OVERCOMING COMMON CHALLENGES IN M&A

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Brett M. Larson

blarson@messerlikramer.com

Overview

- Dealing with Specific Entities
- Types of Acquisitions/Transfers
- Basis Adjustments
- Employee Benefits & Executive Compensation
- Intellectual Property Issues
- Change of Control/Assignment Restrictions
- Stock as Consideration
- Bankruptcy
- Antitrust

Dealing with Specific Entities

Dealing with Specific Entities in M&A

> All US corporations, other than S-corporations, are C-corporations. C-corporations are generally subject to two levels of US federal income tax on their income:
  > At the entity level when earned
  > At the stockholder level when distributed

> A C-corporation generally can avoid this double taxation by electing to be treated as an S-corporation. The S-election must be completed at formation or shortly thereafter.

> There are substantial limitations on the availability of the S-corporation election. For example, an S-corporation can have:
  > Only one class of stock
  > No more than 100 stockholders
  > With certain limited exceptions, only US individuals (citizens or residents) as stockholders

> An S election terminates if the electing company fails to satisfy the requirements for an S-corporation.
  > If the S election terminates, the company converts to a C-corporation and generally cannot make an S election for five years (IRC § 1362(g)).

Types of Acquisitions/ Transfers

Taxable Stock Acquisition

- A taxable stock acquisition can be structured as:
  - A direct acquisition of all of the outstanding stock of the target company
  - A merger treated as a stock acquisition for tax purposes
  - A stock acquisition treated as an asset sale under 338h10

Taxable Stock Acquisition

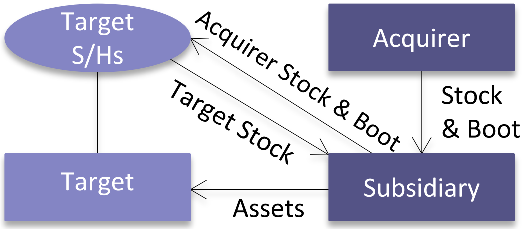
Direct Stock Sale

- A buyer generally acquires a target company's stock with cash or notes, but other consideration such as the buyer's or its affiliate's stock can also be used.
- In a direct acquisition of the target company's stock, a buyer acquires all of the outstanding stock of a target company directly from the target company stockholders.
- After the transaction, the target company often maintains its corporate existence.

Taxable Stock Acquisition

Merger Structure

- A taxable stock acquisition can be structured as a merger.
- Reverse triangular mergers and reverse mergers generally are treated as stock acquisitions for tax purposes.
  - A reverse triangular merger is a state law merger of a buyer's newly formed or existing subsidiary (a merger subsidiary) with and into the target company.



- A transaction can also be structured as a reverse merger but this is not commonly used.
- Forward mergers and forward triangular mergers generally are treated as asset acquisitions for tax purposes.

Taxable Stock Acquisition

338h10

- In certain circumstances, a buyer may be able to buy stock of the target company and also obtain a cost basis in the target company's assets by making an election to treat a taxable stock acquisition of a C- or S-corporation as an asset acquisition for tax purposes by a joint Section 338(h)(10) election.
- This election has several traps for the unwary discussed in more depth later.

Section 338(h)(10) Election

- In certain circumstances, a buyer may be able to buy stock of the target company and also obtain a cost basis in the target company's assets by making an election to treat a taxable stock acquisition of a C- or S-corporation as an asset acquisition for tax purposes.
- This usually is accomplished by the buyer and seller(s) making a joint Section 338(h)(10) election on IRS Form 8023. The buyer can also make an election under IRC Section 338(g) to treat a stock sale as an asset sale, but this election is less common because it often results in adverse tax consequences.
- If a Section 338(h)(10) election is made, the stock sale is ignored for tax purposes. Instead, the target company generally is treated as making a deemed taxable sale of its assets and then deemed to liquidate into the seller.

Section 338(h)(10) Election

Mechanics

- To make a joint Section 338(h)(10) election, there generally must be all of the following:
  - A taxable "qualified stock purchase" of at least 80% of a US target corporation (C or S) within a 12-month period
  - A corporate buyer (C or S)
  - If target is a C-corporation, a corporate seller that owns at least 80% of the target corporation
  - Seller(s) cannot be related to buyer

Section 338(h)(10) Election

Traps for the Unwary

- There must be a corporate buyer (C or S).

- If management owns more than 20% of the target's voting rights or equity value, a tax-free management rollover can prevent the transaction from meeting the requirement for a taxable "qualified stock purchase" of at least 80% of a target corporation.
  - When the management of a target company owns equity in the target company, management may be asked to roll over their existing equity into acquirer shares on a tax-free basis.

- If target is an S-corporation, there generally cannot be a multiple step qualified stock purchase because the target would have an ineligible stockholder (a corporation) before completion of the qualified stock purchase. For a C-corporation target, a qualified stock purchase generally can occur in multiple steps over a 12-month period.

- If target is an S-corporation, consent of all S-stockholders is required to make the 338(h)(10) election (even non-selling stockholders) (Treas. Reg. § 1.338(h)(10)-1(c)(3)).

- Receipt of varying amounts per share by the selling stockholders in a transaction with a Section 338(h)(10) election will not cause the S-corporation to have more than one class of stock, provided that the varying amounts are determined in arm's length negotiations with the buyer (Treas. Reg. § 1.1361-1(l)(2)(v)).

Taxable Asset Acquisition

- A taxable asset acquisition can be structured as:
  - A direct acquisition of the target company's assets
  - A merger treated as an asset acquisition for tax purposes

Taxable Asset Acquisition

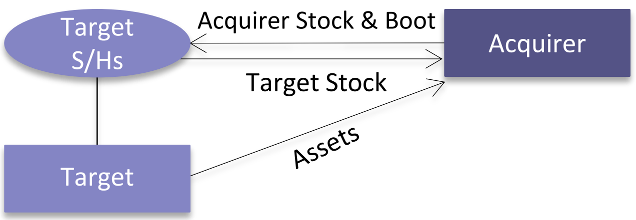
Direct Asset Acquisition

- In a direct acquisition of the target company assets, a buyer generally acquires either:
  - Specific assets and liabilities of the target company (such as a division of the target). After the acquisition, the target company continues to operate; or
  - "Substantially all" of the assets of the target company (and some or all of the liabilities of the target company). After the acquisition, the target company liquidates.

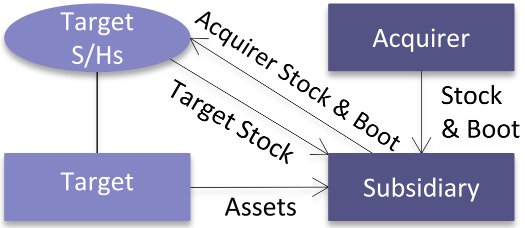
Taxable Asset Acquisition

Structured as a Merger

- Alternatively, a taxable asset acquisition can be structured as a merger. Two types of mergers generally are treated as asset acquisitions for tax purposes:
  - A forward merger.
    - A state law merger of the target company with and into the buyer in which the buyer assumes all of the target company's assets, rights and liabilities by operation of law. After the merger, the target company ceases to exist as a separate entity.



  - A forward triangular merger.
    - A state law merger of the target company with and into a newly formed or existing subsidiary of the buyer (a merger subsidiary) in which the merger subsidiary assumes all of the target company's assets, rights and liabilities by operation of law. After the merger, the target company ceases to exist as a separate entity.



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Tax-Free Stock Acquisition

- If the requirements of a tax-free reorganization are satisfied, the parties generally defer current US federal income tax on gains on their stock and asset transfers. Tax is deferred rather than eliminated, because the basis of the stock or assets received in a tax-free reorganization is a carryover basis.

- To qualify as a tax-free reorganization, a transaction must meet strict statutory and non-statutory requirements.
  - Stock of the buyer generally must be used as a significant portion of the consideration (varying from about 40% to 100% of the consideration, depending on the type of tax-free reorganization) and, in certain tax-free reorganizations, the stock must be voting stock (often referred to as the continuity of interest (COI) requirement).
  - If consideration other than qualifying stock is received by a selling stockholder (often referred to as a boot), the stockholder may be taxed on the receipt of the boot.
  - A plan of reorganization.
  - A business purpose.
  - Continuity of business enterprise (often referred to as COBE).

Tax-Free Stock Acquisition

Continued

- The following types of tax-free reorganizations are treated as stock acquisitions for tax purposes:
  - Direct Type B reorganization.
    - The acquiring company acquires the stock of target company solely in exchange for voting stock of the acquiring company and, immediately after the transaction, the acquiring company has "control" of the target company (IRC § 368(a)(1)(B)).
  - Triangular Type B reorganization.
    - A subsidiary of the parent company acquires the stock of the target company solely in exchange for voting stock of the parent company and, immediately after the transaction, the subsidiary has control of the target company (IRC § 368(a)(1)(B)).
  - Type A reverse subsidiary merger.
    - A subsidiary of the parent company (usually newly formed) merges under state law into the target company in exchange for voting stock of the parent company and other permissible consideration (IRC § 368(a)(2)(E)).

Tax-Free Asset Acquisition

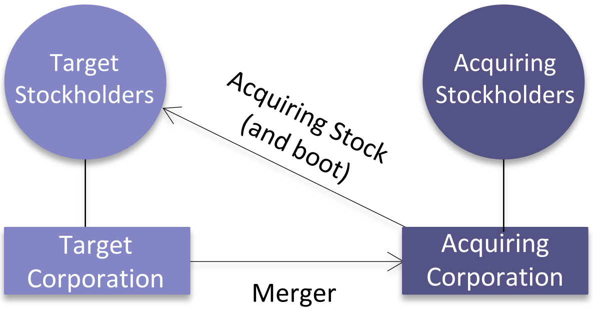
- If the requirements of a tax-free reorganization are satisfied, the parties generally defer current US federal income tax on gains on their stock and asset transfers.
- Tax is deferred rather than eliminated, because the basis of the stock or assets received in a tax-free reorganization is a carryover basis.
- The receipt of a carryover basis in a tax-free reorganization preserves the unrecognized gain for later recognition in a taxable sale or other disposition.

Tax-Free Asset Acquisition

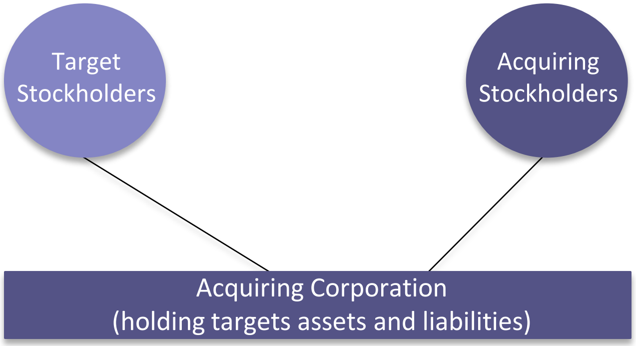
Continued

- The following types of tax-free reorganizations are treated as stock acquisitions for tax purposes:
  - Direct Type A reorganization.
    - A merger or consolidation under state or foreign law that satisfies the COI, COBE and business purposes requirements. The target corporation's assets and liabilities become assets and liabilities of the acquiring corporation and the target ceases to exist (IRC § 368(a)(1)).

Transaction



Result



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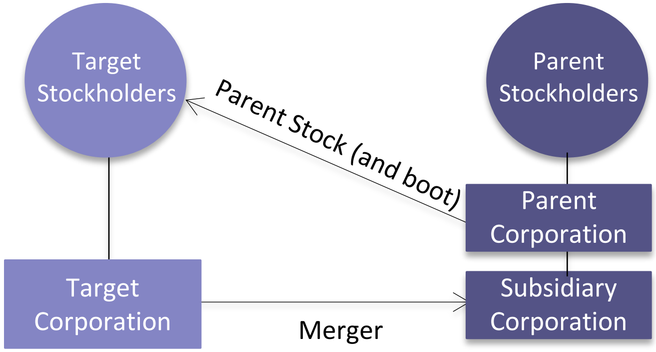
Tax-Free Asset Acquisition

Continued

- Type A forward subsidiary merger.
  - The target company merges under state law into an existing or newly formed subsidiary in exchange for parent company stock and other permissible consideration (including cash and notes). The target's assets and liabilities become assets and liabilities of the subsidiary (which remains wholly owned by the parent) and the target ceases to exist (IRC § 368(a)(2)(D)).

Transaction



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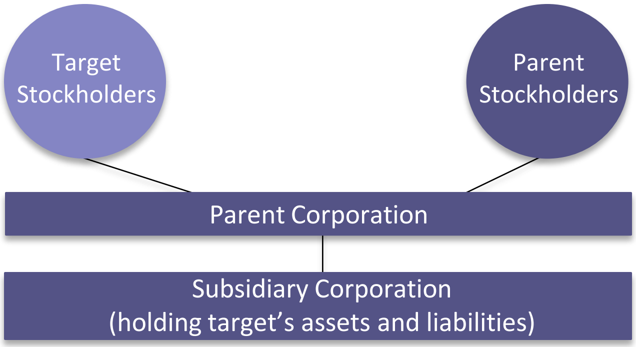
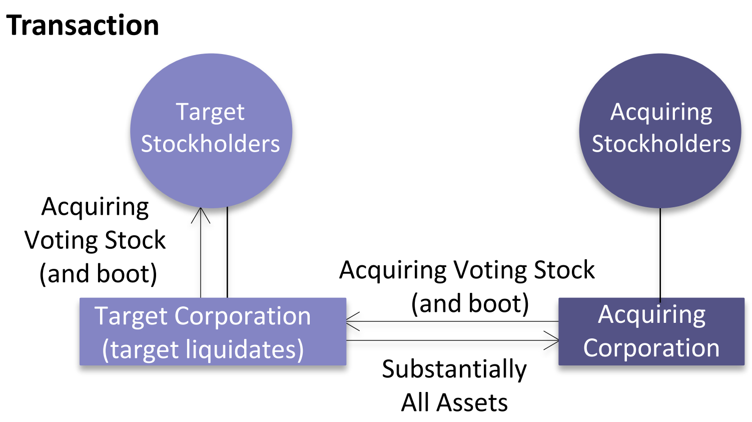
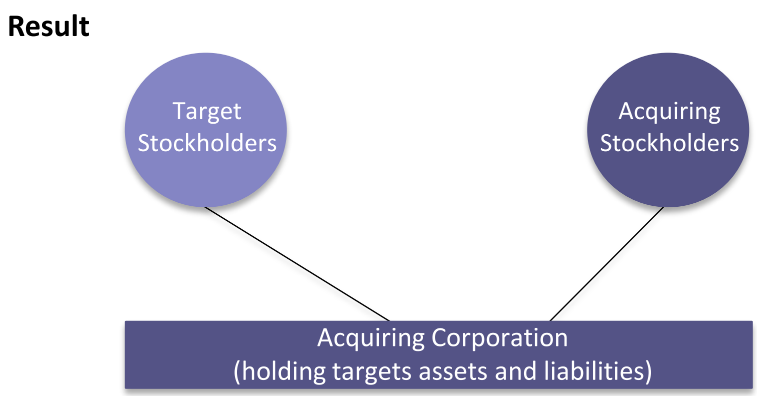


Tax-Free Asset Acquisition

Continued

- Direct Type C reorganization.
  - The acquiring company acquires "substantially all" the assets of the target company in exchange for voting stock of the acquiring company and the target liquidates (IRC § 368(a)(1)(C)).



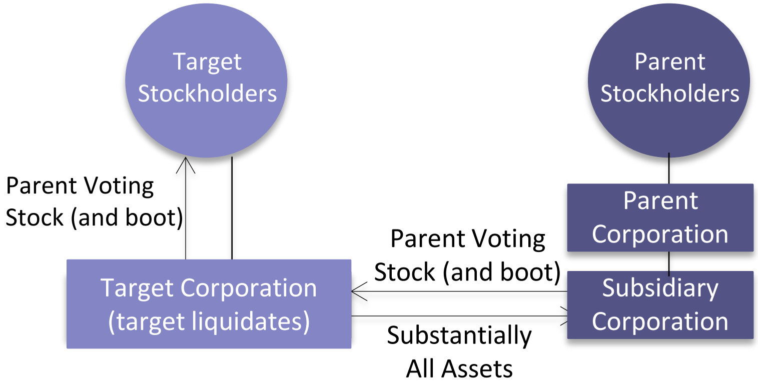


Tax-Free Asset Acquisition

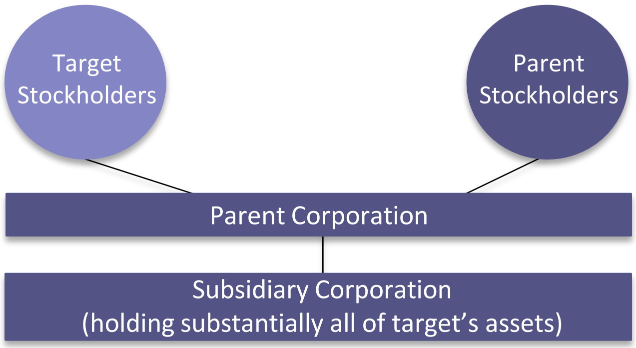
Continued

- Triangular Type C reorganization.
  - A subsidiary of parent company acquires "substantially all" the assets of the target company in exchange for voting stock of the parent company and the target company liquidates (IRC § 368(a)(1)(C)).

Transaction



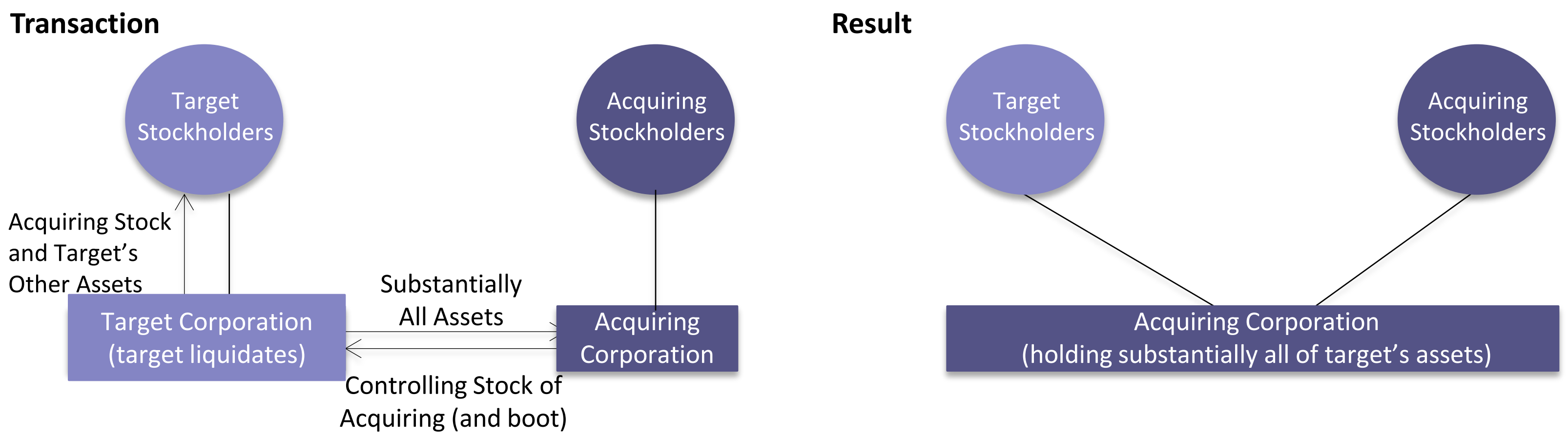
Result



Tax-Free Asset Acquisition

Continued

- Acquisitive D reorganization.
  - To qualify as an acquisitive Type D reorganization (IRC § 368(a)(1)(D)), the following requirements must be satisfied:
    - the acquiring company acquires "substantially all" the assets of the target company;
    - immediately after the transfer of assets, the target company or its stockholders (or a combination of the two) has control of the acquiring company (IRC § 368(a)(1)(D));
    - the target company must liquidate and distribute the acquiring company stock and any other consideration received by the target company from the acquiring company (as well as the target's other properties (if any)) to the target company stockholders in a transaction that qualifies under IRC Section 354; and
    - the transaction must meet the COBE and business purposes requirements.



Basis Adjustments

Buying a Partnership or LLC Interest

Making a Section 754 Election

- When a buyer acquires an interest in a partnership or LLC taxed as a partnership, it should determine whether the partnership or LLC has:
  - Appreciated assets, meaning that the fair market value of the partnership's or LLC's assets exceeds their tax basis.
  - In effect a valid IRC Section 754 election to adjust the tax basis of partnership or LLC assets.
- One tax advantage of a Section 754 election is that the buyer is not subject to tax on the gain inherent in partnership or LLC assets at the time of the acquisition if the partnership or LLC later sells the appreciated property.
- For depreciable property, the buyer benefits from increased depreciation deductions that offset its share of taxable income from the partnership or LLC.

Mandatory Section 754 Basis Adjustments

> An LLC or partnership with a substantial built-in loss must make basis adjustments to partnership or LLC property when there is a sale or exchange of a partnership or LLC interest or a transfer on the death of a partner or member (IRC § 743(a)).

> The basis adjustments must be made whether or not the partnership or LLC has a Section 754 election in place.

> A partnership or LLC has a substantial built-in loss if immediately after a transfer of a partnership or LLC interest the partnership's or LLC's tax basis in its property exceeds the fair market value of the property by more than $250,000.

Employee Benefits & Executive Compensation

Employee Benefits and Executive Compensation

Buyer Side Diligence

- Before beginning the due diligence, the buyer's benefits attorney should:
  - Reach out to the corporate attorneys, as early as possible, to coordinate the employee-related due diligence with the firm's diligence efforts generally.
  - Confirm with the client which aspects of employee-related due diligence the benefits attorney should handle and which aspects the client is handling in house or through other outside advisors.

Employment Buyer Side Diligence

- In a stock transaction, the buyer becomes the employer of the target company's employees and inherits the target company's compensation and benefits liabilities automatically by operation of law.
- In an asset sale, except in limited circumstances the buyer acquires only certain, specified assets of the target business and typically assumes only certain, specified liabilities of the target business. Therefore, in an asset sale, the buyer and seller negotiate to determine:
  - The employees to which the buyer intends to offer employment.
  - The terms and conditions of the offers of employment.
  - The compensation and benefit liabilities that the buyer is assuming and whether any related assets are to be acquired by the buyer.

Employment Buyer Side Diligence

Continued

- Determine whether the transaction constitutes a change in control for purposes of:
  - Code Section 280G. (expected excess parachute payments)
  - Section 409A.

- Identify and quantify any significant compensation and benefits related costs and liabilities, including:
  - outstanding equity award liabilities;
  - unfunded pension liabilities;
  - any significant benefits-related litigation exposure;
  - any potential noncompliance with HIPAA

- Determine whether the seller's compensation and benefit plans and arrangements are the subject of any ongoing governmental audits, examinations, or investigations, including by the:
  - Department of Labor (DOL);
  - Internal Revenue Service (IRS); or
  - Department of Health and Human Services (HHS).

- Determine the seller's ability to modify, at the buyer's request, compensation and benefit plans before the closing of the transaction to reduce the buyer's liability or administrative burden after the closing.

Health and Welfare Plan Due Diligence

Considerations Under the ACA

- Although the ACA contains numerous requirements for health plans, the buyer's benefits attorney should focus on evaluating the seller's compliance with:
  - The ACA's employer mandate.
  - The rules for maintaining grandfathered health plan status under the ACA, if applicable.
  - Nondiscrimination standards under ACA Section 1557.
  - The buyer's benefits attorney should also review the generosity of the seller's health plans, for purposes of the ACA's excise tax on Cadillac Plans.

Employee Benefit Plan Amendments and Terminations

> In some cases, the parties may be able to reduce the post-closing benefits liabilities by amending, merging, freezing, or even terminating certain employee benefit plans.

> There are strict rules governing the types of modifications that may be made to existing plans, particularly under Code Section 414(l) (26 U.S.C. § 414(l)) and Code Section 411(d)(6) (26 U.S.C. § 411(d)(6)).

> The parties should consider whether any proposed amendments are likely to cause a health plan to relinquish its grandfathered status under the ACA.

Treatment of Equity Compensation Awards

- If the seller's equity compensation plan and related award agreements provide broad discretion on the treatment of equity compensation in a corporate transaction, the parties must negotiate:
  - How the outstanding equity awards are to be treated (for example, rolled over or accelerated and cashed out).
  - How the cost of the agreed on treatment is to be allocated between the parties.
  - Which party will be responsible for drafting and distributing employee communications regarding the treatment of equity compensation awards.

Intellectual Property Issues

Intellectual Property Issues

- IP legal due diligence generally includes a review and analysis of these areas:
  - Owned IP.
    - This confirms that the target company owns the IP it claims to own and that the owned IP will be retained by the target company and not be impaired by the transaction. It also includes a review of any licenses of the target company's owned IP to other parties.
  - Third-party IP.
    - This includes a review of IP used by the target company under license from another party.
  - IP disputes and office actions.
    - This includes a review of actual or potential IP-related disputes and office actions involving or affecting the target company.
  - IT assets.
    - This includes a review of the target company's proprietary and licensed software and other IT assets.

Registered Owned Intellectual Property

- The target company's registered IP portfolio may cover:
  - Patents, patent applications, and statutory invention registrations.
  - Trademark and service mark applications and registrations.
  - Copyright applications and registrations.
  - Mask work registrations.
  - Internet domain name registrations, which are not technically IP rights but which are often addressed alongside IP registrations and applications.

Common Registered IP Issues

- Abandoned or expired items.
  - in some cases, it may be possible for the target company to revive the application or registration; and
  - without revival, damages may still be recoverable for pre-expiration or pre-abandonment infringement.
- Pending applications and registrations set to expire or for which renewal, maintenance, or other fees are due.
- Gaps or other inconsistencies in the public record chain of title.
- Unreleased security interests.
- For trademarks and patents, the buyer should also review UCC-1 filings in relevant states. While security interests in trademarks and patents are typically recorded in the USPTO, they are perfected under the Uniform Commercial Code, not through USPTO recordation.

Trade Secrets

- Common issues concerning the target company's trade secrets involve:
  - Confidentiality policies and non-disclosure agreements. The buyer should ensure that:
    - any confidentiality obligations in the target company's non-disclosure agreements covering trade secrets are perpetual (that is, for as long as the information continues to have trade secret status); and
    - the duration of confidentiality obligations for non-trade secret information is appropriate. Some states do not enforce perpetual confidentiality obligations in non-disclosure agreements for non-trade secret information.
- IP and invention assignment agreements. The buyer should ensure that the target company's IP and invention assignment agreements adequately cover trade secrets.

Change of Control/ Assignment Restrictions

Restrictions on Change of Control or Assignment

- The buyer should review the target company's licenses and other IP and IT agreements to determine whether they prohibit or restrict:
  - A change of control of the target company
  - The target company's assignment of the agreement
- If the transaction violates an assignment or change-of-control clause or triggers a termination right by the other party, the licensor's or vendor's consent may need to be obtained before closing to avoid a breach of the agreement or loss of the licensed IP.
- If the agreement contains a change-of-control restriction, the buyer must determine whether the transaction falls within the scope of transactions described in the relevant change-of-control provision.

Stock as Consideration

Using Stock as Acquisition Consideration with Private Companies

- Private Stock vs. Public Stock.
  - Private stock is almost completely illiquid. Public stock, on the other hand, is completely liquid.
- Sellers: Liquidating Public Stock Post-Deal.
  - If you received an excess of 5% of the total acquiring company's stock, then you're considered an "insider." In that case, you'll need to work with your transfer agent and broker-dealer to ensure you sell your stock at a pace that meets the requirements laid-down by the SEC. Newly minted insiders cannot dump stock immediately after its receipt in a strategic M&A deal.

Bankruptcy

Buying/Selling a Distressed or Bankrupt Company

> Sales outside bankruptcy are generally less expensive and time consuming than those in bankruptcy and will not expose the purchaser to the same degree of formal competition for the assets.

> Sales that occur in a bankruptcy setting offer purchasers greater post-sale legal protection from the seller’s creditors and from related concerns.

Sales Outside Bankruptcy

> So long as the owner of a distressed company satisfies its fiduciary duties and contractual obligations, parties are generally free to consummate a sale outside the bankruptcy process.

> In addition, even where a sale is later challenged under governing state law (e.g., as an avoidable fraudulent conveyance), generally the parties need show only that fair value was exchanged.

> Sales consummated outside bankruptcy offer several potential advantages over bankruptcy sales.
>
> > Non-bankruptcy sales are generally quicker and less expensive,
> >
> > Non-bankruptcy sales may be more likely to preserve the company's relationships with its customers and vendors, especially given the likely enhanced speed of the sale, as well as the reduced potential disruption to the seller's business that a bankruptcy filing may cause.
> >
> > The purchaser in a non-bankruptcy sale faces less competition because such sales are not generally subject to the common requirements in bankruptcy of a formal auction or that the sale be subject to higher and better offers.

Bankruptcy Sales

> The Bankruptcy Code bestows powers on the debtor that it would not possess outside bankruptcy.

> The debtor may reject unfavorable unexpired leases and executory contracts and assume and assign favorable ones to a purchaser, subject to curing any payment defaults, even if the terms of such contracts purport to restrict assignment.

> The most substantial benefit to the purchaser in a bankruptcy sale is that the purchaser may buy the debtor's assets free and clear of most liens, claims and encumbrances, greatly limiting the purchaser's exposure to future successor liability and other claims.

> In the case of 363 sales the bankruptcy court is required to hold a hearing to determine whether the purchase price being paid is the highest and best offer for the assets under the circumstances.

Antitrust

Complying with Antitrust Laws

Information Exchange

- The FTC and the Antitrust Division of the DOJ, may have concerns if the exchange is not undertaken in a careful manner out of a fear that the exchanged information may allow parties that are competitors to coordinate future behavior in an anticompetitive manner.

- The federal antitrust agencies' interest in the information exchange generally arises for one of the following four reasons:
  - The transaction itself may be illegal, and the information exchange may allow the parties to impermissibly coordinate their behavior.
  - Even though the transaction may be legal, the information exchange is broader than is necessary to complete the transaction and may result in anticompetitive conduct in other areas where the companies still compete. This is known as a spillover effect.
  - Even if the transaction is legal and completed, the information exchange may have led to a reduction or elimination of competition before completion.
  - If the transaction ultimately is not completed, the information exchanged by the competing companies could be used to coordinate future competitive behavior.

Complying with Antitrust Laws

General Guidelines for Information Exchanges

- The companies should disclose or exchange only information reasonably necessary to analyze or complete the transaction.
- Aside from information necessary for due diligence, the parties should not exchange competitively sensitive information (the other party remains a competitor until the deal is closed).
- Disclosure or exchange of any nonpublic, competitively sensitive information should be on a need-to-know basis only, and should be protected from further disclosure by confidentiality agreements.
- Standardized procedures such as written requests, requirements for the presence of counsel, and limited designations of who will communicate should all be determined in advance, documented, and clearly explained to those involved.
- Under no circumstances should steps be taken to transfer beneficial ownership, allocate customers, integrate any operations, influence the other party's business decisions, or coordinate any pricing, production, promotions, or other competitive practices, decisions or strategies before closing.
- In most cases, information should flow in one direction: from seller to buyer.
- There should be no change or modification of competitive activity based on proprietary information received from the other party, such as pricing changes.