-free treatment, revert to separate steps
  - Definitional, not elective
  - Exception for certain 338 elections made for first step
- Combination of Rev. Rul. 2001-26, Rev. Rul. 2001-46, and Rev. Rul. 90-95

IV. Tax Consequences and Issues

Double Merger: Rev. Rul. 2001-46

- One level of tax on shareholders for reverse merger whereas forward merger has two levels of tax (shareholder-level and corporate-level)
- Step 1 of the double merger is disregarded so the reorganization is a tax-free Type A merger
- If the transaction does not qualify, the tax is incurred on the first step (reverse triangular merger) and avoids a tax at the corporate level





IV. Tax Consequences and Issues

Double Merger: Rev. Rul. 2001-46

- Merger of corporation into single-member LLC may qualify as a reorganization (Treas. Reg. §1.368-2(b)(1))
- Multistep mergers can be used for non-tax reasons too:
  - Hardwire transactions more quickly and obtain fewer consents
  - Clean up loose ends with the second step
  - Test overall transaction to determine if tax-deferred status is met (Rev. Rul. 2001-26)

IV. Tax Consequences and Issues

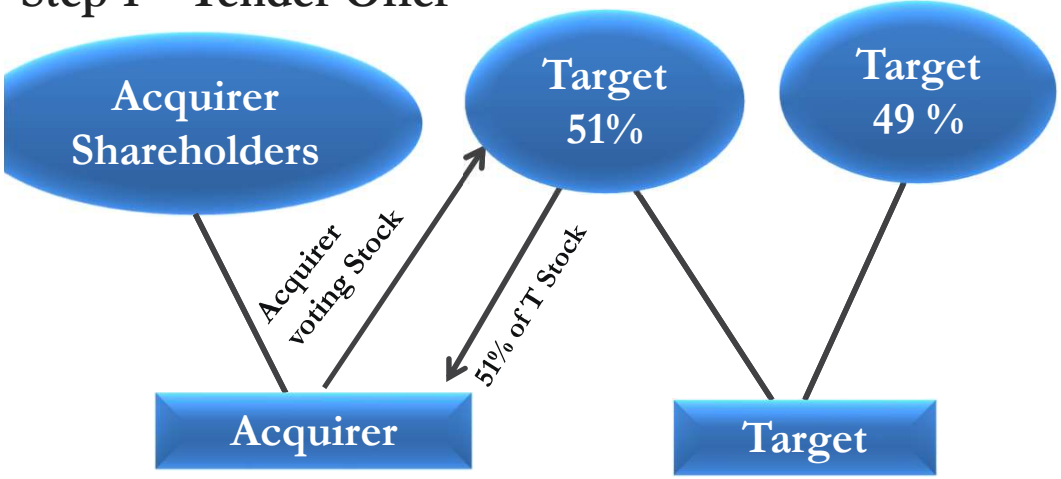
Double Merger: Rev. Rul. 2001-26

- For Rev. Rul. 2001-26 to apply:
  - Target shareholders must receive Acquirer's voting stock as 80% of the consideration and no more than 20% in cash
- Qualifies as an E reorganization

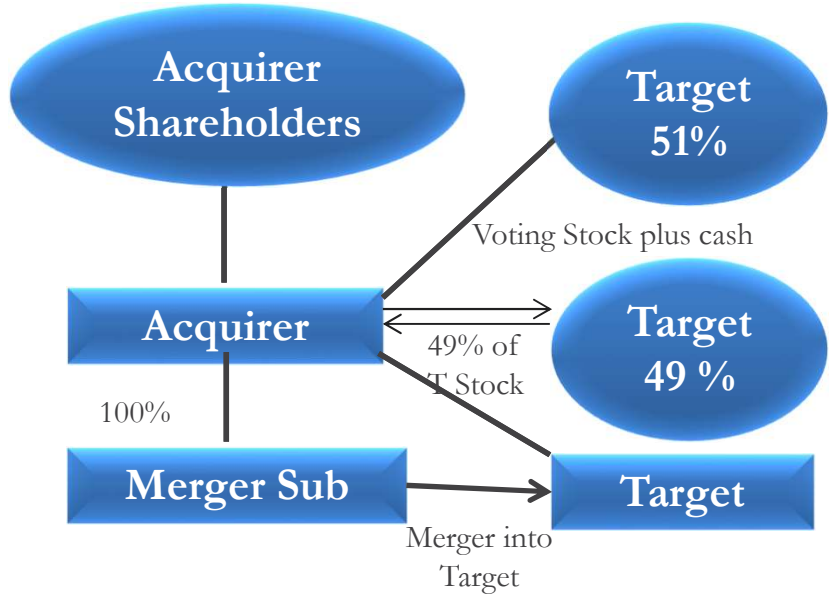
IV. Tax Consequences and Issues

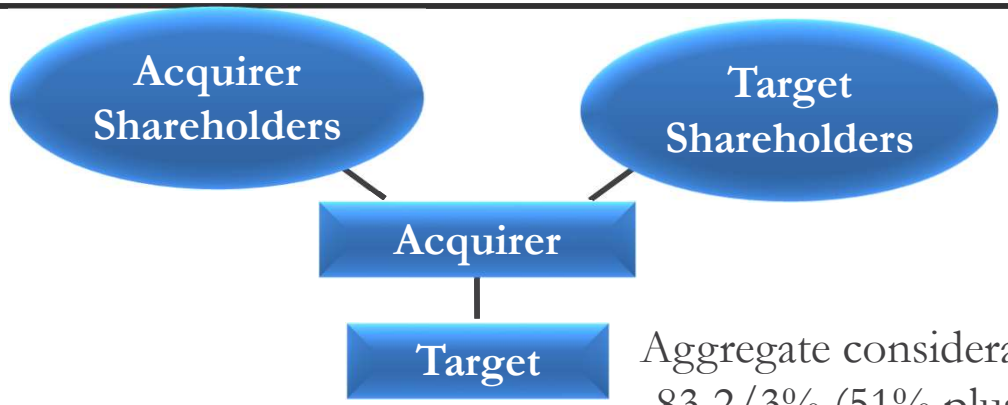
Double Merger: Rev. Rul. 2001-26

Step 1 – Tender Offer



Step 2 – Merger





Aggregate consideration paid by Acquirer:
-83 2/3% (51% plus 2/3 of 49%) voting stock
-16 1/3% cash
-Qualifies as an "(a)(2)(E)" reorganization

V. Employment Law Considerations

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April 15, 2020

V. Employment Law Considerations

Due Diligence

- Employee handbooks/personnel policies
- Personnel files
- Contracts with employees, including intellectual property assignment agreements and covenants not to compete
- Contracts with independent contractor service providers
- Health and retirement plan documents (as amended) and summary plan descriptions
- Executive compensation agreements and plans

V. Employment Law Considerations
Due Diligence (cont.)

- Files re: recent or pending lawsuits or claims with agencies
- Labor union related documents
- EPL, workers compensation, and related insurance certificates and policies
- Request an employee census showing job title, nationality or immigrant work authorization, compensation levels, FLSA exemptions, etc.

V. Employment Law Considerations

Important Considerations: Employees Misclassified as Independent Contractors

- Review employee census and discuss with management to assess risk and determine if additional information is needed
- Review contracts with independent contractors
- Obtain average hours worked per week/month (day as applicable)
- Obtain information on any internal or external audits conducted and method and practice of Target in determining independent contractor status

V. Employment Law Considerations

Important Considerations: Employees Misclassified as Independent Contractors (cont.)

- What's the extent of the liability if an independent contractor is misclassified: unpaid overtime, some states have meal and rest break liability, record keeping liability, payment of employment status and withholding status, retroactive participation in employee benefit plans, including equity incentive plans, fines, and penalties
- Can require special indemnification, review of practices going forward, determination whether to keep contractor engaged, terminate contract or hire as an employee

V. Employment Law Considerations

Pay Special Attention to:

- Health plans
- Qualified retirement plans
- Executive compensation plans

V. Employment Law Considerations

Reverse Triangular Mergers:

- Benefit plans and employees remain undisturbed in the deal – no change in the "employer"
- Buyer thus assumes all liabilities relating to the seller's benefit plans
- This greater risk requires higher level of due diligence and stronger contract provisions (representations, warranties, and indemnification)
- Has potential for "seamless" integration of employees and benefit plans
- Even though integration is less complicated legal in a reverse triangular merger, challenges of integrated corporate culture remain

V. Employment Law Considerations

Reverse Triangular Mergers (cont.):

- Collective bargaining agreements may restrict changes to benefit plans
- Buyer and seller can specify whether employees who transfer to buyer will be deemed separated from service:
  - All employees must be treated consistently
  - Must be arms' length transaction
  - Must state in writing

V. Employment Law Considerations
Reverse Triangular Mergers (cont.):

- Retiree benefits: medical, dental, life insurance:
  - Absent a specific carve-out of liabilities to another seller-related entity, acquiring entity will become responsible for the liabilities
  - Contractual limitations on termination:
    - Generally retiree health plans are not subject to typical "vesting" provisions even for retirees who have already retired
    - Buyer should review documents to make sure reservation of rights language is contained in the plan documents, since courts have held that retiree benefits can contractually vest and not be terminated

V. Employment Law Considerations

Forward Triangular Mergers:

- Employees will have a change in their "employer"
- Buyer does not normally assume seller's benefit plans or plan liabilities
- Buyer may agree to assume benefit plans as part of union negotiations or for other reasons
- Risk is lower if benefit plans are not assumed:
  - Buyer may still have to provide COBRA
  - Risk of "successor employer" liability for unpaid contributions to multiemployer plans

V. Employment Law Considerations
Forward Triangular Mergers (cont.):

- Employee and benefits integration may be more complicated
- Collective bargaining agreements may be assumed; likely requirement to bargain in good faith as successor employer
- Typical transition services:
  - Payroll administration
  - Continued participation in seller's benefit plans:
    - Multiple employer plan issues- amendment and testing
    - Insurers may refuse coverage if advance consent not obtained

V. Employment Law Considerations

Forward Triangular Mergers (cont.):

- Other typical transition services:
  - Employee leasing:
    - Seller continues to employee employees during a transition period
    - Issue of who is the common law employer
- Severance benefits may be payable as a result of the transaction (even if employees are rehired by the buyer)
- Have to look at facts to determine whether separation from service will occur for all purposes

V. Employment Law Considerations
Forward Triangular Mergers (cont.):

- Notwithstanding general rule that liabilities are not assumed by a buyer of assets, the 7th circuit has found successor liability for FLSA violations in an asset deal (and thus presumably in a forward triangular merger)
- Retiree benefits – medical, dental, and life insurance:
  - Buyer rarely will agree to a transfer of the seller's retiree healthcare obligations, especially with respect to employers who retired prior to the sale
  - With respect to active employees, buyers may be more willing to accept the transfer of such obligations; can be made subject to a purchase price adjustment to reflect cost of providing coverage

Recent M&A Decisions and Potential Future Trends

Protecting Attorney-Client Privilege

- 2013 Delaware case Great Hill v. SIG Growth Equity Fund had hotly contested merger negotiations and the agreement was silent as to the pre-merger communications. Surviving company wanted those communications and took possession of email servers and reviewed them. Disappearing company sued asserting attorney/client privilege. The Chancery Court held that Sellers waived their ability to assert privilege because Section 259 of DGCL causes the transfer of all assets and privileges to the surviving company.
- Result: parties "use their contractual freedom" to successfully claw-back privilege over pre-merger communications.

Recent M&A Decisions and Potential Future Trends

Protecting Attorney-Client Privilege (cont.)

- In 2019, in Shareholder Representative Services LLC v. RSI Holdco LLC (Del. Ch. May 29, 2019) the Delaware Court of Chancery addressed the issue of pre-merger attorney-client privilege for the first time since the 2013 Great Hill decision.
- In Shareholder Representative, the sellers included in the merger agreement an express provision that: (1) preserved the privilege attaching to pre-merger communications; (2) assigned to the sellers' rep control over those privileges; (3) required all parties to ensure privileges remained in effect; and (4) prevented the buyer from using or relying on any privileged communications in post-closing disputes against the sellers.

Recent M&A Decisions and Potential Future Trends

Protecting Attorney-Client Privilege (cont.)

- Despite this provision, the buyer, in a post-closing dispute with the sellers, sought to use 1,200 pre-merger emails between seller and its counsel left on computers and email servers acquired in the merger.
- Buyer's argument: the sellers didn't excise or segregate the privileged communications from the computers and email servers transferred to the surviving company and therefore they waived their privilege.
- Chancery Court rejected their argument noting that the agreement provision covered any privileged communication prior to the Closing Date and even if sellers waived their privilege post-closing, the merger agreement prohibited buyer from using such communication.

Recent M&A Decisions and Potential Future Trends

Protecting Attorney-Client Privilege (cont.)

Full text of applicable section of the Radixx merger agreement:

"Any privilege attaching as a result of [Seyfarth] representing [Radixx] . . . in connection with the transactions contemplated by this Agreement [1] shall survive the [merger's] Closing and shall remain in effect; *provided*, that such privilege from and after the Closing [2] shall be assigned to and controlled by [Representative]. [3] In furtherance of the foregoing, each of the parties hereto agrees to take the steps necessary to ensure that any privilege attaching as a result of [Seyfarth] representing [Radixx] . . . in connection with the transactions contemplated by this Agreement shall survive the Closing, remain in effect and be assigned to and controlled by [Representative]. [4] As to any privileged attorney client communications between [Seyfarth] and [Radixx] . . . (including, after the Closing, the Surviving Corporation), together with any of their respective Affiliates, successors or assigns, agree that no such party may use or rely on any of the Privileged Communications in any action or claim against or involving any of the parties hereto after the Closing."