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Structuring US Mergers and Acquisitions

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There are some promising signs that merger and acquisition (M&A) activity involving US companies could be picking up after the drop-off of activity we saw over the last few years. However, the trends the US M&A market saw during the downturn are likely to continue in this cautiously optimistic market. These include:

- As share prices fell, publicly traded companies seeking expansion through US acquisitions were often restricted to using cash, instead of equity, as deal currency, and, even if it were available, many vendors were much more wary of taking equity.
- As market values "stabilized," 1998's "mega-deals" became today's "middle-market deals."
- Prospective buyers are more cautious, time frames from start to completion are increasing, and buyers will use increased due diligence periods to re-negotiate price for any issues that arise.
- Many companies are increasing their focus on "core products and services" and often look to dispositions of non-core sectors as a source of funds for increased investment in the core businesses and for reduction of debt.

Choice of Deal Structure

In line with these more "careful and deliberate" times, the choice of deal structure for a US acquisition or disposition becomes of even more critical concern to the relevant constituencies: buyer, seller, shareholders, and lenders. Should the US deal be an asset sale, a stock sale, or a merger? A stock sale with an Internal Revenue Code Section 338(h)(10) election? A forward triangular or a reverse triangular cash or stock merger? The choice of US deal structure usually impacts buyer and vendor differently (and may well impact deal pricing), so deal structure negotiations are best handled at the earliest stages.

In the "typical" US middle-market M&A deal, there are three main factors driving the choice of deal structure:

- US Tax Considerations
- Allocation of Liabilities
- Consents

US Tax Considerations

Tax considerations are often the most significant factor in determining M&A deal structure. While perhaps not intuitively a commercial issue, the real monetary implications of how an M&A deal is structured make this a focus for any company considering an M&A transaction. The choice of deal structure for an acquisition or disposition involving US taxpayers – whether individual shareholders or corporate taxpayers – will impact how the aggregate US tax burden attributable to the deal is allocated among the various participants. Since that tax burden, in dollar terms, can often represent a material portion of the overall deal consideration, the choice of structure may also influence deal pricing. The various types of typical US M&A structures can be put into three main categories for purposes of US tax planning:

- Taxable Transactions
- "Tax-Free" Transactions
- Hybrid Transactions

In a taxable transaction, the buyer purchases the shares or assets of the target, typically for cash or debt, and the target and possibly the target shareholders will realize US taxable gain or loss on the transaction. Often, an asset transaction is preferred by a US buyer, as it will allow for a favorable "step-up" in the target's basis in its assets for tax purposes. However, the US tax laws do allow the parties in certain stock transactions to elect to have that transaction treated as an asset purchase for US tax purposes - this election is often referred to as a "Section 338(h)(10) election." Another example of a US "taxable transaction" structure includes a merger where cash is paid to the target's stockholders. Such a transaction can take the form of a straight merger of the target into the buyer, a "forward subsidiary cash merger" (where the target merges into a subsidiary of the buyer) or a "reverse subsidiary cash merger" (where a buyer subsidiary merges into the target). If assets are not purchased or no Section 338(h)(10) election is made, no "step-up" in the US tax basis of assets will occur. In such a case, the value of the target assets to the buyer would be less because greater US taxes would be due on future company operations due to the lower tax basis.

Though normally referred to as "tax-free" transactions or "tax-free reorganizations," the second category of transaction may be most appropriately described as "tax deferred." These transactions must be structured consistently with very specific US tax requirements to achieve the desired tax treatment. In such a transaction, generally, the buyer acquires shares or assets of the target in exchange for stock in the buyer or its parent company either in a fairly straightforward purchase of assets or stock for stock, or a variety of mergers consistent with specific tax code provisions (a straight merger of the target into the buyer; a "forward triangular merger" where the target is merged into the buyer's subsidiary; or a "reverse triangular merger" where the buyer's subsidiary is merged into the target). In these instances, the transaction is a "tax-free exchange" generally resulting in no immediate US gain or loss to the target or its shareholders, subject to the discussion of "hybrid transactions" below. Instead, the shareholders "carry over" their basis in their old stock to the new stock and realize US taxable gain or loss only on a taxable disposition of the new shares. Such gain will generally constitute long-term capital gain if the shareholder's holding period for the new shares (which generally includes such shareholder's holding period in its old target shares) is more than one year. The US tax attributes of the target (including the tax basis of assets) generally remain unaffected, subject to certain limitations depending upon the circumstances of the transaction (e.g., where there has been a more than 50% change in the direct or indirect ownership of the target over a certain testing period).

"Hybrid" transactions are those that are tax-free reorganizations but that also involve a certain amount of non-qualified deal consideration (generally, non-stock consideration such as cash or debt instruments, although certain types of "debt-like" preferred stock are denied tax-free treatment). As a result the transaction may be taxable under US tax laws as to certain participants in the transaction and not to others. A hybrid transaction may offer flexibility in deal structuring where, for example, some of the participants receiving consideration are willing to incur US tax upon deal completion, and others need to defer the taxable event until a later time. Most often, non-US companies establish US subsidiaries to avail themselves of these tax-favored structures for a US M&A transaction - in other words, there would normally be US taxpayers (corporate or individual) on both sides of the transaction. The presence of a non-US taxpayer as a primary party to the transaction, or the use of non-US securities as deal currency, may add additional restrictions or limitations on the availability of US tax-favored deal structures. Tax considerations arising from other countries' tax laws, or from tax treaties between the US and other relevant countries, will also impact the M&A tax planning.

Allocation of Liabilities

All else being equal, from an "allocation of liabilities" standpoint, a buyer of a US target company will prefer an asset deal. In an asset deal, a buyer can assume specific liabilities (either identified generally by category or specifically by creditor and/or amount), leaving the unassumed liabilities behind in the target. The seller, of course, will usually prefer a stock deal because, where the buyer purchases the equity of the target, the liabilities of the target remain unaffected by that purchase and "go with" the sale. A seller will often argue that a buyer should be neutral on this issue, both because appropriate purchase price adjustments can be made up front for known liabilities and also because the seller, in either a stock or asset deal, can provide representations, warranties and indemnities with respect to unknown liabilities. The utility of this approach rests heavily on the credit-worthiness, going forward, of the seller – a risk that many buyers resist taking on (at least on an unsecured basis).

Consents

It is fairly common for US contracts to prohibit assignment of the contract without the consent of the parties. However, contracts prohibiting direct assignment are sometimes silent on whether a "change in control" of a contract party is prohibited. Thus, unless state law otherwise dictates, the number of consents from a target's contractual relationships may be less burdensome under a stock as opposed to an asset transaction. While US regulatory and governmental approvals are less likely to depend on whether an M&A deal is structured as a stock or asset deal, the tests, thresholds or standards for compliance with applicable filings or approvals may be impacted by the choice.

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