

# MERGERS & ACQUISITIONS

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## The Tie that Binds: Enforceability of Merger Provisions Against Non-signatory Shareholders

by James J. Scheinkman, Partner, and Elizabeth A. Gadbow, Associate

### The Predicament

One challenge encountered in M&A deals is how to bind all shareholders of the target company to all deal terms. For private companies with few shareholders, this is not much of a challenge. However, many private companies have accumulated a wide group of shareholders. Companies may have sold stock in financings, granted employees incentive equity, and issued equity to other third parties.

The challenge arises on account of an acquirer's insistence on a structure facilitating a timely closing, the acquisition of all ownership interests in the target, and a "price adjustment" via shareholder indemnity if the target's condition is not as represented. Structuring the deal as a stock purchase from many shareholders requires corralling numerous shareholder signatories to a complex purchase agreement and potentially contending with holdout or missing shareholders. An asset acquisition mitigates these risks, but may not be feasible due to tax, regulatory, or other reasons.

A work-around is to structure the deal as a statutory merger whereby a majority, but not necessarily all, of the shareholders vote to approve the merger resulting in acquisition of 100% ownership of the target company. However, state merger statutes typically only provide for conversion of the target's shares into *rights* to cash or other property; the statutes do not expressly provide for the target's shareholders to be subject to post-closing *obligations*, such as indemnification for breaches of the target's representations in the merger agreement.

Many acquirers have addressed this by requiring that, in order for the target company's shareholders to receive the merger consideration, they sign an expanded letter of transmittal which commits shareholders to post-closing obligations.

### The Judicial Response

Two years ago, the Delaware Chancery Court, in *Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc.*, called into question this approach. Cigna was a shareholder of Audax Health Solutions which was acquired by merger by Optum Services. The merger was approved by almost 67% of the Audax shareholders, but not Cigna. Cigna refused to sign the letter of transmittal which would have obligated it, among other things, to release claims against the purchaser and to indemnify the purchaser for the target's breach of the representations and warranties in the acquisition agreement. When the purchaser refused to pay Cigna its merger consideration, Cigna sued, asserting that requiring it to agree to these provisions violated Delaware law.

The Court agreed. It noted that the flexibility provided by the Delaware merger statute is not unlimited, and, by structuring the deal as a statutory merger and not a stock purchase, the purchaser made a choice requiring it to comply with the statute. The Court noted that the requirement of a release by the target company's shareholders was not even mentioned in the merger agreement. Once the merger was consummated, Cigna was entitled to the merger payment by law, and the release was an unenforceable new requirement not supported by legal consideration. The Court noted that to hold otherwise would enable buyers to impose any number of new obligations on shareholders as a condition to receiving merger consideration.

In contrast, the requirement that the target shareholders agree to be responsible for indemnification obligations was in the merger agreement. However, the Court held that the indemnification obligations were so broad that the merger consideration's value was not reasonably ascertainable and therefore violated statutory requirements. The Court noted that, while many representations terminated after 18 months, certain representations continued for a longer period with "fundamental representations" surviving indefinitely. Moreover, at least some of the indemnification obligations were not subject to an aggregate cap on liability. The fact that, years later, the entire merger consideration could be "clawed back" made the merger payment improperly indefinite.

The Court distinguished an unlimited claw back from a permissible escrow provision in which a portion of the merger consideration is put aside to satisfy claims for breaches of target company representations. It also distinguished a prior case addressing balance sheet based post-closing price adjustments, which are frequently contained in deals.

### The Take-Away

The take-away from *Cigna* is not that statutory mergers are no longer appropriate to acquire companies with numerous shareholders; to the contrary, statutory mergers remain an effective, and preferred, structure. The take-away is that the flexibility provided by statutory mergers is not unlimited and one must play within the rules. Fortunately, there remains a range of techniques to do so:

- ▶ Pre-sale planning is important. For instance, a "drag-along" provision in a shareholder agreement requiring shareholders to abide by the wishes of majority owners and agree to be bound by indemnity provisions or other obligations is valuable. Dialogue by management with the shareholder base prior to a transaction can set expectations and reduce conflict.
- ▶ Shareholders remain free to sign support agreements containing post-closing obligations. Buyers may require a requisite percentage of shareholders signing support agreements as a condition of the deal.
- ▶ Shareholder votes may be procured by written consents which also contain agreements to support post-closing obligations.
- ▶ Escrows to secure breaches of representations and warranties remain a viable tool.
- ▶ Representation and warranty insurance may also be available when the target resists an escrow or the acquirer insists on claw back provisions.
- ▶ Including post-closing obligations in the merger agreement and not just the letter of transmittal is wise, as are time limitations and dollar caps for all representations and warranties. Also, consider providing separate consideration for releases and other obligations.

The bottom line is that, properly planned, a statutory merger remains an effective acquisition vehicle.

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#### James J. Scheinkman

James J. Scheinkman is a partner in the Orange County and Los Angeles offices of Snell & Wilmer and is a practice group leader of the firm's Corporate & Securities Group. His practice regularly involves counseling companies involved in M&A transactions and representing companies and shareholders in shareholder disputes. Reach Jim at [jscheinkman@swlaw.com](mailto:jscheinkman@swlaw.com) or 714.427.7037.



#### Elizabeth A. Gadbow

Elizabeth A. Gadbow is an associate in the Los Angeles office of Snell & Wilmer and is a member of the firm's Corporate & Securities Group. Her practice includes mergers and acquisitions, franchising, corporate governance, and securities law compliance. Reach Elizabeth at [egadbow@swlaw.com](mailto:egadbow@swlaw.com) or 213.929.2511.



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**Christine Borrelli, SVP**  
949-623-0931  
[christineborrelli@umpquabank.com](mailto:christineborrelli@umpquabank.com)

Glendale, CA  
**Concetta Smarius, SVP**  
818-254-3496  
[conzettasmarius@umpquabank.com](mailto:conzettasmarius@umpquabank.com)

Torrance, CA  
**Allen Huang, SVP**  
424-337-5981  
[allenuang@umpquabank.com](mailto:allenuang@umpquabank.com)

Oxnard, CA  
**Stacy Peterson, SVP**  
805-288-4505  
[stacypeterson@umpquabank.com](mailto:stacypeterson@umpquabank.com)

Encino, CA  
**Donna Owen, SVP**  
818-464-9707  
[donnaowen@umpquabank.com](mailto:donnaowen@umpquabank.com)

# Regulatory Compliance Issues in China Inbound Investments and Transactions

by Larry A. Cerutti and Daniel Anziska, Troutman Sanders LLP

Investments by Chinese firms in the U.S. have increased significantly over the past 5 years. These investments have been made in a number of industry segments, including consumer goods, entertainment, information and communication technology, automotive and real estate. Acquisitions of U.S. businesses by foreign entities (especially those located in China) are subject to oversight by the Committee on Foreign Investment in the United States (CFIUS).

CFIUS is charged with reviewing the national security implications of transactions that involve the acquisition of a U.S. business by a foreign person. CFIUS has authority to review any merger, takeover, or other acquisition by or with any "foreign person," which could result in "control" of a "U.S. business" by a foreign person. A "foreign person" is any foreign national, entity, or government, or any entity over which a foreign national, entity, or government has "control." The term "control" includes the power to determine, direct, or decide important matters affecting an entity, including the power to block a decision. Determination of "control" is a case-by-case determination that rests upon both the acquirer's level of ownership with no set threshold (e.g., in some cases ownership of as little as 15% of a U.S. business may be considered "control") and the rights exercisable by the acquirer.

CFIUS notification is technically voluntary. Parties may close before a CFIUS review is complete, but that shifts all risk to the acquirer. Even if a filing is not made, CFIUS can compel a review either before or after the closing of a transaction. The CFIUS process can be summarized as follows:

- ▶ Submit draft CFIUS Notification in conjunction with the acquisition agreement.
- ▶ Within 7-14 days, file the CFIUS Notification, which has an automatic 30-day review period.
- ▶ There is a 45-day additional review period if CFIUS opens an investigation.
- ▶ Following CFIUS's recommendation, the U.S. President has a 15-day period to overturn that recommendation, if at all.

Recently, we have observed that the CFIUS staff has been more formal and rigid in following procedures and that it is not sensitive to timing concerns, even in transactions involving publicly traded companies. Other observations include:

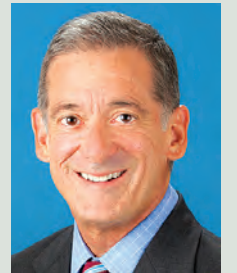
- ▶ CFIUS will have serious concerns where the target technology could place U.S. military interests at a deficit.
- ▶ CFIUS has permitted certain transactions to move forward after lengthy investigations, subject to reaching an agreement to remedy CFIUS' concerns (e.g., agreements not to share certain sensitive information with foreign parents and/or divestiture of the target's military contracts).

- ▶ There is growing U.S. Congressional and media concern about China technology acquisitions, which may lead to more rigorous CFIUS scrutiny during reviews.
- ▶ Many recent transactions took at least 5-6 months to obtain CFIUS clearance.
- ▶ CFIUS will carefully consider the identity of the purchaser, particularly a China State-Owned Entity.

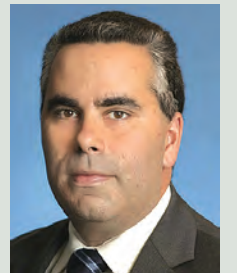
In summary, transactions involving investments by China-based investors in U.S.-based companies require careful analysis of potentially applicable regulations here in the U.S., including CFIUS. Because CFIUS is concerned with national security issues, any transaction involving an investor or target that is engaged in a business that provides products or services to the military or that involve next generation technology applications, will be closely scrutinized by CFIUS. It is important to note that at times transactions which, on their face, appear to be fine (e.g., the purchase of real property), may nonetheless be denied by CFIUS (e.g., where the real property is located in close proximity to a U.S. military installation).



**Larry Cerutti**  
Larry Cerutti is the managing partner of the Orange County office for Troutman Sanders, where he is a senior member of the firm's corporate section. His practice focuses on mergers and acquisitions, public and private securities offerings, corporate governance, and related corporate and securities counseling. Larry can be reached at 949.622.2710 or Larry.Cerutti@troutmansanders.com.



**Dan Anziska**  
Dan Anziska is a partner in the firm's New York office where he focuses on counseling with respect to mergers and acquisitions, drafting relevant deal provisions, and managing the substantive antitrust approval process with government agencies including assisting the firm's China-based clients on competition and national security (CFIUS) issues. He can be reached at 212.704.6009 or Daniel.Anziska@troutmansanders.com.



## Proven M&A Experience

<p>\$1,300,000,000</p> <p>Acquisition of Gland Pharma Ltd.</p>	<p>\$155,000,000</p> <p>Acquisition by China New Way Investment Limited</p>	<p>\$1,910,000,000</p> <p>Acquisition of Diamond Foods</p>	<p>\$175,000,000</p> <p>Acquisition of Aventine Renewable Energy Holdings Inc.</p>
<p>\$66,700,000</p> <p>Sale of interests in Agnita Limited to FDG Electric Vehicles Group</p>	<p>\$624,000,000</p> <p>Acquisition by Sunovion Pharmaceuticals Inc.</p>	<p>\$7,100,000,000</p> <p>Acquisition of Smithfield Foods Inc. <i>Virginia Counsel</i></p>	<p>\$2,350,000,000</p> <p>Acquisition of Motorola Mobility Holdings Inc. from Google</p>

With a strong Orange County presence and recognized national experience, our mergers & acquisitions lawyers are ready to assist clients in structuring, negotiating and implementing domestic and international business transactions. We represent public and private companies, including acquirers, targets, investors, venture funds, management buyout groups, private equity funds, lenders and equity participants. We serve clients ranging from emerging growth to Fortune 500 corporations across a wide variety of industry sectors.



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# Structuring the Exit Transaction: Stock Sale vs. Asset Sale

by Douglas Schaaf, Partner, Paul Hastings LLP, Orange County Office, and Noah Metz, Associate, Paul Hastings LLP, Palo Alto Office



The sale of any company involves a basic structural decision: whether to sell the equity of the company or the assets of the company. This article discusses tax aspects of such a decision, but there are many nontax considerations to weigh as well. This article discusses how asset and equity sales differ from a tax perspective and then highlights common structures that allow the parties to achieve the tax effect of an asset sale when buyer and seller decide to structure an acquisition for all other purposes as a sale of equity.

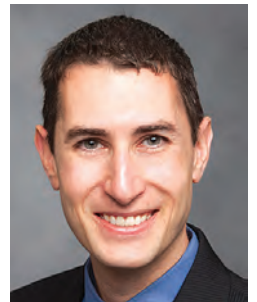
### Asset sale versus equity sale

If a buyer acquires all of a company's assets, for tax purposes, the assets will generally have a tax basis in the buyer's hands equal to what the buyer paid (reduced by depreciation deductions). By contrast, when a buyer acquires the equity of a company, the basis of the assets inside the company (the "inside" basis) is unchanged by the acquisition. A higher inside basis is desirable in part because it allows a company to utilize more depreciation deductions to offset taxable income or to cause a subsequent sale of the assets at a lower tax cost. A sale of assets should allow the seller to achieve a significantly higher purchase price due to the future tax savings that the buyer will enjoy due to the step in the tax basis of the purchased assets.



Schaaf

Unfortunately, the seller of a C-corporation will incur a significant tax cost if the asset sale route is chosen. This is because a C-corporation must pay tax on gain recognized on the sale and then its shareholders owe an additional level of tax when the proceeds are distributed to them. By contrast, an equity sale only involves a single layer of tax, imposed on the shareholders.<sup>1</sup> The double tax cost associated with an asset sale by a C-corporation makes as asset sale an unacceptable alternative in almost all cases (e.g., net operating loss situations).



Metz

Fortunately, many non-public companies have chosen to organize themselves as partnerships (which includes most LLCs) or S-corporations for tax purposes. The owners of these entities are able to enjoy the best of both worlds: (i) the owners can enjoy the single-level of tax associated with the asset sale, and (ii) the buyer is able to enjoy the benefit of a step-up in the tax basis of the purchased assets.

S-corporations and partnerships also are able to utilize various provisions of the tax laws to achieve the desired asset sale treatment even though the transaction may take the form of a sale of equity interests. This is often extremely important from a non-tax viewpoint, as the need to actually transfer each and every asset and obtain the necessary commercial consents from landlords and others is often greatly reduced as compared to an asset sale. The tax code provides a number of ways to do this, depending on the type of entity involved in the transaction.

### Methods to cause an asset sale for tax purposes in the context of an equity acquisition

**Corporate buyer and corporate target: Section 338(h)(10) election.** Where both buyer and target are corporations (usually where target is an S-corporation), a Section 338(h)(10) election allows the buyer to acquire target's stock for state law purposes, while causing the assets held by the target corporation to be stepped up to their fair market value after the transaction. Making this election may result in slightly more taxes being assessed on the sale as compared to an actual asset sale by an S-Corporation.

**Noncorporate buyer and corporate target: Section 336(e) election.** Where the target is a corporation (usually an S-corporation) but buyer is not, a Section 338(h)(10) election cannot be made, but a Section 336(e) election can be, which produces results for buyer and seller that are very similar to the Section 338(h)(10) election.

**Partnership target: Section 754 election.** Where the business being sold is a partnership for tax purposes, a Section 754 election can be made by the partnership to increase the inside basis of the assets with respect to an incoming partner. There is generally a modest tax cost to selling partners in these transactions.

**Partnership target and a single acquirer of 100% of target.** Finally, where the target is a partnership for tax purposes and a single individual or entity acquires all of its equity, this acquisition is treated as if it were as an asset sale for tax purposes.

For more information, contact Douglas A. Schaaf at 714.668.6221 or [dougschaaf@paulhastings.com](mailto:dougschaaf@paulhastings.com). Contact Noah Metz at 650.320.1837 or [noahmetz@paulhastings.com](mailto:noahmetz@paulhastings.com).

<sup>1</sup> Consider the following numerical example (which uses the highest rates of federal income tax and ignores state tax consequences) to illustrate the increased tax burden of an asset sale as compared to an equity sale:

Buyer pays \$1,000 to acquire all of Acme Corp's stock from its sole shareholder, a U.S. resident individual ("shareholder"). Shareholder has held the stock for over a year and has an "outside" basis of \$500 in the stock. Shareholder will receive \$1,000 but must pay federal income taxes at a rate of 23.8%. Thus, buyer receives \$881 on an after-tax basis (\$1,000 less 23.8% tax on a capital gain of \$500).

Alternatively, suppose instead buyer bought the assets directly from Acme Corp for \$1,000. Suppose Acme Corp's "inside" basis in the assets was \$200. Buyer pays Acme Corp \$1,000, but Acme Corp owes federal income taxes at a rate of 35% on its gain of \$800. Acme Corp pays its taxes (\$280), distributes the remaining \$720 to its shareholder and liquidates. The shareholder then owes taxes at a rate of 23.8% on her gain (\$720 less the shareholder's basis of \$500), leaving her with about \$668 on an after-tax basis.

## Use Early Integration Planning and Implementation to Capture M&A Synergies from Day One



by Marc Blythe  
President, Blythe Global Advisors, LLC



At Blythe Global Advisors, we have more than 100 M&A engagements in our portfolio. When it comes to M&As, there's one overarching action that enables companies to exploit synergies the quickest and transition to the future state with the fewest number of surprises – freeing management to focus on financial stability. It's an early start. As soon as companies begin to consider a transaction, the entire M&A team needs to be assembled – both the internal resources and external consultants, each with their respective areas of expertise.

Nowhere is this more important than with the alignment contingent because there's a point a lot of folks miss: The task is called integration **planning** and implementation. Plans to align the two entities should start ideally before due diligence with the implementation effort continuing well after Day One.

For companies that don't apply early efforts to integration and alignment, Day One can be the business equivalent of a false-positive lab result. Everything is changed, but nothing is different. Management and employees go about their work in their respective silos just as the day before – but now sowing the seeds for inefficiency, missed opportunities, lost revenue, low morale, the exit of key employees and, finally, missed forecasts.

Here's a prescription for a successful integration effort.

1. As stated above, assemble the integration experts as soon as the *idea* of a deal seems real. M&As are incredibly complicated; there's never been one without setbacks. This team needs to be superior – battle-tested veterans who have experience dealing with companies' DNA and who know where the pitfalls are because they've fallen into a few, have the scars to prove it and carry forward the lessons learned.

2. Include a small cadre of cross-functional executives on the team – folks from accounting, tax, HR, IT, communications, etc. who know the nuts, bolts, strengths and weaknesses of the organization – to help develop a transition plan that will work across groups and across the lifecycles of systems toward desired objectives. Here's a very short list of the issues that need to be assigned a detailed blueprint.
  - Can both entities consolidate and align payroll by the target date?
  - Can IT implement one seamless ERP system by the target date?
  - How will sales teams, branches, outlets, etc. be consolidated, reallocated, redeployed and compensated?
  - How will future contracts be structured? What are the implications for contracts in place?
  - Who should be retained, released or deployed to other locations?
  - What are the cultural differences that need to be bridged?

3. Develop a communications strategy and involve an expanded level of management. This next level of management is essential on Day One and beyond to complement senior management's messages and provide the necessary local leadership to get the deal off to a successful start. Nothing is more lethal to a merger or acquisition than a leadership vacuum. These folks will keep the company moving forward and provide the positive atmosphere for retaining people who are essential to long-term success.

Aligning two already vibrant entities involves really hard issues. Successful alignment requires expertise and capacity not available inside organizations. It's a job that must be done right – right from the beginning – to meet the expectations of external and internal constituencies. An early start is the best first action.

*Marc Blythe has more than 25 years' experience advising companies on accounting and financial reporting requirements. His areas of expertise include revenue recognition, share-based compensation, mergers and acquisitions/purchase accounting, restructurings/impairments, recapitalizations, divestitures, internal control reporting, consolidations/variable interests, lease accounting, derivatives and complex debt, and equity transactions. Prior to forming Blythe Global Advisors, Marc was an audit partner at EY. He can be reached at marc@blytheglobal.com.*

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## The Fundamentals of a Successful Merger

by Curtis Campbell, CPA, MST and Jodi Ristrom, CPA

For businesses considering a merger, there are several factors that need to work together to make it successful. We typically advise clients in pre-merger financial projections, tax planning and due diligence, as well as post-merger accounting, tax and consulting services.

### Pre-Merger Issues

Financial issues ultimately determine whether a merger will be viable. As such, you may find it helpful to hire a CPA as you attempt to answer these and other questions:

- ▶ Can the value of each company be agreed upon?
- ▶ How can it be structured to minimize taxes for ownership?
- ▶ What are the primary financial benefits?
- ▶ How do compensation levels compare?



Campbell



Ristrom

the post-merger cash flow of a company. Capital gains planning should also be considered for personal income tax planning. Your CPA can make a big difference in helping to decide upon and execute a favorable structure for after-tax cash flow. With the right situation, certain strategies can even have immediate results and lead to better profits and cash flow.

### Management Issues

Some of the greatest benefits of a merger come from integrating operational routines and then eliminating redundant positions by terminating or reassigning personnel. Keep in mind that job security, along with duties and compensation, are key issues for most employees. From a camaraderie standpoint, it is important to encourage a sense of unity and team spirit.

Have clearly defined managerial roles to prevent employees from falling back to old reporting relationships and allegiances. Also, implement standard policies and procedures for all aspects of operations.

You should also do thorough due diligence on all aspects of the other company (i.e., financial, operational, human resources, and sales and marketing). In some industries, it is important to give serious consideration to legal and regulatory requirements.

### Valuation and Ownership

In any merger, the combined entity considers the value of each entity prior to the merger. Sometimes an owner may have a value in mind that may be very unrealistic and this breaks the deal. An independent business valuation professional can provide a resolution through developing an appraisal of each company. When the value is agreed upon, the initial ownership percentages can be derived, allowing owners to decide whether they want to infuse additional cash (or other assets) in order to increase their ownership percentage. Of course, other factors are typically considered, such as paying a premium to those owners who 'own the relationship' with major customers.

### Tax Structuring

The tax structure of a merger is very important and can have a dramatic impact on

### Customer Relationships

As a general rule, customers should be advised immediately after the merger (or prior to it, in some cases) and any concerns addressed. Obviously, losing major customers can significantly undermine the merged company's performance. The entire customer relationship management process of each company should be thoroughly evaluated and integrated into an effective new system. Some companies pay 'stay bonuses' to key personnel to ensure that they continue with the company, especially when they have a significant impact on customer relationships.

*Curtis Campbell, Tax Services, and Jodi Ristrom, Business Assurance Services, are partners at HMWC CPAs & Business Advisors (www.hmwccpa.com), one of Orange County's largest local accounting firms. For more information, see www.hmwccpa.com or call 714.505.9000.*

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