ACQUIRING A PRIVATELY-HELD COMPANY: BASIC STRUCTURING ISSUES

Margaret A. Davenport

ACQUIRING A PRIVATELY-HELD COMPANY
BASIC STRUCTURING ISSUES

Margaret A. Davenport
DEBEVOISE & PLIMPTON

1. **Introduction** There are three principal ways to structure an acquisition of a privately-held company: a stock purchase, an asset purchase and a merger. There are many considerations as to which structure to use in any given transaction but, at a minimum, the parties will want to consider stockholder approval requirements, the number and nature of third party consents and governmental approvals that will be required, the tax treatment of the parties and the effect the structure will have on the allocation of the liabilities of the target company. This outline briefly discusses each of these considerations.

2. **Stock Purchase**

   a. **Basic Structure.** Each stockholder of the target company signs a stock purchase agreement with the Buyer, agreeing to transfer his or her shares of the target company to the Buyer. At the closing, the target company becomes a wholly-owned subsidiary of the Buyer.

   b. **Stockholder Approval.** There is effectively a 100% stockholder approval requirement because each stockholder of the target company must sign a stock purchase agreement so that the Buyer will capture all of the target company's shares. If the target company has many stockholders, obtaining the signature of each stockholder may be impracticable or even impossible. Alternatively, the transaction can be structured as a merger, which almost always enables a buyer to acquire all of the target company's shares without the consent of all of

---

1. This outline does not address, and the parties should also consider, any applicable industry regulations or local law issues, the impact of the proposed structure on the target company's employee benefit plans and agreements and the accounting consequences of the proposed structure.
the target company's stockholders (although the target company stockholders will generally have appraisal rights under applicable state law).

c. **Third Party Consent and Governmental Approvals.** While a stock transaction results in the target company having a new owner, it does not result in any assignment of the target company's contracts. Accordingly, consents will only be required under any target company contracts which require consent for a "change of control." Change of control consents may also be required from governmental authorities with respect to permits and licenses of the target company. In general, however, change of control restrictions are less common than assignment restrictions and as a result, a stock purchase will be have a cleaner profile from a consent perspective than an asset purchase.

d. **Tax Treatment.** The tax treatment of a stock purchase generally favors the Seller.

   i. **Buyer:** The target's assets will retain their same tax basis after the closing of the transaction (referred to as "carryover basis"), unless a 338 election is made. Section 338 treats the transaction, for tax purposes, as an asset sale.

   ii. **Seller:** There is no tax paid by the target as a result of the transaction. Taxable gain is recognized by the selling stockholders.

e. **Allocation of Liabilities.** The risk of all target company liabilities remains with the target company and, therefore, as an economic matter, is shifted to the Buyer as of closing. This risk can be shifted back to the Seller to the extent of any indemnification provisions in the Stock Purchase Agreement,

---

2. This outline assumes the acquirer and the target are taxable U.S. corporations. There would be different tax considerations if either were an S corporation, an LLC or limited partnership, or a foreign entity.
or in the event that the Stock Purchase Agreement does not have indemnification provisions, to the extent that any representations and warranties made by the Seller in the Stock Purchase Agreement survive the closing of the transaction.

3. **Asset Purchase**

a. **Basic Structure.** The target company signs an asset purchase agreement with the Buyer agreeing to transfer specified assets and liabilities to the Buyer or more typically, a newly-formed subsidiary of the Buyer. (This structure is particularly useful where the Seller is selling a division or a part of a business which is not incorporated independently.) Many of the target company’s assets will have to be transferred at closing pursuant to particular types of conveyance documents - e.g., a form of intellectual property assignment which is recordable in the case of registered intellectual property or a real property deed in the case of owned real property.

b. **Stockholder Approval.** The approval of a specified percentage of the target company’s stockholders will be required under applicable state law (e.g., majority under Delaware law (§271)). Higher requirements may be imposed, however, by the target company’s certificate of incorporation, by-laws or stockholder agreement(s).

c. **Third Party Consents.** Because an asset transaction results in a transfer of specific assets and liabilities from a target company to the Buyer, consents will be required under any target company contracts which require consent for "assignment." This is a typical provision in most business contracts and, as a result, it is often impractical to structure a transaction as an asset purchase. It may be that too many third parties would have to be contacted to obtain the requisite consents. Or it may be prohibitively expensive, if not impossible, to obtain the consent of the parties to especially valuable target company contracts. In addition, most governmental permits and licenses are not assignable unilaterally. Consequently, consents will need to be obtained
from the relevant governmental authorities or new permits or new licenses will have to be issued in the name of the Buyer.

d. **Tax Treatment.** The tax treatment of an asset purchase generally favors the Buyer.

i. **Buyer:** The tax basis of the target’s assets is increased at closing to the purchase price paid by the Buyer (referred to as a "step-up in basis").

ii. **Seller:** In general, the selling company will recognize tax as a result of the transaction and, if the proceeds are distributed to shareholders, the shareholders will recognize taxable gain also. (If the target company is a member of a consolidated group, however, the liquidation of the target company into its parent after an asset sale is not taxable.)

e. **Allocation of Liabilities.** The Seller and the Buyer will negotiate which liabilities the Buyer will assume. This can be complex and time-consuming, but is also the most effective structuring tool for the Buyer to insulate itself from unwanted liabilities of the target company. As a matter of law and assuming compliance with any applicable "bulk sales" laws, the Buyer will be liable only for those liabilities which it expressly assumes pursuant to the asset purchase agreement (except under theories of successor liability). As with a stock purchase, however, the risk of such assumed liabilities can be shifted back to the Seller to the extent of any indemnification provisions or surviving representations and warranties in the asset purchase agreement.

4. **Mergers**

a. **Basic Structure.** The target company signs a merger agreement with the Buyer agreeing that the target company will merge with the Buyer, or more typically, a newly formed subsidiary of the Buyer (often referred to as the "merger sub" or the "acquisition sub"). At the closing, the target company becomes a subsidiary of the Buyer by virtue of the merger. The merger agreement will provide that either the target company or the merger sub will
disappear and the other company will become the "surviving corporation." If the transaction is structured so that the target company is the surviving corporation, it is commonly referred to as a "reverse merger". If the merger sub is the surviving corporation, it is commonly referred to as a "forward merger". For both corporate and tax reasons, the reverse merger is far more common in practice.

b. **Stockholder Approval.** The approval of the target company stockholders is required. The approval requirement is dictated by state corporate law (e.g., majority under Delaware law). Higher requirements may be imposed, however, by the target company’s certificate of incorporation, by-laws or stockholders agreement(s).

c. **Third Party Consents.**

i. If the transaction is structured as a reverse merger (i.e., the target company survives the merger), the transaction is usually analyzed like a stock purchase.

ii. If the transaction is structured as a forward merger (i.e., the merger sub survives), the transaction is usually analyzed like an asset purchase.

d. **Tax Treatment.**

i. **Buyer:**

   Reverse: Treated like a stock purchase.

   Forward: Treated like an asset purchase.

ii. **Seller:**

   Reverse: Treated like a stock purchase (unless the Buyer receives at least 80% of the consideration in the form of voting stock of the Buyer, in which case gain on that stock will be deferred until sale).

   Forward: Treated like an asset purchase (unless the Buyer receives at least 40-50% of the consideration in the
form of stock of the Buyer, in which case gain on that stock will be deferred until sale).

e. **Allocation of Liabilities.** Assuming a merger sub is utilized, same analysis as stock purchase. Note that if the target company is merged directly into the Buyer, the Buyer becomes liable for all of the target company's liabilities as a matter of law. This is one of the reasons why it is more common for the target company to merge with a subsidiary of the Buyer.

f. **Merger Structures.**

---


diagram showing before and after structures in a merger process.

---

230