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Business Mergers

In this article I discuss business mergers, from a legal perspective. Without further adieu:

Legal Structure of the Merger. There are a number of possible legal structures for a merger, but usually the choice is either the classic merger or the newco merger. You choose based on the facts of your merger.

Classic Merger. Here you merge Corp 1 into Corp 2. Corp 2 is the surviving corporation. Corp 2 takes the assets of both Corps 1 and 2, and it carries on their combined operations. Corp 1 dissolves not long after the merger. The shareholders of Corps 1 and 2 divide up ownership of Corp 2. [Corp = corporation or LLC]

Corp 2 inherits all contracts and liabilities of Corp 1 and keeps its own old contracts and liabilities. This creates risk for each merger side that it takes on the unknown liabilities of the other. The parties mitigate the risk through pre-merger due diligence on Corps 1 and 2. The shareholders of Corp 1 also indemnify the shareholders of Corp 2 for pre-merger liabilities, and vice-versa.

The IRS treats a classic merger as a tax-free reorganization, which is good. Regarding valuable contracts (e.g. contracts with clients), Corp 2 automatically takes over the contracts without need for the consent of the other contracting party. Note: look for “buy on sale” clauses in certain contracts, e.g. leases and loan documents – you might need the landlord’s or bank’s consent for these contracts.

Newco Merger. The alternative to a classic merger is to start a new company, called Corp 3 (aka Newco). Corps 1 and 2 transfer their assets (but not their receivables or liabilities) to Corp 3. This transfer can be direct to Corp 3 or via an intermediary distribution to the shareholders, who then contribute the assets to Corp 3. The shareholders contribute cash to Corp 3 to cover its startup period until post-merger receipts come in. The shareholders divide up ownership in Corp 3.

The primary benefit of the Newco is limited liability. Corps 1 and 2 dissolve, giving Corp 3 and the shareholders an argument that old liabilities died with the old Corps. These liabilities might include, for example, bad contracts, tax audits, employment law claims, etc. If this argument holds, the shareholders of Corps 1 and 2 can feel safe that the new venture doesn’t take on old liabilities, including the liabilities of the other Corp to the merger. This limited liability benefit is not full-proof, however, and the creditors have a counter-argument. The creditors can sue Corp 3 for liabilities of Corps 1 and 2 on grounds that Corp 3 is the successor to Corps 1 and 2. The facts of the merger will tell you the strength of the creditors' argument.

As for taxes, the IRS can characterize as a taxable sale the transfer to Corp 3 of assets out of old Corps 1 and 2. This can be painful. Corps 1 and 2 also must assign their client contracts and other valuable contracts to Corp 3, which can be painful depending on the number and nature of the contracts.

Contributions to Ownership. The hardest part of a merger is figuring out how the shareholders of Corps 1 and 2 divide up ownership of the new, merged business. In any merger, expect to spend a majority of the negotiation on this problem.

The problem is accounting for differences in value between Corp 1 and 2 so that you divide ownership of the new business in a fair way. It's rare that Corps 1 and 2 are so equal in value that shareholdings translate directly across from the old to the new. One way to solve this dilemma is to put a dollar value on all assets to be contributed to the new business, and base new shareholder percentages directly on the dollar values. The parties can use cash to equal out the asset values / shareholder percentages.

Exit Clause. Sometimes a party to a merger wants an exit clause in case the merger isn't working out, usually within the first year. With the exit, the party receives the return of its assets, plus customer lists, phone numbers, office leases, staff, equipment, and corporate name and entity. Note that items acquired jointly (post-merger) need a special mechanism to ensure a buy-out at fair value.

Miscellaneous Issues. Some additional issues to consider in the merger:

- How to divide corporate control, including membership on the board of directors, veto rights and super-majority votes.
- How to set the formula for compensation of the shareholders, including salary.
- Drafting a Buy-Sell Agreement for the shareholders.
- Transferring insurance from the old corps to the new business.
- Transferring licenses to the new business.

I hope this article helps you. Call me if you want to talk more.

PJ O'Rourke:

- Children must be considered in a divorce valuable pawns in the nasty legal and financial contest that is about to ensue.
- If you spend 72 hours in a place you've never been, talking to people whose language you don't speak about social, political, and economic complexities you don't understand, and you come back as the world's biggest know-it-all, you're a reporter.

Freeman Dyson:

We gain knowledge of our place in the universe not only from science but also from history, art, and literature. Science is a creative interaction of observation with imagination. Hermann Weyl, who was one of the main architects of the relativity and quantum revolutions, said to me once, "I always try to combine the true with the beautiful, but when I have to choose one or the other, I usually choose the beautiful."