There are many observations to make about merger and acquisition transactions, and this book does not describe them all. Some excellent reference books go much deeper into M&A, such as Anatomy of a Merger by James C. Freund, Negotiated Acquisitions of Companies, Subsidiaries, and Divisions by Lou R. Kling and Eileen T. Nugent, Mergers, Acquisitions, and Buyouts by Jack S. Levin and Martin D. Ginsburg.

Presented here are some basics of which you should be aware.

Following are the three transaction structures that nearly all acquisitions follow:

1. **Asset purchase.** In an asset purchase, the buyer buys all (or part) of the seller’s assets and assumes only the seller’s liabilities expressly agreed to be assumed (except where the law causes some liabilities to follow the assets regardless). Assets can be both tangible (e.g., plant, property and equipment) and intangible (e.g., intellectual property, corporate name and goodwill). For example, if the company selling the assets owed money to a creditor before the sale of assets, it will continue to owe the money after the sale, but the buyer of assets will not be liable for it, as long as the asset sale does not constitute a “fraudulent conveyance.” (See this and other terms in the Glossary at the end of this book).

2. **Stock purchase.** The acquisition of a company by stock purchase involves the purchase of all the seller’s shares. A buyer may purchase less than all of a seller’s shares and “squeeze out,” or force a sale by statutory short-form merger (see Glossary), the remaining shareholders in order to own 100 percent of the shares of the company being acquired. Unlike a buyer in an asset sale, a buyer of stock accepts ownership of the company with all of its assets and liabilities. So if the purchased company owed money to a creditor before the sale, the company in the buyer’s hands still owes the money after the sale. The purchase of a company by acquiring all of its publicly-traded stock involves a “tender offer” by the buyer in which
the buyer publicly solicits for shares of the seller at a certain price. Tender offers are regulated by federal securities law.

3. **Merger.** In a merger, two companies combine to form one upon the issuance of a “merger certificate” by the relevant state. The surviving company in a merger assumes all liabilities and receives all assets of the disappearing company. A merger is a creation of law and for this reason can be hard for some people to conceptualize. In a stock purchase, the buyer holds stock. In an asset purchase, the buyer holds assets. Upon a merger, however, the law deems two entities combined, and all assets of both are owned by the surviving company.

Regardless of whether the acquisition is an asset purchase, a stock purchase, or a merger, the buyer usually forms a wholly owned subsidiary to hold the acquired business and shield itself from any of the liabilities of the purchased company.

The terms of acquisition transactions are reflected in an acquisition agreement. The acquisition agreement could be an asset purchase agreement, a stock purchase agreement, or a merger agreement, depending upon which structure the transaction assumes. Regardless of the transaction structure, all mergers and acquisitions agreements have four main components:

1. **Representations and Warranties.** Representations and warranties are statements made by a party in an agreement referring to facts or matters about the party making them. They speak both negatively—e.g., “there is no litigation pending, or to the knowledge of the company, threatened;” and affirmatively—e.g., “each of the company’s employees earning more than $100,000 per year are listed on Schedule A.” These representations, or “reps,” are negotiated over issues such as whether individual reps are qualified by the “knowledge” of the person making them or whether an individual rep is made only as to “material” matters. A vital counterpart to reps and warranties is the disclosure schedule. See Chapter 6 for a discussion of disclosure schedules.

2. **Covenants.** Most covenants exist to assure the buyer that the acquired business will not change significantly during the period between signing the acquisition agreement and closing the acquisition. “Closing” occurs when the buyer provides the seller the payment of cash, stock, or debt and the seller transfers to the buyer the assets or stock being acquired. During the period after signing the acquisition agreement but before closing, the parties take actions required for closing, such as obtaining consents of shareholders and/or other third parties (e.g., where a seller contract with a third party would terminate upon a “change of control”). Some
covenants, such as covenants to indemnify the buyer or to refrain from competing with the buyer, cover the period after the closing of the acquisition.

3. **Conditions to Closing.** Conditions to closing recite things that must happen, or not happen, for each party to be obligated to close the acquisition. Some of these are obvious: the buyer must pay and the seller must deliver the stock, assets, or company. Other common conditions to closing include:

- that the reps made at signing are still true in all material respects at closing;
- that board and shareholder approval was obtained;
- that no law or court order prohibits the transaction from closing; and
- that any other agreements to be delivered as part of the acquisition (such as employment agreements from key seller-employees) be signed by the parties required to sign them.

4. **Indemnification.** In the indemnification section, the parties agree as to who must pay for liabilities resulting from the acquisition and incurred by the buyer after the closing. Indemnification is negotiated over issues such as:

- how long the buyer has to discover that the seller breached the reps and warranties in the purchase agreement (“survival” of the reps and warranties);
- total monetary exposure of the seller to the buyer and whether there is a limit to the seller’s exposure (an “indemnification cap”);
- whether any money to be paid to the seller should be held in escrow to satisfy potential future indemnity claims and, if so, how much and for how long it should be held; and
- whether there should be a minimum amount of damage that the buyer must sustain before having the right to require the seller to pay for losses and, if so, whether the buyer may recover the full amount of the damages sustained or only the amount in excess of the minimum amount (this provision is known as a “basket”).

In addition, there are a few agreements that often accompany an acquisition agreement. These might include:

- Disclosure Schedules: see Chapter 6.
- Employment Agreements: Buyers usually want to retain the sellers’ management team for at least some period after the acquisition. Keeping the
seller’s management in place helps to facilitate a smooth transition from the previous owners to the new one. Generally, employment agreements are used to provide these executives with the incentive to work for the new owner. Employment agreements generally include provisions relating to salary, bonus, any stock options or other equity compensation of the employee, other benefits, and the bases for his or her termination (with and without “cause,” as the agreement defines it).

- **Noncompetition Agreements:** Noncompetition agreements give the buyer the right to restrict a person, such as a seller or employee from working for a competitor if he or she quits or is terminated by the new owner. In any case, they should be carefully considered because state laws regarding restrictions on competition vary greatly. Some states, such as California, disallow restrictions on competition in almost all situations. Other states restrict the duration and breadth of noncompetition agreements. Because of this, you may want to ask your supervising lawyer whether an employment lawyer should review the noncompetition agreement (or clause) in your transaction.

- **Resolutions approving the transaction:** see Chapter 10.

Note that companies sometimes use their stock to pay for an acquisition. Where this is the case, the buyer must issue securities legally. See “Issuing Securities” set forth in Chapter 13.

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**LAWS GOVERNING MERGERS AND ACQUISITIONS**

Merger and acquisition transactions are governed by several different areas of law. No single area of law governs M&A transactions because (1) they affect many different corporate constituencies; and (2) for the seller (and occasionally the buyer), an acquisition represents a change in corporate control. The corporate constituencies affected in a merger include the seller’s shareholders, customers, employees, and vendors. In addition, corporate directors have special obligations when the company is to be sold. A change of corporate control means that each of these groups will be working under new owners whose approach to the business may differ from the prior owners. Following are the areas of law that most frequently apply to mergers and acquisitions transactions:

**Corporate Law**

*Merger statute.* Where an acquisition is structured as a merger, the corporate law of each state includes a statute that details the requirements necessary
to complete a merger and, usually, the effect of the merger upon its completion. Sections 251 and 252 of the Delaware General Corporation Law are good examples. Section 251 governs mergers between Delaware corporations (i.e., between two “domestic” corporations), and Section 252 governs mergers between a domestic corporation and a corporation incorporated in another state (a “foreign” corporation).

BOARD DUTIES
Members of the board of directors of a corporation are fiduciaries who owe duties to the corporation’s shareholders. When the corporation is considering a sale, directors continue to owe these duties, and fulfilling them in mergers and acquisitions transactions often requires special care. Court decisions in Delaware and other states provide some guidance to directors in fulfilling their duties to shareholders in the course of a transaction. A broad discussion of board duties is described in Corporate Directors Guidebook edited by the American Bar Association’s Committee on Corporate Law.

Duty of care. As you probably already know, directors are obligated to exercise appropriate diligence to become informed in making decisions and overseeing the management of the company. This means regular attendance at meetings, reviewing materials provided, engaging experts where appropriate, and asking questions of the company and its management. In a merger and acquisitions transaction, the duty of care generally requires that directors take sufficient time to make decisions, inform themselves about alternatives, and thoroughly analyze all proposals, including their strengths and weaknesses. Sometimes directors engage outside experts, such as investment bankers or valuation experts, to help them confirm whether a given acquisition proposal fairly values the company.

Duty of loyalty. The duty of loyalty generally requires a director’s conduct be in the corporation’s best interest and that the director not deal with the company in a manner that favors himself or herself over the corporation. In a merger and acquisitions transaction, the duty of loyalty restricts directors from improperly profiting from a company sale in a manner not shared by shareholders. This could occur if a director serves on the boards of both the buyer and the seller, in which case recusing oneself from acquisition discussions on either board is the best advice. Another possible violation of the duty of loyalty in an acquisition transaction would be an “interested director transaction,” such as special fees a director might receive from the company for services in connection with an acquisition. State merger statutes usually permit interested director transactions as long as disinterested directors or shareholders are fully informed and approve them. As an example, review Delaware’s interested director statute, Section 144 of the Delaware General Corporation Law.
Business judgment rule. The business judgment rule is not a description of a duty; it is a principle used by courts to assess the conduct of corporate directors in order to determine whether the directors can be held liable for their actions. The business judgment rule is often analyzed when shareholders sue directors after an acquisition or other corporate transaction ends badly (or at least not as well as the shareholders would have preferred). The business judgment rule provides that as long as directors do their job honestly and diligently, the law will not penalize them for a bad outcome. The policy behind this rule is that no court should be able to second guess the judgment of a director who had adequately informed himself or herself at the time the decision was made.

SHAREHOLDER VOTE REQUIRED
The merger statute of the target’s state of incorporation provides for the shareholder approval requirement for a merger. The voting requirements for a sale of substantially all assets may sometimes be found elsewhere in the corporate statute. Stock purchases do not require shareholder votes because shareholders make the decision to sell their shares individually. Note also that the contents of a company’s charter may have its own voting requirements for a company sale, so be sure to consult the charter as well as the relevant statutes. When a company is required to take a vote of its shareholders, state corporate laws generally permit the vote to take place either at a meeting of shareholders or by written consent. When the vote is taken at a shareholders’ meeting, the company will most likely solicit proxies from shareholders.

PROXY SOLICITATIONS
Proxies authorize one person to vote the shares of another. As a legal matter, shareholder proxies are governed by both state corporate laws and federal securities laws. The law of the company’s state of incorporation governs issues related to the proxy itself, such as what content is required for an effective proxy, when it can be revoked, and the like. For example, Section 212 of the Delaware General Corporation Law addresses these issues for Delaware corporations. When a proxy is solicited from holders of registered securities (publicly held securities), federal securities laws govern what information must be included in the proxy statement. Federal laws related to proxies are found in Section 14(a) of the Regulation 14A under the Securities Exchange Act of 1934. Proxy statements with respect to registered securities must be filed with the Securities and Exchange Commission (SEC).

Tax Laws
Tax issues are everywhere in mergers and acquisitions. The very decision by a client to make an acquisition can be significantly influenced by tax considera-
tions. Certainly, the structure of acquisitions is influenced heavily by tax issues. Tax lawyers need to be involved in mergers and acquisitions transactions from the beginning. Nearly all of these issues arise under the Internal Revenue Code of the United States (IRC), although state and local taxes can also be important. One mergers and acquisitions treatise useful for understanding the tax issues in acquisitions is *Mergers, Acquisitions, and Buyouts* by Jack S. Levin and Martin D. Ginsburg. Among the tax issues frequently seen in acquisitions are: whether the transaction can be structured as a tax-free reorganization, whether the sellers can receive capital gains treatment of the consideration, whether the sellers may be subject to two levels of tax (as opposed to one), whether the buyer can use any net operating losses that the seller may have accrued, the buyer’s tax basis in the acquired assets, whether the purchase price can be structured as an installment sale (with resulting tax deferral), and whether any payments to insiders of the seller will be deemed “golden parachutes,” which are subject to additional taxes.

**Securities Laws**

**SHAREHOLDER VOTES**

As discussed above under “Proxy solicitations,” the federal securities laws govern communications with holders of registered securities, including acquisition-related communications.

**ISSUING SECURITIES**

Mergers and acquisitions transactions also become subject to securities laws when securities are issued by the buyer as full or partial payment for the company being acquired. Securities issued in connection with acquisitions must either be registered with the SEC or exempt from the federal registration requirements. They must also comply with the requirements of “blue sky” laws in each state they are offered. See Chapter 13, “Issuing Securities” for a full discussion of these issues. Where securities are issued by the purchaser in an acquisition and no exemption applies, the buyer may be eligible to register the acquisition shares on a registration statement. The form of registration statement can vary, but form S-4 is often used for some kinds of acquisitions.

**RESELLING SECURITIES**

Where securities form part of the purchase price, shareholders of the target company will want to know when and how the shareholders can sell the shares of buyer stock that they receive. The sellers usually negotiate contractual registration rights as part of the acquisition (for an explanation of registration rights, see page 21 under “Investors’ Rights Agreement”). Whether or not the seller’s shareholders receive registration rights, it is important to know
the laws that govern the resale of securities. Rule 145 under the Securities Act addresses resale of securities received in acquisition transactions.

**TENDER OFFERS**

Tender offers are federally regulated under Sections 14(d) and 14(e) of the Exchange Act (collectively known as the “Williams Act”), but the term itself is not defined there. A tender offer is generally a public invitation to shareholders to sell their stock. In a merger or an asset sale, the buyer approaches the company through its board of directors, but in a tender offer, the buyer approaches the company’s shareholders directly. The policy behind the Williams Act is ensuring that shareholders have sufficient information to make informed sale decisions.

The Williams Act also imposes substantive requirements such as the “all holders rule,” which requires that all shareholders of the same class of shares be invited to sell their shares in the tender offer, and the “best price rule,” which requires the consideration paid to any shareholder in a tender offer be the highest consideration paid to any other shareholder in the offer. In addition, the minimum time tender offers must remain open is regulated by the Williams Act. Further, bidders in a tender offer are also required to file with the SEC documents that include the terms of the offer, their source of capital, and their plans for the company after the tender offer is complete, among other things.

The specific requirements regarding tender offer procedures and documents are found at Regulations 14D and 14E under the Exchange Act and Schedule TO (Tender Offer Statement under 14(d)(1) or 13(e)(1)). In addition, SEC Regulation M-A addresses some issues related to communications surrounding tender offers.

**Antitrust**

The Federal Trade Commission has the right to review business combinations for their potential anticompetitive effect *prior to* closing of the transaction. The statute authorizing this review is the Hart-Scott-Rodino Antitrust Improvements Act, or HSR Act. A pre-acquisition HSR filing must be filed when both the “size of person” and “size of transaction” tests are met, or when the transaction is valued in excess of $200 million. Each of these tests is explained more fully on the FTC’s HSR Web site, which includes an “Introduction to Hart Scott.”

**Bulk Sales Laws**

Bulk sales are addressed under Article 6 of the Uniform Commercial Code (UCC). Essentially, when a company proposes to sell all or a material portion
of its assets, the selling company may be required to notify its creditors. The contents of the notice must also conform to the requirements of the relevant state’s commercial code. Failure to provide the notice of the terms required by the statute renders the transfer ineffective and voidable, so both the buyer and the seller in an acquisition benefit from careful compliance.

**Labor Laws: The WARN Act**

Unfortunately, acquisitions are sometimes accompanied by layoffs. When layoffs or plant closings occur, a specific federal statute, the Worker Adjustment and Retraining Notification Act, or WARN Act, sometimes applies. The WARN Act requires that workers be provided with advance notice that these events are going to occur. Not every company is subject to the WARN Act, nor is every layoff or plant closing. Where an acquisition may result in a plant closing or layoff, you may want to consult a labor lawyer about the WARN Act. More information about the WARN Act is available at [http://www.doleta.gov/layoff](http://www.doleta.gov/layoff) under “WARN Act” below the “Rapid Response” heading.

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**ROLE OF JUNIOR ASSOCIATES**

When you are assigned to a mergers and acquisitions transaction, consult with the assigning lawyers about the following:

1. Ask about confidentiality procedures: Which employees know about the proposed acquisition? Should you use code names or code words? Are there special fax numbers or e-mail addresses to which you should send deal material? Should you refrain from sending materials to any other fax numbers or e-mail addresses?

2. Prepare a working group list that conforms to confidentiality procedures. See Chapter 14.

3. Obtain and review a copy of the term sheet or letter of intent. Ask a senior lawyer any questions you may have. Reviewing the term sheet will help you understand the transaction and thus help you contribute to it.

4. Perform due diligence.

  ▼ In a sale for cash, only the buyer performs due diligence. Where a part of the price is paid with stock or promissory notes, the seller may also evaluate the buyer’s business prospects or credit.

  ▼ The goal of due diligence in an acquisition is to make sure the business is in the condition described by the seller, that key contracts are valid, that assets are owned free and clear of liens or other
claims, and that appropriate agreements are in place with employees. The buyer also wants a complete understanding of all liabilities that it will assume by purchasing the target company. See “Organizing and Conducting Due Diligence,” Chapter 5.


6. Draft ancillary agreements, such as any employment or consulting agreements and escrow agreements. Ask the assigning lawyer for a form of agreement to start with. See “Drafting Agreements,” Chapter 11.

7. Conduct legal research on legal issues that may arise in the transaction as directed by a senior lawyer.

8. Assist in preparing memoranda and presentations to the management or board of directors of your client company regarding any legal issues. These may concern issues unique to your transaction or matters common to similar transactions, such as the fiduciary obligations of the board.

9. Prepare or assist in preparing a proxy statement and/or registration statement, if applicable. Proxy statements are required where a shareholder vote is taken to approve the transaction and applicable law requires (or the senior lawyers recommend) that shareholders be given detailed information about the sale prior to voting on it. A registration statement is required where the buyer issues securities in the acquisition and there is no available securities law exemption for the sale. See Chapter 13, “Issuing Securities: The Basics,” and Section 5, “U.S. Securities Law.”

10. Seller’s counsel is usually assigned to obtain waivers and consents related to existing contracts of the company being sold. Buyer’s counsel also usually keeps a list of required contracted consents, many of which appear as “conditions to closing” the transaction in the acquisition agreement. Buyer’s counsel will normally communicate with seller’s counsel during the period between signing and closing to monitor the progress of collecting these consents, and seller’s counsel normally provides copies of the consents as they are collected. Consents are necessary because many contracts have “change of control” provisions that may require notification and/or cause termination of the contract where one of the parties to it is acquired by a third party. Obtaining the waiver letters is not analytically complex, but it is important. You must organize your effort and be persistent. Consents can be hard to obtain. You do not, however, want to be in the position of needing to tell the senior lawyer, “You know that consent we need? Well, no one from the company returned my calls or e-mails.” Occasionally, people from whom you attempt to solicit consents will be totally nonresponsive. If this happens, identify it as a problem to senior lawyers as early as possible.
Collecting consents usually involves:

- Preparing a form waiver or consent letter that should identify the clause in which the “change of control” provision lies in each different contract (ask your supervising lawyer for an appropriate form and consider with your supervising lawyer whether you should show your form to the buyer’s counsel to get their approval before sending it to the parties from whom waivers of consents are to be solicited);

- Sending the waiver or consent to those of the sellers’ vendors and customers entitled to notice or termination under their contract with the seller together with a cover letter from the seller asking them to sign it (lawyers’ letters are less effective because they tend to intimidate people);

- Following up the mailing with phone calls (in which you are unfailingly courteous, no matter how frustrated you may be); and

- Keeping a log of which waivers have been received. If required waivers and consents are not obtained, closing of the transaction can be delayed (or even cause the transaction not to close at all). So keep senior lawyers aware of your progress.