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FUNDAMENTAL TRANSACTIONS: MERGERS AND ACQUISITIONS

12.1 INTRODUCTION

Among the most important transactions in corporate law are those that pool the assets of separate companies into either a single entity or a dyad of a parent company and a wholly owned subsidiary (which is practically the same thing, only better). There are three legal forms for such transactions: the merger, the purchase (or sale) of all assets, and — in MBCA jurisdictions — the compulsory share exchange. A merger is a legal event that unites two existing corporations with a public filing of a certificate of merger, usually with shareholder approval. In the classic form, the so-called statutory merger, one of the two companies absorbs the other and is termed the "surviving corporation."[1] This company subsequently owns all of the property and assumes all of the obligations of both parties to the merger. An MBCA share exchange, as we describe below, closely resembles certain kinds of mergers in its legal effects. Finally, "acquisitions" comprise a generic class of "non-merger" techniques for combining companies under one management, which generally involve the purchase of either the assets or the shares of one firm by another. Following an acquisition, the acquiring corporation may or may not assume liability for the obligations of the acquired corporation, as we discuss below.

Mergers and acquisitions by public companies (M&A transactions) are among the most complex of business transactions. They implicate diverse legal questions[2] and profoundly alter the characteristics of shareholder investments. In this Chapter, we first examine economic motives for M&A transactions and then turn to specific protections that the law accords shareholders in these transactions. In particular, M&A transactions provide a useful platform

1. A merger in which both parties disappear and are survived by a new third corporation is technically called a consolidation. See, e.g., DGCL §251(a).

2. Even the simplest M&A transaction involving public companies typically raises issues of securities law, tax law, compensation law, and quite possibly competition law, in addition to corporate law, of course. See Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions and Buyouts (2006).

for revisiting two fundamental questions of policy in corporate law: the role of shareholders in checking the board's discretion and the role of fiduciary duty in checking the power of controlling shareholders.

12.2 ECONOMIC MOTIVES FOR MERGERS

Like other legal forms of enterprise, the corporate form partitions business assets into discrete pools managed by particular management teams.[3] There is, however, no guarantee that an initial match among assets and managers continues to be the most productive match in a continuously changing economy. The law of M&A transactions provides (relatively) quick and inexpensive ways to reform the partitioning and management of corporate assets. We begin by surveying motives, value-increasing or not, for combining corporate assets.

12.2.1 Integration as a Source of Value

Gains from merging corporate assets arise from what economists term economies of "scale," "scope," and "vertical integration." Economies of scale result when a fixed cost of production — such as the investment in a factory — is spread over a larger output, thereby reducing the average fixed cost per unit of output. Consider two companies, each with a widget factory that operates at half capacity. If these companies merge, the "surviving" company might be able to meet the combined demand for widgets at a much lower cost by closing down one of its two factories and operating the other at full capacity. This source of efficiency often explains so-called "horizontal mergers" between firms in the same industry.

"Economies of scope" provide a similar source of efficiency gains. Here mergers reduce costs not by increasing the scale of production but instead by bundling together a broader range of related business activities. A typical example might be a merger between our widget manufacturer and a major supplier of raw materials that ensures an uninterrupted flow of raw materials of precisely the right quality that minimizes manufacturing costs.[4] Another example might be the widget maker's merger with another company that produces a product often used with widgets and that can be efficiently marketed through the widget maker's sales force. In theory, at least, even a merger

3. See our discussion of asset partitioning in Chapter 2.

4. This example illustrates "vertical integration," a special form of economies of scope, which may sometimes arise by merging a company backward, toward its suppliers, or forward, toward its customers. Buying a component on the market has advantages, but so, too, does buying the factory that makes the component. Contracting through the market can be expensive if the component is highly specialized. Moreover, even if a supplier is found, it may behave opportunistically once it determines that its customer has no good substitutes and is therefore dependent on it. Thus, if the component is very important, it may be cheaper in the long term to acquire the supplier through a merger than it would be to buy its product. See

between the widget maker and the manufacturer of a very different product might be said to bring economies of scope if it extends the underutilized talents of the widget maker's management team to a second line of products.[5]

12.2.2 Other Sources of Value in Acquisitions: Tax, Agency Costs, and Diversification

Apart from integration gains, M&A transactions are often said to generate value for at least three other reasons, relating to tax, agency costs, and diversification. Consider tax first. Corporations with tax losses (i.e., deductible expenses greater than income during the tax year) may set those losses off against income in subsequent years for up to 20 years. This ability to carry a net operating loss (NOL) forward is itself a valuable asset — but only if its owner has sufficient taxable income to absorb it. Since an NOL cannot be sold directly, a corporation that lacks sufficient income might prefer to find a wealthy merger partner rather than waste its NOL. In this transaction, the shareholders of the NOL's owner and its merger partner would implicitly share the NOL's present value.[6]

A very different economic motive for M&A transactions is the replacement of an underperforming management team that has depressed the company's stock price. As a company's stock price declines because the market anticipates

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generally F.M. Scherer & David Ross, Industrial Market Structures and Economic Performance (3d ed. 1990). Professors Brealey and Myers, the finance mavens, offer the following illustration of how integration through ownership can increase efficiency. Suppose that airlines rented their planes on short-term leases but owned their brand names, operated airport gates, advertised, sold tickets, etc. The administrative cost of matching the supply of rented planes with the published schedule of flights would be enormous. Intuitively, any airline that switched to either owning its own planes or leasing them for long periods (which is economically quite similar) could realize huge savings. Thus, we would expect airlines to move to vertical integration — either owning or leasing the vital aircraft input for long periods. Nevertheless, a good thing can be overdone. Professors Brealey and Myers also note that, in the late 1980s, the Polish State Airline owned not only its own planes but also its own hog farms to supply meat to its customers and employees. See Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance (7th ed. 2003).

5. Thus, a management team with superior "general management" skills could attempt to wring added value from its skills by expanding the asset base over which it exercises its judgment. Something like this idea was a popular rationale for mergers during the "conglomerate merger" movement of the 1960s. Those mergers, however, did not generally prove to be efficient. See, e.g., Ronald W. Melichner & David F. Rush, *The Performance of Conglomerate Firms: Recent Risk and Return Experience*, 28 J. Fin. 381 (1973); David J. Ravenscraft & F.M. Scherer, Mergers, Sell-Offs and Economic Efficiency (1987). Indeed, many commentators believe that the "bust-up" takeover movement of the 1980s was largely about the unwinding of these inefficient mergers of two decades before. See, e.g., Andrei Shleifer & Robert W. Vishny, *The Takeover Wave of the 1980s*, 249 Sci. 745 (Aug. 17, 1990).

6. See Ginsburg & Levin, *supra* note 2, at ch. 12. The Internal Revenue Service not only bars the sale of NOLs but also disallows their deduction if the merger appears to have been structured solely to capture their value. Thus, the surviving company in a tax-driven merger must generally continue to operate the assets acquired from the NOL's owner, at least for a period of time.

that its incumbent managers will mismanage *in the future*, it becomes more likely that an outside buyer can profit by purchasing a controlling block of stock and replacing the incumbent managers.[7] Of course, acquiring a controlling block of stock, by means of a tender offer or otherwise, is usually enough to displace the target company's managers. The point is not merely to depose bad managers, however, but also to realize the maximum economic returns from doing so. Realizing maximum returns will generally require that the target company merge with a subsidiary of the acquiring company.

In the 1980s, most transactions to displace underperforming managers appear to have been hostile. As we discuss in Chapter 13, an acquirer would first bid for a controlling block of stock in a public tender offer and then, when successful, would arrange for a merger to cash out minority shareholders. Once in control, the acquirer would be free to discipline or fire management. Although hostile takeovers have been less common in recent years, the desire to improve management may also motivate friendly acquisitions. Why would poorly performing managers leave if they were not forced to do so? The answer is money, of course. As a matter of fact, poor managers (or good managers) can be bought off as part of the premium that a new investor must pay to acquire the corporation's assets. One device for sharing takeover premia with managers is the "golden parachute" contract, which provides senior managers with a generous payment upon certain triggering events, typically a change in the ownership of a controlling interest in the corporation or a change in the membership of its board. A second compensation technique is a term in a grant of restricted stock or options that allows them to vest immediately upon a change in control when they would otherwise vest over a four- to six-year period.[8]

Yet a third way in which M&A transactions are sometimes said to increase corporate value is by diversifying a company's business projects, thus smoothing corporate earnings over the business cycle. For example, the managers of an air conditioner company might wish to merge with a snow-blower company to ensure stable year-round earnings. Just why this sort of merger should increase the value of corporate assets is unclear, since investors can "smooth" corporate earnings at less cost merely by diversifying their *own* investment portfolios. Nevertheless, such "smoothing" is frequently offered as a rationale for mergers. The reason may be that such mergers simply make life more comfortable for managers,[9] or it may be that they actually can increase company value for some reason as yet undiscovered by financial economists.[10]

7. See Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 Colum. L. Rev. 891 (1981).

8. Single trigger vestings — here, the change in control term — are increasingly viewed with some suspicion. What might be a source of shareholder concern in the example of the control trigger?

9. See Yakov Amihud & Baruch Lev, *Risk Reduces Managerial Motive for Conglomerate Mergers*, 12 Bell J. Econ. 605 (1981).

10. See Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions 312-357 (2d ed. 1995). Wholly apart from smoothing earnings, product diversification can add efficiency by combining complementary assets, as when an acquirer can use its

12.2.3 Suspect Motives for Mergers

The discussion thus far has emphasized positive or neutral motives for mergers that increase the value of corporate assets without making anyone else worse off (except the government in tax-driven deals). There are, however, also opportunistic motives to enter mergers that increase shareholder value or management compensation at the expense of another corporate constituency. One example is a squeeze-out merger, in which a controlling shareholder acquires all of a company's assets at a low price, at the expense of its minority shareholders. Another form of opportunistic merger is one that creates market power in a particular product market, and thus allows the post-merger entity to charge monopoly prices for its output. (Of course, the government also attempts to block anticompetitive mergers under the elaborate federal framework of antitrust statutes.[11])

In addition to opportunistic M&A transactions, there is a last class of mergers that destroy value, perhaps even more so than opportunistic mergers. These are "mistaken" mergers that occur because their planners misjudge the difficulties of realizing merger economies. Common errors of judgment include underestimating the costs of overcoming disparate firm cultures; neglecting intangible costs, such as the labor difficulties that might follow wholesale layoffs; and failing to anticipate the added coordination costs that result merely from increasing the size of a business organization.[12] Finally, we note that some mergers are motivated not so much by a vision of making the acquirer more efficient, but to prevent its competitor from achieving some competitive advantage. We see this, for example, in consolidating industries, in which it seems important to each management team to achieve sufficient size to be among the last firms standing. Whether such mergers are efficient

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distribution channels to sell a target's products. A merger between a snow blower company and an air conditioner company makes good sense if the combined firm can use shared physical facilities or the same trained workers. Economies of scope such as these do increase the real value of the target's assets, and thus the value of the surviving corporation's stock.

11. See Phillip Areeda & Donald F. Turner, Antitrust Law, 5 vols. (1978, 1980); Thomas W. Brunner, Mergers in the New Antitrust Era (1985). The Sherman Antitrust Act, the Clayton Act, and the Federal Trade Commission Act are the three most notable such statutes.

12. While there are often advantages to a larger scale, there is also a special burden that large-scale organizations must bear. That burden is reflected in minor part by the costs of determining transfer prices within large firms and, in a more important way, by the imperfections in these transfer prices. Very large firms may lose market information and discipline by assigning internal costs that differ from true market prices. This problem is small where the input has a comparable market price, in which case internal pricing can be based on an actual price. But as the organization grows large and its inputs become specialized, the costs assigned to them grow unreliable. As a result, the firm comes to lack critical information about the relative efficiency of different aspects of its operations. See Ludwig von Mises, Human Action: A Treatise on Economics (1949) and Ludwig von Mises, Socialism: An Economic and Sociological Analysis (1922) (J. Kahane trans., 1951). In addition, large-scale organizations typically require complex compensation schemes to encourage team cooperation and motivate individual performance. Such plans grow increasingly difficult to design and operate as the scale and complexity of the firm increase. Correlatively, smaller firms are better able to monitor worker productivity and create functional incentives.

or not in any particular case cannot be answered categorically, but it does seem like a risky strategy from the investors' perspective.

12.2.4 Do Mergers Create Value?

There is a vast empirical literature on the wealth effects of mergers. While the magnitude of the result varies widely from study to study, the general weight of the evidence indicates that, measured by immediate stock market price reaction to the merger's announcement, on average, mergers do create value.[13] In one frequently cited study, Professors Gregor Andrade, Mark Mitchell, and Erik Stafford examine 3,688 deals over the period 1973-1998 and find an increase in combined (target and acquirer) wealth of 1.8 percent in the window around the announcement of the deal.[14] This value, however, is not evenly distributed: within the short window the studies use to measure gains, targets generally win, while acquirers break even or lose on average. Andrade and colleagues, for example, report that the targets in their sample experienced positive abnormal returns of 16 percent on average, while the acquirers experienced negative abnormal returns of 0.7 percent.[15] (The combined effect is only modestly positive because acquirers are generally much larger than targets.)

Using a more recent M&A sample, a second study by Moeller and colleagues, reports an acceleration in acquirers' losses from acquisition: Between 1998 and 2001, acquiring firm shareholders lost 12 cents at deal announcement for every dollar spent, as compared to a loss of just 1.6 cents per dollar spent during all of the 1980s.[16] The authors note that their results for the 1998–2001 period are driven by a small number of acquisition announcements with extremely large losses. But a still more recent study by Benjamin Bennett and Robert Dam suggests that most M&A event studies understate the gains from mergers.[17] They estimate that 10 percent of a typical firm's stock price reflects the anticipation of being acquired and receiving a premium, in which case pre-merger stock price understates merger gains because it already reflects the expected value of an acquisition. This cameo summary suffices to show that empirical studies of acquisition gains must be interpreted with caution because we do not have data on the counterfactual — what would have happened to their market values had they opted to remain unattached and avoided acquisition activity?

13. For a comprehensive survey of the empirical evidence, see Robert F. Bruner, Applied Mergers and Acquisitions 47-49 (2004) (summarizing the results from 24 studies and concluding that "M&A does pay the investors in the combined buyer and target firms").

14. Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. Econ. Persp. 103, 110 (Table 3) (2001).

15. See id.

16. Sara B. Moeller, Frederick P. Schlingemann & Rene M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. Fin. 757 (2005).

17. Benjamin Bennett & Robert A. Dam, *Merger Activity, Stock Prices, and Measuring Gains from M&A* (August 1, 2019). Available at SSRN: https://ssrn.com/abstract=3000574 or http://dx.doi.org/10.2139/ssrn.3000574.

12.3 The Evolution of the U.S. Corporate Law of Mergers

The history of U.S. merger law is one of constantly loosening constraints, driven by dynamic markets and technological change. It begins in a world without any mergers at all and ends in a world in which mergers can force shareholders to divest all of their stock in a company. The fundamental move in this evolution occurred when the law became willing to treat equity investors as a class of interests that could, except where fiduciary duties were triggered, be adequately protected by majority vote and a right to a statutory appraisal of fair value. For convenience, we can divide the history of merger law into two periods.

12.3.1 When Mergers Were Rare

The first period is the era when mergers were rare, which covers the history of U.S. corporate law until roughly 1890. Until about 1840, corporate charters were acts of the sovereign, in theory and in actuality. Legislatures created business corporations by special acts of incorporation, often to facilitate projects with a public purpose: the construction of canals or railroads, the creation of financial intermediaries (banks and insurance firms), or, more rarely, the establishment of manufacturing enterprises. Shareholders naturally lacked the power to amend these legislative charters, and thus, mergers could not occur except by intervention of state legislatures. Beginning around 1840, however, the enactment of general incorporation statutes permitted shareholders to incorporate on their own initiative with a charter of their own design. But until around 1890, state incorporation law uniformly barred shareholders from amending their charters (which a merger would require) without unanimous consent, in order to protect investors who had contributed funds in reliance on the charter. Thus, in this respect, the mid-nineteenth-century corporate form looked rather like the general partnership form.

12.3.2 The Modern Era

Technological change in the last decades of the nineteenth century increased the efficiency scale of many industries. Nevertheless, mergers could not become an economical way to restructure businesses into larger units as long as they required the unanimous consent of shareholders, which created crippling hold-up problems at the hands of minority shareholders. Thus, toward the end of the nineteenth century, corporation statutes were amended to permit mergers and charter amendments that received less than unanimous shareholder approval, providing that they were recommended by the board and approved by a majority (at first a supermajority) of a company's shareholders. Class vote provisions were sometimes added to assure fairness to subgroups of shareholders. Today, Delaware and many other states allow mergers to proceed with the approval of only a bare majority of the outstanding shares of each class of stock that is entitled to vote on them. In addition, a second innovation introduced more than 100 years ago was the establishment of the shareholder's right to dissent from a proposed merger and demand an "appraisal" — or judicial determination of the cash value of her shares — as an alternative to continuing as a shareholder in the new, merged enterprise.

A second important element of merger law in the modern era followed some 50 years later, when states greatly liberalized the permissible forms of merger consideration. Originally, shareholders of a merging company could receive only equity in the surviving company in exchange for their old shares. Under the mid-century statutes, the range of possible forms of consideration moved beyond securities in the surviving corporation to include all forms of property — most notably cash. Thus, from at least mid-century onward, it has been possible under state law to construct a "cash-out" merger, in which shareholders can be forced to exchange their shares for cash as long as the procedural requirements for a valid merger are met.

12.4 The Allocation of Power in Fundamental Transactions

Today, the merger is the most prominent among a handful of corporate decisions that require shareholder approval.[18] Of course, those who formulate the corporation's original charter could shape additional shareholder voice in almost any way thought useful. Charters could create shareholder veto power, for example, in the sale of certain assets or in order to leave or enter certain lines of business. But as far as we are aware, no charters of public companies contain such provisions. All rely strictly on the provisions of the statutes to allocate power between the board and shareholders.

So, why does the law usually require shareholder consent for mergers and certain other transactions? Or put differently, how *should* the law draw the line between transactions that are completely delegated to the board and those that also must be approved by shareholders?

To explore this question, consider first the universal requirement that shareholders approve material amendments of the articles of incorporation, the basic "charter" of the corporation. Investors buy shares subject to the terms of the charter, and the board of directors exercises its management powers subject to these same terms. Thus, if it is useful for investors to be able to rely on any constraint in the charter, then the law must preclude unilateral amendment of the charter by the board. In fact, the law in all jurisdictions

18. In most U.S. jurisdictions, the other corporate decisions that require shareholder approval include sales of substantially all assets, charter amendments, and voluntary dissolutions. Some states and foreign jurisdictions add other classes of decisions to the short list of fundamental decisions requiring shareholder approval.

does this.[19] Moreover, to protect investors' reasonable expectations, the law must provide a shareholder veto over all transactions that might effectively amend the charter. Thus, shareholders must approve both corporate dissolution, which nullifies the corporate charter, and corporate mergers, in which the surviving corporation's charter may be amended. But the power to change the charter cannot be the only criterion for determining which transactions require a shareholder vote. Other transactions that do not change the charter also require shareholder approval. Specifically, a sale of substantially all of a corporation's assets may not occur unless it has been approved by a vote of the company's shareholders, even though no change in the company's charter occurs.[20] In some non-U.S. jurisdictions, shareholders must approve other transactions as well, such as large share issues and asset purchases.[21] (While in the United States these transactions do not require shareholder approval as a matter of corporation law, the listing rules of the major securities exchanges require shareholder approval if companies issue 20 percent or more of their outstanding stock in a single transaction.[22])

As a general matter, three major considerations ought to determine the allocation of decision-making power within organizations: Who has the best information, who has the most knowledge or skill in regard to this matter, and who has the best incentives? At least in large companies, the answers to these questions are usually not the same. Managers will generally have much better information regarding a company's business and knowledge concerning the specifics of its proposed transactions. But managers may have incentive problems — the most obvious example is the decision to sell the company, which may cost them their job. So the boundary case of complete managerial authority does not seem socially optimal when corporate control transactions are involved. We suggest that, rationally, principals with strong incentives to maximize value will reserve power to veto those matters that are most economically significant and in which they have some capacity to exercise informed judgment. In the corporate context, these criteria suggest that dispersed shareholders will wish to decide at most only very large issues (those that affect their entire investment) and will wish to decide only issues that they can be expected to decide with some competence ("investment-like" decisions rather than "business" decisions).

The general contours of corporate law follow this logic. Bet-the-company operational decisions (take, for example, Microsoft's decision to develop Microsoft Windows; or Boeing's decision to develop the 747 wide-body jet) do not require a shareholder vote. Even though such decisions are of supreme economic importance, shareholders generally lack the ability and information to make them relative to the alternative decision maker, the board and top

19. See, e.g., DGCL §242(b); MBCA §§10.03, 10.04.

20. E.g., DGCL §271; MBCA §12.02. We are focused on charter and bylaw provisions. Shareholders agreements, discussed in Section 3.2.5, may govern shareholder voting in some situations not specifically covered by the charter or bylaws. However, they may not be very common in publicly traded firms.

21. Theodor Baums & Eddy Wymeersch, Shareholder Voting Rights and Practices in Europe and the United States (1999).

22. E.g., NYSE Listed Co. Rule 312.03(c); ASE Co. Guide §712(b).

managers. Likewise, very small acquisitions (sometimes called "whale-minnow" acquisitions) do not require a vote by the whale's shareholders, because they would be rationally apathetic about evaluating the merits of the transaction. Far better to leave both of these kinds of decisions to the board.

What about large-scale M&A? Depending on your intuition about shareholder competence (or information) you might conjecture either that shareholders should vote on *all* large M&A transactions — including mergers, large asset sales and purchases, and share exchanges — or on none of them. The benefits of avoiding errors might seem to be large enough for such transactions that shareholders might plausibly believe that they (or the market) are sufficiently well informed to evaluate these deals.

United States law, however, does not conform to the binary logic of mandating shareholder approval for all or none of these transactions. Mergers require a vote of *both* the target and the acquiring company's shareholders (DGCL § 251(b)) unless the acquiring company is much larger than the target, in which case only the target shareholders vote. Sales of substantially all assets require a vote by the target's shareholders (DGCL §271), but purchases of assets do not require a vote. Thus, even if the seller of substantially all assets is much larger than the buyer, the buyer's shareholders lack a statutory right to approve the deal. What accounts for the different treatment of a very large purchase of assets that transforms the business and a merger that has a similar effect? It cannot be the magnitude of these transactions (and hence the size of potential management error), as both transactions are equally large. Nor can it be the likely quality and cost of shareholder decision making, since similar transactions can take either form. However, there is a third factor bearing on optimal delegation that may have some role here: the potential severity of the agency problem between the principal (the shareholders) and the agent (the board).

By and large, the M&A transactions that require shareholder approval are those that change the board's relationship to its shareholders most dramatically, and thereby reduce the ability of shareholders to displace their managers following the transaction. This is true, for example, in a stock-for-stock merger between equally sized corporations because the shareholders of both corporations will be substantially diluted. It is also true when the board proposes to sell substantially all corporate assets because the company is likely to dissolve after the deal, leaving management to go its own way (perhaps to the purchaser of the assets) with no further ties to the target's shareholders. By contrast, a purchase of assets for cash does not alter the power of shareholders to displace their managers.[23] The purchase of assets for shares is another matter, and it is puzzling why American corporate law does not generally require shareholder votes to authorize large-scale share issues. One (unsatisfying) explanation might be that shareholders have already approved the corporate charter that authorizes such issues. But the major U.S. stock exchanges do require shareholders to authorize large-scale stock issues (20 percent or more).

23. This point is developed in Ronald H. Gilson & Bernard Black, The Law of Finance of Corporate Acquisitions 714-722 (1995).

For these reasons, it seems possible that concerns relating to shareholder future control over managers, rather than size or shareholder competence, are the binding functional determinants of when the law requires a shareholder vote. But we can easily see how other jurisdictions might delineate a wider or narrower class of corporate decisions that require shareholder approval.

12.5 Overview of Transactional Form

How is the acquisition of a business to be structured? As we noted above, there are three principal legal forms of acquisitions: (1) The acquirer can buy the target company's assets, (2) the acquirer can buy all of the target corporation's stock, or (3) the acquirer can merge itself or a subsidiary corporation with the target on terms that ensure its control of the surviving entity. In each of these transactional forms, the acquirer can use cash, its own stock, or any other agreed-upon form of consideration. Each form, moreover, has particular implications for the acquisition's transaction costs (including its speed), potential liability costs, and tax consequences. Here we focus on the transaction costs and liability implications of transactional forms. While taxes play an important part in choosing a transaction form, we must leave that large subject to other courses in the curriculum. For those who cannot wait, however, we direct you to the great treatise by Professor Martin Ginsburg and Jack Levin, Esq. cited in note 2, above.

12.5.1 Asset Acquisition

The acquisition of a business through the purchase of its assets has a relatively high transaction cost (but a low liability cost). The purchase of assets — any assets — presents a standard set of contracting problems. One must identify the assets to be acquired, conduct due diligence with respect to these assets (e.g., investigate quality of title and existence of liens or other interests that may exist in the assets by others), establish the representations and warranties that both parties must make respecting the assets or themselves, negotiate covenants to protect the assets prior to closing, fix the price and terms of payment, and establish the conditions of closing. Titled assets, such as land and automobiles, must be transferred formally through documents of title and, frequently, by filing with an appropriate state office. Each of these individual steps is costly, and in the case of purchasing a large firm, aggregate acquisition costs can be quite large.[24]

Finally, as we have just discussed, a sale of substantially all assets is a fundamental transaction for the selling company, which requires shareholder approval under all U.S. corporate law statutes. See, e.g., DGCL §271; MBCA

24. See generally American Bar Association, Business Law Section, Negotiated Acquisition Committee, Model Asset Purchase Agreement with Commentary, available at: https://www.americanbar.org/products/inv/book/213895/.

§12.02. But neither the meaning of "all or substantially all" assets nor the policy intent behind these words is always clear.

NOTE ON KATZ v. BREGMAN *AND THE MEANING OF "SUBSTANTIALLY ALL"*

Delaware's approach to "substantially all" assets has changed over time. In the classic *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) case, Chancellor Marvel held that when a target sells 51 percent of its assets, producing 45 percent of its sales, that can amount to a sale of "substantially all" assets. In *Katz*, Plant Industries was attempting to sell one of its subsidiaries — Plant National (Quebec) Ltd. (National) — which apparently accounted for roughly 50 percent of Plant Industries' pre-tax profits in 1979 and 1980. There was considerable interest in National with two purchasers vying for it — Vulcan Industrial Packing, Ltd. and Universal Drum Reconditioning Co. National agreed to Vulcan's offer and cut off any further negotiations with Universal because its management reasoned that "a firm undertaking having been entered into with Vulcan, the board of directors of Plant may not legally or ethically negotiate with Universal." Perhaps, unsurprisingly, plaintiff-shareholders brought suit seeking an injunction to block the Vulcan-National merger in order to permit competitive bidding. Chancellor Marvel granted plaintiffs' request for an injunction until a shareholder vote to approve the transaction occurred and held at page 1278 that

> In the case at bar, I am first of all satisfied that historically the principal business of Plant Industries, Inc. has [been] to manufacture steel drums . . . a business which has been profitably performed by National of Quebec. Furthermore, the proposal, after the sale of National, to embark on the manufacture of plastic drums represents a radical departure from Plant's historically successful line of business, namely steel drums. I therefore conclude that the proposed sale of Plant's Canadian operations, which constitute over 51% of Plant's total assets and in which are generated approximately 45% of Plant's 1980 net sales, would, if consummated, constitute a sale of substantially all of Plant's assets. . . .

This outcome might seem surprising. After all, how does 51 percent of the assets reasonably represent "substantially all" of Plant's assets? Others have wondered as well, and no later court has approached this level of liberality in interpreting these words. Moreover, drafters of the Model Business Corporation Act have expressly indicated that "substantially all" is intended to mean much more than 51 percent. See MBCA §12.02(a).

The result in *Katz* can be explained, we think, as an early precursor to the cases decided in 1985 that revolutionized mergers and acquisition law. Specifically, in *Katz* the court is struggling to protect an active bidding contest for control of National. The same task was more aggressively undertaken by the Delaware Supreme Court in its famous *Revlon* case of 1985 (which we take up in Chapter 13). In *Katz*, the court apparently thought either that management had agreed to sell too early (before a higher bidder came along) or that there was something inherently suspect about selecting a lower price over a higher one. Plaintiffs' claim was that management was guilty of a "studied refusal to consider a potentially higher bid. . . ."[25]

Thus, for historians of corporation law (a small set for sure) and for students seeking to uncover the true motivation of courts in reaching decisions (a large set, we believe), *Katz* is an interesting case. We suggest that it represents a court taking up the tools at hand (§271) to reach a result that it thought fairness to shareholders required. For the legal doctrinalist, this case marks the outer boundary of the meaning of the statutes that mandate shareholder votes on sales of assets.

A more recent interpretation of the "substantially all" test under DGCL §271 arises in *Hollinger, Inc. v. Hollinger Intl.*[26] The question presented in that case was whether the sale of the *Telegraph* Group of newspapers (consisting of various newspapers associated with the London-based *Daily Telegraph*) constituted "substantially all" of the assets of Hollinger International ("International"), which owned over 100 other newspapers too. International's controlling shareholder, Conrad Black, claimed that a shareholder vote was required under the substantially all test, which would have allowed him to block the sale.

Examining relative revenue contributions, profitability, and other financial measures, then Vice Chancellor Leo Strine found that the *Telegraph* Group accounted for 56 to 57 percent of International's value, with the *Chicago* Group accounting for the rest. In his characteristically direct (and often entertaining) way, V.C. Strine held that the sale of the *Telegraph* Group did not constitute "substantially all" of International's assets:

> Has the judiciary transmogrified the words "substantially all" in §271 of the [DGCL] into the words "approximately half"? . . . I begin my articulation of the applicable legal principles with the words of the statute itself. There are two key words here: "substantially" and "all." Although neither word is particularly difficult to understand, let's start with the easier one. "All" means "all," or if that is not clear, all, when used before a plural noun such as "assets," means "[t]he entire or unabated amount or quantity of." . . . "Substantially" conveys the same meaning as "considerably" and "essentially." . . . A fair and succinct equivalent to the term "substantially all" would therefore be "essentially everything."[27]

By 2004, then, it would seem that the Delaware courts have moved quite a bit back from *Katz v. Bregman*.

25. *Katz*, at 1275. The court twice cites *Thomas v. Kempner*, which was an unreported 1973 case on preliminary injunction in which Chancellor Marvel, the author of *Katz*, granted an injunction against the closing of a sale of substantially all assets when a higher price emerged after contract signing but before closing. While a contract entered on imperfect information is not rescindable for that reason alone, if the early contract represents an effort to favor one buyer over another for private reasons, it will constitute a breach of duty. The court also cites *Robinson v. Pittsburgh Oil Refining Company*, 126 A. 46 (Del. 1924), an old case that stands for the proposition that a fiduciary must sell for more rather than less cash where price is the only material difference between bidders.

26. 858 A.2d 342 (Del. Ch. 2004).

27. 858 A.2d 342, 377.

NOTE ON ASSET ACQUISITIONS AND POTENTIAL LIABILITY

As we noted above, the chief drawback of asset acquisition as a method of acquiring a company is that it is costly and very time consuming to transfer all of the individual assets of a large business. Offsetting this drawback, it might seem, is that an acquirer accedes only to the assets, and not the liabilities, of the target. In theory, this is true so long as an asset purchase is at arm's length and does not violate the Fraudulent Conveyance Act and its successors (discussed in Chapter 4). However, when the assets at issue constitute an integrated business, courts have identified circumstances in which a purchaser of assets may become responsible for liability associated with those assets. The best-known examples of this doctrine of "successor liability" involve tort claims as a result of defective products manufactured in plants now held by different owners. They also tend to be cases in which the culpable previous owners of the assets — the plants that produced the injury-producing products — have dissolved and paid out a liquidating distribution to their shareholders, leaving no one else to sue but the asset's new owners.[28] Note, however, that courts are less likely to invoke successor liability today than they were in the 1970s and 1980s.

A different legal risk that attends asset acquisition is liability for environmental cleanup expenses that are imposed under various federal statutes on "owners" or "operators" of acquired assets. Thus, the purchase of assets that constitute hazardous environmental conditions may make the new owner jointly liable for cleanup expenses. In response to the risk of successor liability and environmental liability, business planners find it prudent to make acquisitions in the triangular form — that is, through separately incorporated subsidiaries, even when they plan to purchase only the assets of a target firm. When a liability later arises that the acquiring subsidiary cannot pay, courts have not generally "pierced" the corporate existence of this separate legal buyer itself, absent independent grounds to do so (see Section 4 of Chapter 4).[29]

12.5.2 Stock Acquisition

A second transactional form for acquiring an incorporated business is through the purchase of all, or a majority of, the company's stock. As we discussed in Chapter 11, a company that acquires a controlling block of stock in another has, in a practical sense, "acquired" the controlled firm. Thus, tender offers for a controlling block of a company's stock may be thought of as acquisition transactions. In a technical sense, however, the purchase of control by an acquirer is merely a shareholder transaction that does not alter the legal

28. See, e.g., *Ray v. Alad Corp.*, 506 P.2d 3 (Cal. 1977). See generally Michael D. Green, *Successor Liability*, 72 Cornell L. Rev. 17 (1986).

29. See *United States v. BestFoods, Inc.*, 524 U.S. 51 (1998) (refusing to pierce the corporate veil to impose CERCLA liability on parent of wholly owned subsidiary).

identity of the corporation. Something more is needed beyond the purchase of control to result in a full-fledged acquisition.

To acquire a corporation in the full sense of obtaining complete dominion over its assets, an acquirer must purchase 100 percent of its target's stock, not merely a control block. As a practical matter, moreover, acquirers typically do not want a small minority of public shares outstanding. There are costs to being a public company, including the costs of complying with SEC regulations and the implicit costs of assuring that all transfers among controlled entities are fair to the public minority. Corporate law recognizes the legitimacy of the desire to eliminate a small public minority by creating the easy-to-execute short-form merger statutes, which allow a 90 percent shareholder to simply cash out a minority unilaterally.[30] Also, some states take the additional step of offering acquirers and targets a statutory device termed a "compulsory share exchange." This permits a direct exchange of target shares for acquirer shares held by the acquirer's subsidiary. The target shareholders become shareholders in the acquirer (or receive cash consideration) while the target becomes a wholly owned subsidiary of the acquirer. The result is a form of acquisition that receives the tax treatment of a tender offer without the attendant holdup problems of a true tender offer or the awkward residue of a minority of public shareholders.[31]

Delaware has no compulsory share exchange statute. Nevertheless, Delaware lawyers can achieve the same result either through a triangular merger, addressed below, or if, for reasons of tax or timing, an initial tender offer is desired, a new Delaware transaction form — the "intermediate-form merger" under DGCL §251(h) — can fit the bill. With the agreement of the target and acquiring corporations' boards, the acquirer first makes a tender offer for the target's shares. If the number of shares tendered would suffice to approve a merger under the voting requirements of the merger statute, then the second-step merger is treated as having been approved (assuming it is at the same price as the first-step tender offer and meets the other requirements of §251(h)). The effect is that the merger can now occur promptly after the tender offer closes.[32]

12.5.3 Mergers

A merger legally collapses one corporation into another. As noted earlier, the corporation that survives with its legal identity intact is, not surprisingly, the "surviving corporation."[33] A management team that wishes to acquire another

30. See, e.g., DGCL §253.
31. See MBCA §12.02.
32. The expedited §251(h) process has become an increasingly popular deal structure. See Piotr Korzynski, *"Forcing the Offer": Considerations for Deal Certainty and Support Agreements in Delaware Two-Step Mergers*, Harv. L.S. Forum on Corp. Gov., April 2, 2018. When stock is used as consideration for the target's shares under §251(h)(5), the outcome is identical to a compulsory share exchange.
33. A less common transaction, a "consolidation," collapses two corporations into a new legal entity, the "resulting corporation." In most respects, corporation statutes treat mergers and consolidations identically.

company in a merger typically researches the target and initiates negotiations over the terms of a merger itself—although the target company might also approach a possible acquirer about a possible deal and open its books to facilitate its potential suitor's due diligence. A merger requires the approval of the board, too, of course. But just *when* a CEO raises a proposed merger with the board and *how involved* the board will be are not dictated by law. Courts have, however, plainly signaled that they wish to see boards involved early and deeply in the acquisition or sale process. This means that outside directors should be involved intensively since they constitute most or almost all of the board, excepting only the CEO in the modal case. In all events, the management teams of the two corporations, aided by lawyers and investment bankers, prepare a merger agreement for board approval. (We provide a simple, excerpted example below.) After the board formally authorizes the execution of this agreement, the board will, in most instances, call a shareholders' meeting to obtain shareholder approval of the merger.

In most states, a valid merger requires a majority vote by the outstanding stock of each constituent corporation that is entitled to vote.[34] The default rule is that all classes of stock vote on a merger unless the certificate of incorporation expressly states otherwise.[35] Oddly, the Delaware merger statute, DGCL §251, does not also protect preferred stock with the right to a class vote in most circumstances.[36] Of course, the Delaware statute does give class-voting rights to preferred stock if their rights are adversely affected by a charter amendment. See DGCL §242(b)(2). But this narrow right is triggered only when a charter amendment alters the *formal* rights of the preferred stock, not when it reduces the economic value of the stock.[37] Thus, under Delaware law, the most important source of preferred stock's voting rights either on a merger or on an amendment of the charter is in the corporate charter itself.[38] Competent corporate practitioners working with Delaware incorporated firms do not rely upon statutory defaults but

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Note that civil law jurisdictions generally have not only a merger transaction but also its statutory inverse, a statutory "separation" transaction, in which a portion of the assets and liabilities of a single large company are *assigned* to a new corporate entity. In the United States, separation is generally accomplished by dropping a portion of a company's assets into a subsidiary and distributing the shares of this subsidiary to the original company's shareholders.

34. See, e.g., DGCL §251(c).

35. E.g., DGCL §212(a). Generally, all common stock votes, although non-voting common is possible. The voting rights of preferred stock are typically more limited. Most commonly, preferred has no right to vote at all except in stated circumstances (e.g., when a preferred dividend has been skipped). But when preferred stock has a right to vote, it is generally the right to a class vote, since preferred votes would otherwise ordinarily be swamped by the votes of common stock if they voted together.

36. Compare MBCA §§11.03, 11.04. Thus, under Delaware law, preferred stockholders are heavily dependent on the terms of their security for their protection and receive scant help from Delaware corporate law. There is an interesting history here for the specialist. See *Federal United Corp. v. Havender*, 11 A.2d 331 (Del. 1940).

37. *Shanik v. White Sewing Machine Corp.*, 19 A.2d 831 (Del. 1941). Compare MBCA §10.04(a)(6) (contra).

38. By contrast, the MBCA creates parallel class-voting tests for charter amendments and mergers. Under these provisions, any special effect on a class of security holders (even

define the voting rights of preferred stock in the document that creates that security, typically called a "Certificate of Preferences, Special Rights and Limitations."

The voting common stock of the "target" or collapsed corporation always has voting rights. The voting stock of the surviving corporation is generally afforded statutory voting rights on a merger *except* when three conditions are met: (1) The surviving corporation's charter is not modified, (2) the security held by the surviving corporation's shareholders will not be exchanged or modified, and (3) the surviving corporation's outstanding common stock will not be increased by more than 20 percent.[39] The rationale for this exemption from the usual requirement that shareholders of both companies approve a merger is that mergers satisfying these conditions have too little impact on the surviving corporation's shareholders to justify the delay and the expense of a shareholder vote.

Of course, higher or special voting requirements for mergers may be established by the corporate charter or by state takeover statutes (e.g., DGCL §203). Moreover, the stock exchanges require a listed corporation to hold a shareholder vote on any transaction or series of related transactions that result in the issuance of common stock (or convertible preferred stock) sufficient to increase outstanding shares by 20 percent. Unlike corporate statutes, the stock exchange rules require approval of 50 percent of shares voting on the matter (a "simple majority"), as opposed to 50 percent of outstanding shares (an "absolute majority"). Thus, if the acquisition contemplates the issuance of more than 20 percent of the acquirer's common stock, shareholders of the acquirer, as well as those of the target, must approve the transaction, regardless of how it is structured.[40]

Following an affirmative shareholder vote, a merger is effectuated by filing a certificate of merger with the appropriate state office. The governance structure of the surviving corporation may be restructured in the merger through the adoption of an amended certificate of incorporation (or articles of incorporation) and bylaws, which will have been approved by the shareholders as part of the merger vote. Shareholders who disapprove of the terms of the merger must dissent from it in order to seek, as an alternative, a judicial appraisal of the fair value of their shares. (Generally, if they have no right to vote on the merger, they will not have appraisal rights for similar reasons.)

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stock that is made expressly non-voting in the charter) will give that class of security holders a right to vote as a class. See MBCA §§10.04, 11.04(f). Other statutes, including the California and Connecticut codes, give non-voting preferred stock the right to vote on a merger even if the merger does not affect the legal rights of the holders. See also our prior discussion of class voting in Chapter 6.

39. See, e.g., DGCL §251(f); Cal. Corp. Code §1201 (b), (d).

40. It is possible, for example, that the approval of the buyer-parent's shareholders may be required in a reverse triangular stock merger under the NYSE rules even though no vote of parent shareholders would be required under the DGCL. See NYSE Listed Co. Manual ¶B12.03(C), at www.nyse.com. (This situation, in fact, arose in the planned stock acquisition of Warner Communications by Time, Inc. in 1989.) See *Paramount Communications, Inc. v. Time, Inc.*, 1989 WL 79880, Fed. Sec. L. Rep. 94,514, 15 Del. J. Corp. L. 700 (Del. Ch. 1989).

12.5.4 Triangular Mergers

As we have noted, the surviving corporation in a merger assumes the liabilities of both constituent corporations by operation of law. But to expose the acquirer's assets to the (imperfectly known) liabilities of a new acquisition is inevitably a risky step. Thus the acquirer has a strong incentive to preserve the liability shield that the target's separate incorporation confers. This can easily be done by merging the target into a wholly owned subsidiary of the acquirer (or reversing this by merging the subsidiary into the target). And this is precisely what is done. Preserving the liability protection that separate incorporation provides to the acquirer is almost always a highly desirable business goal. Most mergers are accomplished in a way that permits two separate corporate entities to survive the merger.

This maintenance of the liability shield is the premise for the *triangular merger* form. In this structure, the acquirer (A) forms a wholly owned subsidiary (call it NewCo). Imagine that A transfers the merger consideration to NewCo in exchange for all of NewCo's stock. Then Target will merge into NewCo (or NewCo will merge into Target). In either event, at the time of the merger, the merger consideration will be distributed to Target shareholders, and their Target stock will be canceled. The stock of A in Target, if it owned any, will also be canceled. Thus, after the merger, A will own all of the outstanding stock of NewCo, which, in turn, will own all of Target's assets and liabilities. If NewCo is the surviving corporation, the merger is referred to as a "forward triangular merger." If Target is the surviving corporation (its shareholders nevertheless having their shares converted into the merger consideration), the merger is said to be a "reverse triangular merger." Of course, if NewCo is the surviving company, it can immediately change its name to Target, Inc., after the merger and thus preserve the value of Target's brands and goodwill. But no matter which company — NewCo or Target — is the survivor, its charter can be restated (and typically is restated) at the merger to include the governance terms and capital structure that A deems desirable. The merger agreement will be entered into by all three parties — A, Target, and NewCo. In practice, the merger consideration — cash or shares of A typically — will not be transferred first to NewCo, as in our example, but will be distributed at the closing of the transaction directly from A to the holders of Target shares in consideration of the cancellation of those shares.

12.5.5 De Facto Mergers

Should a "merger" be regarded as a functional concept (as implied in Section 12.4), or a formal or technical concept precisely defined by the corporation statute? Might there be functional reasons for treating the concept of a "merger" formally?

Consider, for example, a sale of substantially all assets by one corporation in exchange for stock of the buyer, followed by dissolution of the seller and distribution of buyer's stock to the seller's shareholders. In effect, this resembles a stock-for-stock merger, with the buyer as the surviving entity that owns all of the assets and the investors in both companies owning buyer's stock. Should shareholder sellers be able to seek appraisal of the fair value of their shares from the buyer as they could in a merger? Some U.S. courts have adopted a functionalist approach to questions of this type and have accorded shareholder voting and appraisal rights to all corporate combinations that resemble mergers in effect. These courts have reasoned that when a de facto merger has the same economic effect as a de jure merger, shareholders should have the same protection.[41]

There is, of course, a (functional) counterargument to such a functionalist approach. Corporate law contains a large element of formalism. Corporations exist as entities because certain formal steps are taken. Incorporators sign incorporation documents containing designated information, they hold an organizational meeting at which designated acts are performed, they file a charter in a prescribed form, they make a small payment, and — voila! — a legal person is born.[42] Still other formalities carry the corporation forward in its new life. Boards meet and vote, shareholders elect directors annually (usually), and filings are made. And finally, mergers are consummated by filing with the appropriate state office. All of this is not "mere formality"; it is a source of utility. It permits people to predict accurately the legal consequences of their activities.

Delaware courts, together with most other U.S. courts, take the formalist side of the argument, at least with respect to the range of statutory protections that are available to shareholders in a corporate combination. The provisions of the Delaware statute are said to have "equal dignity" or "independent legal significance." A self-identified sale of assets that results in exactly the same economic consequences as a merger will nonetheless be governed by the (lesser) shareholder protections associated with a sale of assets and not the full panoply of merger protections. A well-known formulation of this position is *Hariton v. Arco Electronics, Inc.*, excerpted below.[43]

HARITON v. ARCO ELECTRONICS, INC.

182 A.2d 22 (Del. Ch. 1962), aff'd, 188 A.2d 123 (Del. 1963)

SHORT, V.C.:

Plaintiff is a stockholder of defendant Arco Electronics, Inc., a Delaware corporation. The complaint challenges the validity of the purchase by Loral

41. Outside of the United States, similar reasoning has been used to extend voting rights to shareholders, especially under German law, where the seminal *Holzmuller* decision extended voting rights in the 1980s to protect an entire class of fundamental transactions. BGHZ, Zivilsenat, II ZR 174/80Y (1980) (German judicial decisions extending shareholder voting rights to apparently fundamental corporate transaction).

42. If corporate organizers get it wrong, courts of equity may resort to a number of devices, such as corporation by estoppel, to try to reach fair outcomes. But if the firm is not formally created, the separate personality does not exist. See Frank William McIntyre, *Note and Comment: De Facto Merger in Texas: Reports of Its Death Have Been Greatly Exaggerated*, 2 Tex. Wesleyan L. Rev. 593 (Spring 1996).

43. A noted American formulation of the opposite position, the de facto merger doctrine, is *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958). We do not reproduce the

Electronics Corporation, a New York corporation, of all the assets of Arco. Two causes of action are asserted, namely (1) that the transaction is unfair to Arco stockholders, and (2) that the transaction constituted a de facto merger and is unlawful since the merger provisions of the Delaware law were not complied with. . . .

[At this point,] the only issue before the court, therefore, is whether the transaction was by its nature a de facto merger with a consequent right of appraisal in plaintiff. . . .

In the summer of 1961 Arco commenced negotiations with Loral with a view to the purchase of all of the assets of Arco in exchange for shares of Loral common stock. I think it fair to say that the record establishes that the negotiations which ultimately led to the transaction involved were conducted by the representatives of the two corporations at arm's length. There is no suggestion that any representative of Arco had any interest whatever in Loral, or vice versa. In any event, Arco rejected two offers made by Loral of a purchase price based upon certain ratios of Loral shares for Arco shares. Finally, on October 12, 1961, Loral offered a purchase price based on the ratio of one share of Loral common stock for three shares of Arco common stock. This offer was accepted by the representatives of Arco on October 24, 1961 and an agreement for the purchase was entered into between Loral and Arco on October 27, 1961. This agreement provides, among other things, as follows:

> Arco will convey and transfer to Loral all of its assets and property of every kind, tangible and intangible; and will grant to Loral the use of its name and slogans.
> Loral will assume and pay all of Arco's debts and liabilities. Loral will issue to Arco 283,000 shares of its common stock.
> Upon the closing of the transaction Arco will dissolve and distribute to its shareholders, pro rata, the shares of the common stock of Loral.
> Arco will call a meeting of its stockholders to be held December 21, 1961 to authorize and approve the conveyance and delivery of all the assets of Arco to Loral.
> After the closing date Arco will not engage in any business or activity except as may be required to complete the liquidation and dissolution of Arco.

Pursuant to its undertaking in the agreement for purchase and sale Arco caused a special meeting of its stockholders to be called for December 27, 1961. The notice of such meeting set forth three specific purposes therefor: (1) to vote upon a proposal to ratify the agreement of purchase and sale, a copy of which was attached to the notice; (2) to vote upon a proposal to change the name of the corporation; and (3) if Proposals (1) and (2) should be adopted, to vote upon a proposal to liquidate and dissolve the corporation and to distribute the Loral shares to Arco shareholders. . . .

Plaintiff contends that the transaction, though in form a sale of assets of Arco, is in substance and effect a merger, and that it is unlawful because the

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Farris decision — partly because its continuing authority is suspect but principally because the underlying issue is identical to that in the *Hariton* case.

merger statute has not been complied with, thereby depriving plaintiff of his right of appraisal.

Defendant contends that since all the formalities of a sale of assets pursuant to 8 Del. C. §271 have been complied with the transaction is in fact a sale of assets and not a merger. In this connection it is to be noted that plaintiffs nowhere allege or claim that defendant has not complied to the letter with the provisions of said section. . . .

The right of appraisal accorded to a dissenting stockholder by the merger statutes is in compensation for the right which he had at common law to prevent a merger. . . . The Legislatures of many states have seen fit to grant the appraisal right to a dissenting stockholder not only under the merger statutes but as well under the sale of assets statutes. Our Legislature has seen fit to expressly grant the appraisal right only under the merger statutes. This difference in treatment of the rights of dissenting stockholders may well have been deliberate, in order "to allow even greater freedom of action to corporate majorities in arranging combinations than is possible under the merger statutes." 72 Harv. L. Rev. 1232, *The Right of Shareholders Dissenting from Corporate Combinations to Demand Cash Payment for Their Shares.*

While plaintiff's contention that the doctrine of de facto merger should be applied in the present circumstances is not without appeal, the subject is one which, in my opinion, is within the legislative domain. Moreover it is difficult to differentiate between a case such as the present and one where the reorganization plan contemplates the ultimate dissolution of the selling corporation but does not formally require such procedure in express terms. . . .

[That] Arco continued in existence as a corporate entity following the exchange of securities . . . only for the purpose of winding up its affairs by the distribution of Loral stock is, in my mind, of little consequence. . . . The right of the corporation to sell all of its assets for stock in another corporation was expressly accorded to Arco by §271 of Title 8, Del. C. The stockholder was, in contemplation of law, aware of this right when he acquired his stock. . . .

I conclude that the transaction complained of was not a de facto merger, either in the sense that there was a failure to comply with one or more of the requirements of §271 of the Delaware Corporation Law, or that the result accomplished was in effect a merger entitling plaintiff to a right of appraisal.

NOTE AND QUESTIONS

1. Which company is the de jure acquirer in this transaction? Which company is likely to have been the functional acquirer? How do you know?

2. The Model Business Corporation Act removes the issue of de facto mergers by giving shareholders a right to dissent and seek appraisal every time a restructuring is authorized. See MBCA §13.02(3).

3. Was *Hariton* rightly decided? Should courts provide identical protections to minority shareholders involved in economically identical transactions? If not, should legislatures do so?

12.6 Structuring the M&A Transaction

To choose the right structure for an M&A transaction, the lawyer, banker, and client must consider the interaction of many variables. Costs, taxes, speed, liabilities, information known and unknown, accounting treatment, regulatory hurdles, and the possibility of a competing bidder are among the obvious considerations that bear on crafting a deal. In this section, we address a number of these concerns briefly while reserving others, such as deal protections, for the section 12.6.5 and Chapter 13. Thus, M&A agreements contain the customary provisions found in most commercial contracts. In addition to resolving issues of timing, cost, risk, and price that go to the heart of the deal, they typically include terms identifying the property subject to the contract, specifying obligations, fixing the nature and times of performance, and setting forth the representations, warranties, and covenants that the parties undertake.

12.6.1 Timing

Consider first timing. Speed is almost always desirable in acquisition transactions. In dynamic markets, the conditions that make an agreement advantageous may suddenly change. Since each side wants the deal to occur on present information and since neither can predict future market movements, it is rational, once a deal is reached, for businesspeople to be impatient to close it.

An all-cash, multistep acquisition is usually the fastest way to secure control over a target and complete the acquisition of its shares. An all-cash tender offer may be consummated in 20 business days under the Williams Act, as discussed in Chapter 11. By contrast, a merger generally requires a shareholder vote of the target company's shareholders and may require a vote of the acquiring company's shareholders as well. Shareholder votes, in turn, typically take several more months for clearance of the proxy materials and the solicitation of proxies before a shareholder meeting. Of course, the relatively recent adoption of the "intermediate-form merger" introduced by DGCL §251(h), which combines a tender offer and a §251 merger in a single transaction, has done much to mitigate the painful choice between a one-step or two-step transaction in a large class of friendly cash-out deals.[44] However, if lengthy regulatory procedures must be completed before a first-step tender offer can be closed (as is the case in bank acquisitions), a multistep or intermediate-form structure may not offer a timing advantage, in which case a one-step merger may be the best choice.

44. For discussion of DGCL §251(h), see *supra* at pp. 510-511.

12.6.2 Regulatory Approvals, Consents, and Title Transfers

As noted above, timing considerations also turn on mechanical aspects of a transaction, such as regulatory approvals, consents, and title transfers. Title transfers are not a matter of concern in a merger, since all assets owned by either corporation vest as a matter of law in the surviving corporation without further action. In a sale of assets, however, title transfers may impose substantial cost and delay. Thus, reverse triangular mergers are the cheapest and easiest methods of transfer because they leave both preexisting operating corporations intact. Stock purchases entail stock transfers and the corresponding costs of documentation (stock certificates, stock powers), but they are nevertheless much simpler to conclude than asset purchases.

Governmental approval and third-party consents vary with the form of transaction. Transaction planners will attempt to choose a structure that minimizes the cost of obtaining regulatory approvals or consents under contracts (e.g., real estate leases, bank loans, service agreements) needed to close the transaction. In addition, planners will wish to make the transfer of corporate assets as cheap as possible.

12.6.3 Planning Around Voting and Appraisal Rights

From the planner's perspective, shareholder votes and appraisal rights are costly and potentially risky. Sometimes planners may voluntarily condition transactions on shareholder approval or provide appraisal rights even when they are not technically required. (Why might they do this?) But ordinarily, they will choose a structure that avoids or minimizes such requirements. Planners are particularly wary of structures that trigger class votes for holders of preferred (or non-voting common) stock, since these votes may enable the holders of such securities to extract a "holdup" payment in exchange for allowing the deal to proceed.[45]

12.6.4 Due Diligence, Representations and Warranties, Covenants, and Indemnification

In any deal, the buyer will wish to acquire reliable information about the target. In many deals involving public companies, acquiring this information is made much easier by public SEC filings and the availability of financial statements audited by an independent public accountant. This is especially true in highly regulated industries such as banking. "Hostile" transactions,

45. See, e.g., *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982); *Warner Communications, Inc. v. Chris Craft Industries, Inc.*, 583 A.2d 962 (Del. Ch. 1989). Chris Craft alleged that it was the sole holder of a class of preferred stock that had a right to a class vote in the merger that created Time-Warner Corp.

of course, are incompatible with due diligence from the target itself. Even if and when such deals turn "friendly," hostile takeovers will rarely provide much opportunity for due diligence. Risk and uncertainty will accordingly be greater.

In negotiated transactions, the representations and warranties contained in a merger agreement will facilitate the due diligence process by requiring the disclosure of accurate information respecting the financial statements of the target, its assets and liabilities, and any other material information that the buyer requires.[46] They establish conditions necessary for closing the transaction as well as allocating between the parties the risks arising from the property subject to the transaction. Target warranties and representations are particularly useful when there is a solvent corporation or individual to stand behind them. When the target is a public corporation, there are generally fewer such provisions because information about these companies is already relatively good, and more importantly, there is no easy way to enforce a breach of warranty against the persons who will have the acquirer's money. It follows that warranties and representations have their greatest use in private deals—that is, where control is acquired through any method from a single entity or small group.[47]

Covenants in merger agreements are another tool for controlling risk. They are designed to offer assurance to the buyer that the company it contracts to acquire should be in roughly the same condition at the time of closing of the transaction. A typical covenant offered by a target in a merger agreement will provide that the business will be operated only in the normal course from the date of the signing of the agreement to the closing and may, for example, require the target to confer with the acquirer before undertaking material transactions. Another typical covenant will require the target to notify the buyer if it learns of any event or condition that constitutes a breach of any representation or warranty. A third standard covenant is a pledge by the target to use its best efforts to cause the merger agreement to close. This often will include a covenant that the board will recommend approval of the merger agreement by the corporation's stockholders (subject usually to a "fiduciary out," discussed in Chapter 13).

46. The most important function of warranties and representations is to force the disclosure of information respecting the target's property and liabilities. To learn about a target's business, an acquirer commonly asks for broad representations and warranties concerning properties owned, potential liabilities, or whatever other information is relevant to value. The acquirer then learns about the business by discussing why such warranties are impractical or what aspect must be excepted from any such warranties. The process is similar with representations. The target must carefully shape each representation on which the acquirer will rely, which teaches the acquirer about the firm.

47. In this context, it is also customary for the acquisition agreement to contain detailed representations concerning the organization of the seller/target; its capital structure; its good standing and the authority to enter into the transaction in question; its financial statements; its tax payments; its licenses, etc., necessary to conduct its businesses; its title to intellectual property and real property; and its insurance and environmental liabilities. While the seller/target will be giving most of the representations and warranties, the buyer/acquirer may be asked to make representations that will go to its ability to close the transaction.

Another fundamental aspect of the agreement will be a statement of the conditions that need to exist before a party can be legally obligated to close the deal. In general, these conditions will include such things as all representations and warranties remain true and correct (except to the extent that all deviations taken together do not constitute a "material adverse change" in the condition or business of the target), any financing condition has been satisfied, and no injunction against closing has been issued. In addition, the parties will customarily indemnify each other for any damages arising from any misrepresentation or breach of warranty. This indemnification has the effect of making every representation a covenant to hold harmless. Thus, the agreement will effectively allocate the burden of undiscovered noncompliance to the party making the representation (ordinarily the seller). Of course, this sort of protection is generally not feasible in a public company acquisition unless it can be negotiated from a large block holder.

12.6.5 Deal Protections and Termination Fees

The period beginning in 1985 witnessed a revolution in the corporate law of mergers and acquisitions. That revolution was initiated by a quartet of surprising Delaware Supreme Court opinions. Those opinions — *Smith v. Van Gorkom*, *Unocal*, *Revlon*, and *Moran v. Household* — and their progeny are examined in Chapter 13, which deals with hostile changes in corporate control. Today, in light of the changes that this revolution wrought, among the most important terms of a friendly merger agreement are those terms that are designed to assure a prospective buyer that its investment in negotiating in good faith with a target will result in a closable transaction. Any discussion of these "deal protection" terms requires an understanding of the doctrine that emerged from the revolutionary cases, and therefore, we take up these provisions in the next chapter.

12.6.6 Accounting Treatment

Under current standards for the accounting for mergers, in a direct merger the surviving corporation will typically record the assets acquired at their fair market value. To the extent the merger consideration exceeds the total of the fair market value of the assets (as it ordinarily will, since the business organization and intangible assets of the target will contribute value to it), the survivor will record this excess as an intangible asset, "goodwill." Under current rules, the value of this goodwill need not be amortized against earnings so long as it continues to represent this economic value. This asset must, however, be periodically evaluated to ensure that the goodwill account continues to be a reasonable approximation of the intangible value embedded in the firm. If it is not, then the goodwill account will be reduced by taking a charge against earnings (a noncash expense) in the amount of its impairment.

12.6.7 A Case Study: Excerpt from Timberjack Agreement and Plan of Merger

AGREEMENT AND PLAN OF MERGER ("Agreement") dated as of this 13th day of April, 1989, by and among RAUMA-REPOLA OY ("Parent"), a corporation organized under the laws of Finland; RAUMA ACQUISITION CORPORATION ("Purchaser"), a Delaware corporation and a direct, wholly-owned subsidiary of Parent; and TIMBERJACK CORPORATION ("Company"), a Delaware corporation.

WITNESSETH

WHEREAS, the respective Boards of Directors of Parent, Purchaser and the Company have approved the acquisition of the Company by Purchaser pursuant to the terms and subject to the conditions set forth in this Agreement;

WHEREAS, as an integral part of such acquisition, Purchaser will make a cash tender offer for all shares of the issued and outstanding common stock, par value $0.01 per share, of the Company (the "Common Stock"), upon the terms and subject to the conditions set forth in this Agreement;

WHEREAS, the Board of Directors of the Company has approved the Offer and has recommended that the stockholders of the Company tender their shares of Common Stock pursuant to the Offer;

WHEREAS, in order to induce Parent and Purchaser to enter into this Agreement, the Company has entered into a Cancellation Fee Agreement with Parent and Purchaser, dated as of an even date herewith (the "Fee Agreement");

NOW, THEREFORE, in consideration of the premises and the representations, warranties, covenants and agreements contained herein and in the Fee Agreement, and intending to be legally bound hereby, Parent, Purchaser and the Company hereby agree as follows:

ARTICLE I
THE OFFER

1.01. *The Offer.* Provided this Agreement has not been terminated pursuant to Section 6.01 hereof, Purchaser shall, as soon as practicable after the date hereof, and in any event within five (5) business days after the date on which Purchaser's intention to make the Offer is first publicly announced, commence a tender offer to acquire any and all issued and outstanding shares of the Common Stock, at a price of $25.00 per share net to the seller in cash (the "Offer"). Subject to the conditions to the Offer set forth in Annex I hereto, including the condition that a minimum amount of at least 70% of the issued and outstanding shares of Common Stock be tendered and available for acquisition (the "Minimum Amount"), Purchaser (a) shall not extend the Offer beyond midnight, New York City time, on the twentieth business day from the date of commencement of the Offer and (b) shall purchase by accepting for payment, and shall pay for, all Common Stock validly tendered and not withdrawn promptly after expiration of the Offer; *provided, however,* that (i) if, as of the then-scheduled expiration of the Offer, in excess of 50%, but less than 90% of the Common Stock have been validly tendered and not withdrawn, Purchaser may, at its sole option, extend the Offer for a period not to extend beyond an additional ten business days in order to qualify for a "short-form merger" in accordance with Section 253 of the Delaware General Corporation Law (the "Delaware Law"), (ii) Purchaser may, at its sole option, extend the Offer with the consent of the Company, (iii) Purchaser may, at its sole option, extend and re-extend the Offer for reasonable periods of time, not to exceed ten business days in any instance, in order to allow a condition to the Offer specified in Annex I to be satisfied that is reasonably likely to be satisfied within the period of such extension and (iv) Purchaser, at its sole option, reserves the right to waive any condition to the Offer set out in Annex I, to purchase fewer than the Minimum Amount and to increase the price per share pursuant to the Offer.

ARTICLE II
THE MERGER

2.01 *The Merger.*

(a) Subject to the terms and conditions hereof, at the Effective Date (as such term is defined in Section 2.01(b)), Purchaser will be merged with and into the Company (the "Merger") in accordance with Delaware Law, the separate existence of Purchaser (except as may be continued by operation of law) shall cease and the Company shall continue as the surviving corporation in the Merger ("the Surviving Corporation").

(b) As soon as practicable after satisfaction or waiver of the conditions set forth in Article V, the parties hereto shall cause the Merger to be consummated by filing with the Secretary of State of Delaware appropriate articles of merger (the "Articles of Merger") in such form as is required by, and executed in accordance with, the relevant provisions of Delaware law, and with this Agreement (the date and time of such filing being referred to herein as the "Effective Date"). . . .

2.02 *Conversion of Shares.* Subject to the terms and conditions of this Agreement, at the Effective Date, by virtue of the Merger and without any action on the part of the Purchaser, the Company or the holder of any of the following securities:

(a) Each share of Common Stock then issued and outstanding, other than (i) shares then held, directly or indirectly, by Parent, Purchaser or any direct or indirect subsidiary of Parent, or (ii) shares held in the Company's treasury, or (iii) Dissenting Shares (as such term is defined in Section 2.03), shall be converted into and represent the right to receive (as provided in Section 2.04) $25.00 net in cash, without any interest thereon (such amount of cash or such higher amount as shall be paid pursuant to the Offer, being referred to herein as the "Merger Consideration"), subject only to reduction for any applicable federal backup withholding or stock transfer taxes which shall be payable by the holder of such Common Stock.

(b) Each share of Common Stock then held, directly or indirectly, by Parent, Purchaser or any direct or indirect subsidiary of Parent shall be canceled and retired without payment of any consideration therefor.

(c) Each share of Common Stock held in the Company's treasury shall be canceled and retired without payment of any consideration therefor.

(d) Each issued and outstanding share of common stock, par value $1.00 per share, of Purchaser shall be converted into and become one validly issued, fully paid and nonassessable share of common stock of the Surviving Corporation. . . .

2.07 *Certificate of Incorporation.* The Restated Articles of Incorporation of the Company in effect immediately prior to the Effective Date (except as such Restated Articles of Incorporation may be amended pursuant to the Articles of Merger) shall be the Articles of Incorporation of the Surviving Corporation until thereafter amended as provided therein and under Delaware Law.

2.08 *By-laws.* The By-laws of the Purchaser, as in effect immediately prior to the Effective Date, shall be the By-laws of the Surviving Corporation until thereafter amended as provided therein and under Delaware Law.

2.09 *Directors.* The directors of Purchaser immediately prior to the Effective Date shall be the initial directors of the Surviving Corporation and will hold office from the Effective Date until their successors are duly elected or appointed and qualified in the manner provided in the Certificate of Incorporation and the By-laws of the Surviving Corporation, or as otherwise provided by law.

2.10 *Officers.* The officers of the Company immediately prior to the Effective Date shall be the initial officers of the Surviving Corporation and will hold office from the Effective Date until their successors are duly elected or appointed and qualified in the manner provided in the Certificate of Incorporation and the By-laws of the Surviving Corporation, or as otherwise provided by law. . . .

ARTICLE III
REPRESENTATIONS AND WARRANTIES

3.02 *Representations and Warranties of the Company.* The Company hereby represents and warrants to Parent and Purchaser that:

(a) *Organization.* The Company and each of its Subsidiaries (as such term is defined in Section 3.02(c)) is a corporation duly organized, validly existing and in good standing (or, with respect to any Subsidiaries organized under the Laws of Canada, subsisting) under the laws of its jurisdiction of incorporation and has all requisite corporate power and authority to own, lease and operate its properties and to carry on its business as now being conducted. The Company and each of its Subsidiaries is duly qualified as a foreign corporation to do business, and is in good standing, in each jurisdiction in which the property owned, leased or operated by it or the nature of the business conducted by it makes such qualification necessary, except where the failure to be so qualified would not have a Material Adverse Effect on the Company and its Subsidiaries. The Company has made available to Purchaser true, correct and complete copies of the Articles of Incorporation and By-laws of the Company and its Subsidiaries, and any amendments thereto. . . .

(d) *Authorization and Validity of Agreements.* The Company has all requisite corporate power and authority to enter into this Agreement and the Documents contemplated to be executed hereunder, including, without limitation, the Fee Agreement, and to perform all of its obligations hereunder and under all documents contemplated to be executed hereunder (subject, in the case of performance of this Agreement, to obtaining the necessary approval of its stockholders if required under Delaware Law). The execution, delivery and performance by the Company of this Agreement and the documents executed hereunder, including, without limitation, the Fee Agreement, and the consummation by it of the transactions contemplated hereby and under all documents executed hereunder, have been duly authorized by the Board of Directors and no other corporate action on the part of the Company is necessary to authorize the execution and delivery by the Company of this Agreement. . . .

(f) *Legal Proceedings.* Except as set forth in the Company Commission Filings (as such term is defined in Section 3.01(g)) or as previously disclosed to Parent or Purchaser in writing, there is no claim, suit, action, proceeding, grievance or investigation pending, or to the Company's best knowledge, threatened against or involving the Company or properties or rights of the Company or its Subsidiaries which, if adversely determined, would have, either individually or in the aggregate, a Material Adverse Effect on the Company and its Subsidiaries. . . .

(h) *Absence of Certain Changes or Events.* Since December 31, 1988, except as disclosed in writing to Parent or Purchaser or in the Company Commission Filings, or as contemplated in this Agreement, the Company and its Subsidiaries have conducted their business only in the ordinary course and in a manner consistent with past practice and have not made any material change in the conduct of the business or operations of the Company and its Subsidiaries taken as a whole, and there has not been (a) any event resulting in any Material Adverse Effect with respect to the Company and its Subsidiaries; (b) any strike, picketing, unfair labor practice, refusal to work, work slowdown or other labor disturbance involving the Company or any of its Subsidiaries; (c) any damage, destruction or loss (whether or not covered by insurance) with respect to any of the assets of the Company or any of its Subsidiaries resulting in any Material Adverse Effect on the Company or any of its Subsidiaries; (d) any redemption or other acquisition of Common Stock by the Company or any of its Subsidiaries or any declaration or payment of any dividend or other distribution in cash, stock or property with respect to Common Stock, other than regularly scheduled cash dividends; (e) any entry into any material commitment or transaction including, without limitation, any material borrowing or material capital expenditure) other than in the ordinary course of business or as contemplated by this Agreement; (f) any transfer of, or any transfer of rights granted under, any material leases, licenses, agreements, patents, trademarks, trade names or copyrights, other than those transferred or granted in the ordinary course of business and consistent with past practice; (g) any mortgage, pledge, security interest or imposition of lien or other encumbrance on any asset of the Company or any of its Subsidiaries that when viewed in the aggregate with all such other encumbrances is material to the business, financial condition or operations of the company and its Subsidiaries taken as a whole; (h) any change in the Certificate of Incorporation or By-laws or equivalent organizational documents of the Company or any Subsidiary; or (i) any change by the Company in accounting principles or methods except insofar as may have been required by a change in generally accepted accounting principles. . . .

(i) *Title to Property.*

(a) The Company and its Subsidiaries have good and marketable title, or valid leasehold rights in the case of leased property, to all real and personal property purported to be owned or leased by them and material to the business and operations of the Company and its Subsidiaries taken as a whole, free and clear of all material liens, security interests, claims, encumbrances and charges, excluding (i) liens securing any revolving term loan with any bank; (ii) liens for fees, taxes, levies, imports, duties or other governmental charges of any kind which are not yet delinquent or are being contested in good faith by appropriate proceedings which suspend the collection thereof; (iii) liens for mechanics, materialmen, laborers, employees, suppliers or similar liens arising by operation of law for sums which are not yet delinquent or are being contested in good faith by appropriate proceedings; (iv) liens created in the ordinary course of business in connection with the leasing or financing of operating assets, including, without limitation, vehicles and office computer and related equipment and supplies and (v) liens, encumbrances or defects in title or leasehold rights that, in the aggregate, do not have a Material Adverse Effect on the Company and its Subsidiaries.

(b) Consummation of the Offer and the Merger will not result in any breach of or constitute a default (or an event which with notice or lapse of time or both would constitute a default) under, or give to others any rights of termination or cancellation of, or require the consent of others under, any material lease under which the Company is a lessee, except for such breaches or defaults which in the aggregate would not have a Material Adverse Effect on the Company and its Subsidiaries. . . .

QUESTIONS ON TIMBERJACK MERGER AGREEMENT

1. What course of events is envisioned by the merger agreement?

2. What happens to the shares of Timberjack upon the merger? Why are all shares not treated in the same way? What will be the charter and the bylaws, and who will be the officers and directors of the surviving corporation?