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STRUCTURING MERGERS AND ACQUISITIONS

Asset Purchase versus Stock Purchase

While two companies may be excited by the possibility of joining resources through a corporate merger or acquisition, the feasibility of such a business venture depends entirely on the legal structure that the transaction takes. The company who is "selling" and the company who is "buying" generally have competing interests and thus different perspectives on how to structure the transaction. The challenge becomes arriving at a deal structure that resolves these competing interests. To assist both purchasers and sellers of companies, the following explains some of the differences between an asset purchase and a stock purchase.

STRUCTURES DESCRIBED

In an *asset purchase*, the Purchaser buys only operating assets and goodwill of the Target Company. The Target Company remains in existence, owned by the Seller (the Target's shareholders) with its primary assets being the "consideration" received from the Purchaser. The Purchaser pays the purchase price to the Target Company, who then distributes it as income to the Seller's shareholders.

Steps:

1. Purchaser pays consideration to Target Company.
2. Target Company sells assets to Purchaser.
3. Target Company distributes income to the Seller, which is usually its shareholders.

In a *stock purchase,* the Purchaser buys the stock of the Target Company directly from individual shareholders. The legal and corporate status of the Target Company remains the same after the transaction except that the stock of the Target Company is owned by the Purchaser. The consideration is paid directly to the shareholders.

Steps:

1. Purchaser pays consideration to Seller.
2. Seller transfers stock to Purchaser.

ADVANTAGES OF ASSET PURCHASE TO PURCHASER

1. The Purchaser can pick and choose the assets it buys.
2. The Purchaser is generally not liable for any of the Target Company's liabilities except for those that are expressly assumed.
3. The Purchaser generally avoids contingent and unknown liabilities of the Target Company.
4. Depending on how the purchase price is allocated, the Purchaser generally gets a "stepped up" tax basis on the assets which can result in depreciation and amortization tax deductions down the road.

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Asset Purchase versus Stock Purchase

DISADVANTAGES OF ASSET PURCHASE TO THE PURCHASER

1. The transaction can be complex, time consuming, expensive and cumbersome, particularly for small closely held companies, because title to each of the assets must be transferred.

2. The Purchaser typically pays state and local sales tax and/or bulk sales tax on the purchase price.

3. Consents and assignments from third parties are required for each third party services agreement, contract, or lease, which can take considerable time, particularly if the parties to such agreements contest assignment or seek additional consideration for its trouble.

4. Assignment of registered patents and trademarks can sometimes be difficult and requires filing and approval with the US Patent & Trademark Office.

5. The liability avoidance is not clear cut. Successor liability under Superfund can still apply. Unpaid creditors of the Target can sometimes assert claims directly against the Purchaser (stock paid for consideration, or payments made directly to shareholders).

6. Corporate formalities must be followed (approval of BOD of Purchaser and approval of BOD and Shareholders of Target).

7. Purchaser does not receive Seller's tax attributes such as any Net Operating Loss (NOL) carryovers.

DISADVANTAGES OF ASSET PURCHASE TO THE SELLER

1. Transaction is complex and time consuming because every asset needs to be separately transferred.
2. Consents and assignments from third parties are required.

3. Seller remains responsible for liabilities that are not expressly transferred, including contingent and unknown liabilities.

4. Seller generally incurs a "double tax" on the transaction—one at the corporate level (if a C-Corporation) and then again when the consideration is distributed to the Seller (shareholders).

5. A significant amount of the tax paid by the Seller can be ordinary income as opposed to capital gains.

ADVANTAGES OF STOCK PURCHASE TO THE PURCHASER

1. Speed and simplicity, especially with small closely held companies with few shareholders.

2. No transfers of title to assets required.

3. Generally few third party consents required (but still need to review contracts for change in control provisions).

4. No shareholder meetings or votes required, at least from Seller.

5. Generally, no state and local sales taxes or bulk sales taxes are applicable.

6. Purchaser may be able to take advantage of Seller's tax attributes such as NOL carryovers.

7. May be able to retain favorable insurance and employment ratings if Target maintained.

8. Less disruption with clients and employees.

ADVANTAGES OF ASSET PURCHASE TO THE SELLER

1. Seller may retain cash in the Target, certain accounts, and A/Rs as part of the deal.
2. Generally the consideration paid is in cash or cash equivalents.
3. Seller can continue operation of Target and maintain tax attributes of Target.

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DISADVANTAGES OF STOCK PURCHASE TO PURCHASER

1. Purchaser assumes all liabilities of the Target, including contingent and unknown future liabilities (can transfer certain liabilities to Seller by agreement, but ultimate end point is Purchaser).

2. Purchaser does not get a "stepped up" basis on the assets of Target.

3. Purchaser cannot pick and choose the assets to be acquired.

4. Purchaser may get lulled into "ease" of the transaction and fail to perform adequate due diligence; due diligence into potential liabilities is particularly important.

ADVANTAGES OF STOCK PURCHASE TO THE SELLER

1. Speed and simplicity: the Sellers simply sell their stock certificates to the Purchaser.

2. Board and Shareholder approval not required.

3. Seller gets capital gains treatment on the sale.

4. Seller is not liable for the liabilities of the Target (contingent, unknown or otherwise), except as expressly assumed in the agreement.

5. Seller only incurs one level of tax as the transaction is between the Purchaser and the Seller (shareholders) directly.

6. No third party consents required.

7. Less disruption in the business.

DISADVANTAGES OF STOCK PURCHASE TO THE SELLER

1. Since the transaction involves a sale of securities, SEC compliance is necessary (generally exemptions apply).

2. Generally less cash consideration involved.

3. Seller does not retain tax attributes of Target.

4. Seller has no continuing operation in Target, except as expressly provided in contract.

DEAL CONSIDERATIONS

"Tax Free" Structures

You can structure the transaction to be "tax free" under Section 386 of the IRC:

(1) Type A Reorganization—Target merges into Purchaser and Target shareholders receive Purchaser stock for consideration. (40-50% of consideration must be in stock to meet "continuity of interest" requirement).

(2) Type B Reorganization—Target exchanges its stock for stock of Purchaser (must be voting stock).

(3) Type C Reorganization—Target sells substantially all of its assets for voting stock of Purchaser (at least 80% of purchase price must be in stock).

(4) Forward and Reverse Triangular Mergers (Involving subsidiaries of Purchaser and/or Seller).

Other Issues

In a stock transaction, it is advisable to include "hold backs" or off sets on promissory notes to account

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the sales tax component with the stepped up basis when allocating the purchase price.

In a stock transaction, sometimes it makes sense to allow the key shareholder of the Target to continue to maintain stock in the Target after the transaction.

Due diligence will be different for a stock transaction versus an asset transaction.

Both types of transactions will require extensive representations and warranties from the Seller.

SUMMARY

For a transaction involving a closely-held corporation that has not been in business long and has few shareholders, it usually makes sense to take the simple approach and structure a stock purchase. It is important to understand, however, that the Purchaser will be acquiring whatever liabilities this company has, so due diligence becomes critical.

In addition, understand the tax consequences of the different structures may lead you to change structures when negotiating a final deal. For example, you may start negotiating for an asset purchase, but subsequently determine that the liabilities are insignificant. This may lead to a change to a stock purchase which may lower the price but increase the net benefits to the Sellers.

Finally, each deal is different, and there may be certain factors that drive the structure of the deal. Therefore, it is important that you remain flexible so that you arrive at the best structure in the end.

For further questions, feel free to give David Eckberg at

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