

Structuring Fundamentals

BASIC CORPORATE FINANCE CONCEPTS

We will violate our initial promise of practicality by starting with a few pages on the corporate finance concepts underlying acquisitions and then a short section on the reasons for acquisitions.

Valuation Theory

At its simplest, there is really only one reason for a Buyer to do an acquisition: to make more money for its shareholders. A fancier way of expressing this is to *create shareholder value*, but that is not very precise or helpful. Creating shareholder value simply means making the acquirer's business more valuable. In an academic sense, how is the value of a business or asset theoretically determined?

At the most theoretical level, the value of a business (or an asset) is the economic present value of the future net cash generated by that business. *Inflows* are roughly equivalent to the operating cash flow component of the company's net income. *Net income* means the revenues of the business minus the expenses to run it determined on the accrual basis as described in the paragraphs that follow. There are other cash inflows and outflows that are not components of net income (e.g., cash investments in the business that are used to finance it). Also, a business's valuation is partially dependent on its balance sheet, which lists the company's assets and liabilities as of a point in time. In a purely theoretical sense, however, the balance sheet is relevant only for the net cash inflows and outflows that ultimately will result from the assets and liabilities shown. In other words, a balance sheet is a component of future net cash flow in the sense that the assets ultimately will be sold or otherwise realized, and the liabilities will take cash out of the business when they are paid.

An income statement looks pretty simple: Money in, money out over a period of time, not as of a particular point in time. But in order to

truly understand an income statement, one must understand accrual basis accounting.

Cash flows are uneven and do not necessarily reflect the health of the business on a period-to-period basis. Accounting attempts to rectify this problem by employing the accrual method that puts cash flows in the period when the actual service or transaction occurs, not when cash is exchanged. A simple example is where you buy a widget-making machine for \$100 in year one and that machine generates \$20 in cash each year for 10 years, at which point it can no longer be used. In evaluating the health of the business in year one, you would not look at it as the business losing \$80 in that year (\$20 minus the \$100 cost of the machine) because you will not have to spend money to buy a new machine for another 9 years. So accrual accounting depreciates the machine by \$10 per year for 10 years. Thus, the real income of the business is \$10 in each year in our example (\$20 of generated cash minus the \$10 depreciation on the machine).

Ultimately, the *intrinsic value* of the business is, as already stated, the present value of all future net cash flows generated by the business. Because stock market analysts and others in part try to evaluate the ultimate value of the business, they would like to know what cash the business is generating in each accounting period. The reconciliation of the income statement to cash flow is contained in the statement of cash flows, which is one of the financial statements that are required to be presented to comply with generally accepted accounting principles (GAAP).

In valuing a business, you also have to consider the element of risk that is involved in generating the future cash flows that are to be discounted to present value. More precisely, the value of the business is the sum of each of the possible outcomes of net cash generated to infinity *multiplied* by the probability of achieving each one, then *discounted* to present value.

Take the example of a ski resort. The cash flows from the business looking out indefinitely are dependent on whether or not there is global warming. If there is no global warming, cash flows will be one thing; if there is, cash flows will be less. So, in valuing that business, we need to take an educated guess as to the likelihood of there being global warming. More generally, in valuing a business, you have to estimate the range of possible outcomes and their probabilities. This is what stock market analysts do for a living. Because it is not practical to value cash flows to infinity, analysts typically will look at projected cash flows over a period of five years, for example, and then add to that value the expected terminal value of the business at the end of the five years using another valuation method.

Comparing Investments

Another problem faced by an investor or an acquisitive Buyer is to analyze the desirability of one acquisition versus another by using common measures

of return on investment. In reality, investments will be made, to the extent of available funds, in the opportunities that are better than the others, *provided that* the rate of return on those investments meets minimum standards.

So take our widget-making machine example. The so-called internal rate of return or *yield* on that investment of \$100 in year one is computed algebraically by solving the following equation:

$$100 = 20/(1+r) + 20/(1+r)^2 \dots 20/(1+r)^{10}$$

where r is the rate that discounts the stream of future cash flows to equal the initial outlay of 100 at time 0.

Another method is the *net present value* method where the cash inflows and outflows are discounted to present value. If you use a risk-free interest rate as the discount rate, that tells you how much more your dollar of investment is worth, ignoring risk, than putting it in a government bond for the same period of time.

Element of Risk

Adding in the concept of risk makes things even more complicated. The term *risk* as used by financial analysts is a different concept from the probabilities that are used to produce the expected present value of the business. Risk is essentially the separate set of probabilities that the actual return will deviate from the expected return (i.e., the variability of the investment return).

In the economic sense, being *risk averse* does not mean that an investor is not willing to take risks. Whether the investor wants to or not, there are risks in everything. The first cut at an investment analysis is to take all of the possible negative and positive outcomes and then sum them, weighting each outcome by its probability. For most investors, that is not sufficient, however. The reason is that investors are *loss averse*, meaning that the value of a negative outcome of x multiplied by its probability of y is not the exact opposite of a positive outcome of x multiplied by its probability of y . As an example, if you were offered the opportunity to toss a coin—tails you lose your house and heads you are paid the value of your house—you would probably not take this bet because your fear of losing your house would outweigh the possible dollar payout—you would be loss averse.

Risk and Portfolio Theory

These risk concepts are applied to the construction of a portfolio of securities. The concept of *diversification* is commonly misunderstood. Using the term with reference to the foregoing discussion, you attempt to reduce the risk of a severely negative outcome by placing more bets that have independent outcomes, or diversifying. You equally reduce the chance

of spectacular gains. Taking the example of the coin toss/bet the value of your house, if you were to agree to do 10 bets in a row, betting 10 percent of the value of your house each time, the odds of your losing the entire value of your house are infinitesimal since you would have to lose ten 50/50 bets in a row. On the other hand, the odds of your doubling the value of your house are infinitesimal as well.

In the case of the stock market, you can never reduce your risk to zero because the market itself has a base level of risk that results from risks that affect all stocks. If you want an essentially risk-free investment, you have to invest only in U.S. Treasuries.

The term *beta* is simply a measure of the extent to which a particular stock's risk profile differs from the market generally. In theory, if you held all available stocks, you would have diversified away all of the risks of each of the stocks in your portfolio other than those that affect all stocks. You cannot completely eliminate them, but in economic terms, the stock-specific risks with any particular stock should, if the worst happens, have a minuscule effect on the overall portfolio. Put another way, if one of your stocks experiences a loss or gain from its specific risk, it changes the risk profile and return of your portfolio close to nothing because you hold thousands of stocks. The implicit assumption here is that it is unlikely that your portfolio would experience many bad outcomes from individual stock-specific risks.

Portfolio Theory as Applied to Acquisitions

What do these risk concepts and portfolio theory have to do with acquisitions? Simply, an acquisition is an investment by the Buyer. What a Buyer will rationally pay for a business or asset in an efficient market is a combination of the expected return from that asset, the riskiness of the investment, and the Buyer's appetite for risk.

An interesting way to look at portfolio construction is by using what are known as *indifference curves*. The curves in Exhibit 1.1 show that for a hypothetical investor (and everyone is different), if that investor were happy with the risk/reward profile for an investment represented by a particular point on the grid (risk on one axis, return on the other), then you could construct a curve of the points on the grid where the investor would be equally happy (i.e., the investor presumably would be happy with an investment that offered greater returns as risk increased). Everyone's curves would be different, but it is thought that the curves would look something like those in Exhibit 1.1. The other thing depicted here is that each higher curve (in the direction of the arrow) represents a better set of investments for the particular individual investor than any curve in the opposite direction, because for

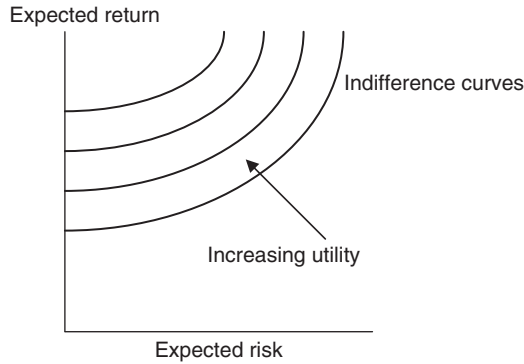


EXHIBIT 1.1 Indifference Curves

any given amount of risk, the higher curve offers more return. That is what the words *increasing utility* mean in this diagram.

So far, we are dealing with theoretical sets of risks and returns that may have no relation to what is actually available in the market.

So, for an exclusively stock portfolio, one can plot sets of actual stock portfolios. Each actual stock portfolio has a different risk/reward combination. In Exhibit 1.2, the shaded area represents all of the possible combinations of stocks that are actually available in the market. If, within this area, you choose any particular point, the point immediately higher than it or immediately to the left of it would represent a better set of stocks—either it would have the same risk but a higher reward or it would have the same reward but a lower risk. So, in portfolio theory, the optimal stock portfolio for the particular investor is obviously the one that achieves the optimum risk/reward ratio. In terms of this diagram, you keep moving straight up in the shaded area to get a better return for the same amount of risk, or you move straight left in the box to achieve the same return at lower risk. The *efficiency frontier* essentially represents the results of that exercise.

Combining this concept with the preceding concept of indifference curves, the optimal portfolio is the tangent where the efficiency frontier touches the highest indifference curve.

Another interesting element of portfolio theory is what happens when you add risk-free assets to the portfolio (i.e., U.S. government bonds or U.S. Treasuries). Assume that the risk-free return is represented where the dotted line touches the y -axis in Exhibit 1.2. The dotted line is drawn between this totally risk-free investment on the y -axis to the tangent where the efficiency frontier curve meets the highest indifference curve; it represents a varying mix of increasing amounts of that risk-free investment combined with the

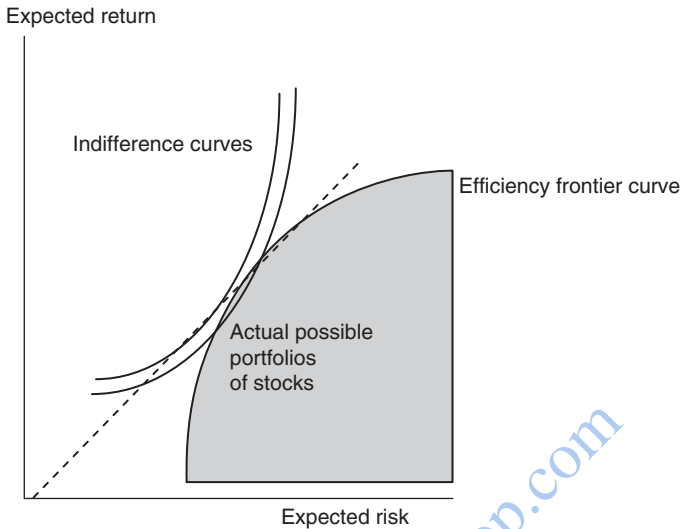


EXHIBIT 1.2 Optimal Stock Portfolio

risky stock portfolio. Interestingly, assuming the curves are shaped as they are in the exhibit, there is a point in that portfolio that is at a higher indifference curve than the one that contains the tangential point for the all-stock portfolio. That higher point represents the optimal portfolio for that particular investor.

There is another derivative of this theoretical exercise called the *capital asset pricing model* (CAPM), which simply says that in an efficient market, expected return is directly and linearly proportional to risk.

Of course, all of this is a worthwhile game and not purely academic *if* these curves can actually be derived and *if* there is any credibility to the risks and returns assigned to the actual portfolio. However, taking a typical personal portfolio as an example, this is purely academic. It seems that in reality, the broker's stock analysts do not simply take each possible investment, determine each possible cash flow result, and assign an appropriate probability to it, calculate the expected outcome, add it into the actual possible portfolio, and see where the efficiency frontier meets the highest indifference curve. This appears to be more easily said than done.

Efficient Market Hypothesis

There are a few more buzzwords here, most importantly, the *efficient capital market hypothesis* in its various forms. One variant of this hypothesis is that

market prices at any given time will reflect an unbiased forecast of future cash flows that fully reflect all publicly available information.

There is a corollary of this hypothesis that is relevant to acquisition pricing: If a Buyer is paying above market for a publicly traded company, then the combination of the two businesses will increase cash flows or create a better risk profile, or the Buyer has information that the market does not have—or, a third possibility, the Buyer does not know what it is doing or got outfoxed by the Target.

There is continuing debate as to whether, or to what extent, the efficient market hypothesis is actually true. There are also other hypotheses to explain market behavior. One theory is that uninformed investors irrationally chase market trends and/or that too much weight is put on new information. It certainly seems to be the case that the market overreacts to bad news. How many times have we seen that if a company misses expected earnings per share (EPS) by a penny, its stock gets clobbered?

Another reason that markets may not be entirely rational is that money managers may base their decisions on what is best for them instead of their clients, based on their own risk/reward profile. For example, some money managers get paid on a straight percentage of assets under management. Other investment vehicles such as hedge funds pay managers a portion of profits made but do not require the managers to pay out equivalent losses. This skewing of values affects decisions. If you are playing with other people's money (OPM), you might as well make investments that have the potential for abnormally large gains and losses. In effect, you have a lot more to gain than you have to lose, given that you have no personal funds at risk.

Decisions are also skewed in other ways. Holders of debt would like a company to make different decisions than shareholders would, because they get none of the upside from risky decisions. Shareholders and management with stock options have different incentives because managers can never lose money on stock options. So, in theory, managers may be more prone to taking risks. But managers are not as well diversified as shareholders because they tend to have a disproportionate amount of their net worth in their company's stock, so they may in theory be *more* loss averse than shareholders because they have not diversified away the specific risk inherent in their company's stock.

Bottom line, nobody really knows how all of this works.

REASONS FOR ACQUISITIONS

If any of the preceding corporate finance concepts are valid, they should bear directly on acquisition practice. In the most theoretical sense, a Buyer would

acquire a Target because the future cash flows of the combined business, discounted for risk, would ultimately net the Buyer's *existing* shareholders more money. What are the ways that can happen in an efficient market?

Intrinsic value can be created, in a theoretical sense, if the combined businesses would generate an increase in aggregate cash flow. That should always be the case.

In addition to a simple additive increase in value, an increase in intrinsic value can be achieved in other ways by such things as *financial engineering*, economies of scale, better management of the combined business, or changes in the capital structure that should increase cash flows to shareholders, perhaps with an attendant increase in risk. A leveraged buyout (LBO) is an example of financial engineering: A business is purchased partly with borrowed funds; the Buyer believes that it will make money from the deal because the present value of the cash flows from the leveraged business will exceed the price paid by the Buyer with its own funds, often because the Buyer thinks that the business does not have enough leverage.

Acquisitions should all be additive in the sense that the combined business is worth more than the separate businesses. The real question is how the addition to value is allocated between the Target's shareholders and the Buyer. The Buyer's goal is that the portion of the increased value allocated to the Buyer is worth more than what the Buyer paid. In a deal where the Buyer pays only in cash, *all* of the increase in value is allocated to the Buyer, and the question comes down to whether the increase in value exceeds the purchase price. In a deal where stock is used as currency, the question is whether the increase in value allocated to the Buyer (i.e., the percentage of the combined company that the Buyer's shareholders will own) is greater before or after the deal. So the allocation occurs via the acquisition price, with the better negotiator taking a bigger slice of the pie.

Other than by simple addition, how is value created? What are some of the synergies in acquisitions?

Enhancing financial performance—that is, increasing earnings per share (EPS)—can sometimes be accomplished by financial engineering. EPS is the net income of the business divided by the number of shares outstanding. One business may acquire another for purely financial reasons, particularly where the Buyer has a higher price-to-earnings ratio (P/E ratio) than the Target. P/E is the ratio of a company's stock price to its earnings per share. If the acquisition is for cash, then the costs of the new business have to be measured against the loss of the income from the cash spent in order to determine whether EPS goes up. Where stock is involved, the measurement is the addition to net profits from acquiring the business against the number of additional shares issued to pay for the acquisition.

This deserves a bit of background. After all is said and done on the various academic theories of value, the stock market and company managers are largely focused on a company's EPS and its P/E ratio. The company's P/E ratio multiplied by its EPS multiplied by the number of shares outstanding equals the company's market capitalization or market cap. Public companies are valued (traded) in significant part as a multiple of EPS or expected future EPS. So, all things being equal, the price per share goes up (and managers get richer) if EPS goes up. The P/E ratio is the market's shortcut way of expressing its view of the company's future value—it is a measure of how much the market perceives that EPS and cash flow will grow over time. So-called growth companies have higher P/E ratios.

Managing EPS is the reason companies introduce debt into their capital structures. Basic modern corporate finance strategy seeks to maximize EPS within acceptable risk parameters. Earnings per share can be increased with the prudent use of debt in the right circumstances, which are that the company can, with the cash proceeds of the debt, generate incremental earnings that are greater than the interest paid on the debt. No shares of capital stock are issued with straight (nonconvertible) debt, so EPS goes up.

If sold at the right price, sales of additional equity can increase EPS as well. The company expects, either in the short or long term, to be able to grow its business and earnings from the cash generated by the sale of additional shares of capital stock so that after the growth occurs, EPS will go up even though more shares are outstanding.

In the M&A context, if buying a business will increase *pro forma* EPS—that is, what is expected to happen to EPS if the deal happens—then that is an important reason for doing the deal. In one sense, it is often just a substitute for the so-called real reasons for acquisitions, such as economies of scale, discussed shortly—but not always.

Stock acquisitions can be done for pure financial engineering reasons. Take the following example. Two companies each have a million dollars in annual earnings and one million shares outstanding. If the Buyer has a P/E ratio of twice that of the Target, in order to acquire the Target for a price that merely equals the current market price of the Target, it must only issue half a million shares. So it doubles its income but only has 50 percent more shares outstanding. Its EPS, therefore, goes up. Surprisingly, the stock market frequently maintains the old P/E ratio of the Buyer or something close to it, so that the Buyer's stock price rises as a result of the acquisition. This also gives the Target company some negotiating leverage; because the deal is *accretive* to the Buyer's EPS, there is room to keep the deal accretive, but less favorably to the Buyer, by forcing the Buyer to pay a premium to the market as the acquisition price. A deal that prospectively raises EPS is

called a *nondilutive* or *accretive* deal, even though there may be more shares outstanding (and thus dilution in another sense) in a stock deal.

Of course, acquisitions are done other than for pure short-term financial considerations, as previously mentioned. Even though a deal may not be initially accretive, the Buyer may still want to acquire the business for its future economic potential, believing that the acquisition will ultimately become accretive because of the growth of the acquired business or expected cost savings or other synergies over time. That type of transaction takes brave managers at the Buyer.

What, then, are some of the *real* reasons (synergies) why one business acquires another? In other words, how is value created other than by the mere additive combination of two businesses?

- *Economies of scale.* In an acquisition of one company and a competitor, economies of scale can be achieved where the acquisition results in lower average manufacturing costs or by elimination of redundancies in the organization. A good example of this is the consolidation in the banking industry. Banking competitors in different locations may combine and streamline their operating and marketing functions. Banking competitors in the same location may combine to increase their customer base but eliminate costs like redundant branch offices in the same location.
- *Time to market.* A variant on economies of scale is extending a product line, for example, where it is cheaper or faster (or both) for the Buyer to purchase the product line and its underlying technology rather than develop it independently, or where the Buyer cannot develop it independently because it is blocked by the prospective Target's patent portfolio. This logic also applies to enhancing a particular business function—for example, sales and marketing—where similar cost and speed considerations are present. One company in a particular business may have a great marketing team and poor technology, while its Target has the opposite. Another common rationale in the technology company arena is that the disincentives for potential customers to deal with a small and possibly unstable technology company will be eliminated if it is acquired by a larger company with market presence.
- *Combination of customer and supplier.* Here, a company buys a supplier, or a supplier acquires a customer. A company might do that in order to reduce the risk of dependence on an outside supplier. Bringing the supply function in-house also eliminates the risk of price gouging.
- *Product line diversification.* A business might also want to diversify into other areas to change its risk profile.

- *Defensive acquisitions.* Sometimes businesses are acquired because the acquirer may be facing a severe downturn in its business, and the acquisition will alleviate the cause of the severe downturn. An example is a drug company that has massive marketing power but is running out of patent protection on its key drugs. It may acquire a promising new drug and put it into its powerful marketing channel.
- *New and better management.* Managers may not act in the best interest of the shareholders for different reasons. They may be lousy managers, lazy, stupid, inexperienced, or a combination, or they divert for their own benefit certain assets of the business, like paying themselves too much. An acquirer might think it can enhance the value of an acquired business by replacing its management.
- *Acquisition of a control premium.* Some argue that the public trading markets always misprice publicly held stocks because the value of the stock in the market is that of the individual holder who is not in a control position. Bidders may bid for companies simply to capture the control premium inherent in the stock, which they then can cash out by selling the control premium to another purchaser.

Regardless of the motives for acquisitions, those involved must still have an understanding of the basic acquisition structures that are available to them and of the structural and other legal and business aspects that dictate the use of one structure over another.

THREE BASIC ACQUISITION STRUCTURES

There are three basic ways to structure an acquisition:

1. *Stock purchase*, where the outstanding stock of the Target is sold to the Buyer or a subsidiary of the Buyer by the shareholders of the Target.
2. *Merger*, where the Target is merged, pursuant to the applicable state merger statute(s), with the Buyer or merged with a subsidiary of the Buyer that has been formed for the purpose of effecting the merger. After the merger, either the Target or the Buyer (or its subsidiary) can be the corporation that survives the merger (called the surviving corporation).
3. *Asset purchase*, where all or a selected portion of the assets (e.g., inventory, accounts receivable, and intellectual property rights) of the Target are sold to the Buyer or a subsidiary of the Buyer. In an asset purchase, all or a selected portion or none of the liabilities and obligations of the Target are assumed by the Buyer.

In each of these cases, the purchase price may be paid in cash, stock, or other equity securities of the Buyer, promissory notes of the Buyer, or any combination. Sometimes a portion of the purchase price is paid on a deferred basis tied to the subsequent performance of the acquired business. This technique is called an *earnout*. Sometimes, as in a leveraged buyout, the Buyer buys only a majority of the stock of the Target and does not acquire all or part of the stock held by management or others who are to continue to be involved in the business.

Following is a brief additional explanation of these three forms of acquisition. We go into them in much greater detail later.

Stock Purchase

In a stock purchase, the Buyer (or a subsidiary—we will not keep making this distinction unless necessary) purchases the outstanding capital stock of the Target directly from the Target's shareholders. If the Target is a private company, this is effected by a stock purchase agreement signed by the Buyer, the Target's shareholders if they are relatively few in number, and sometimes the Target itself. In a public company, this is effected by a tender offer, in which the Buyer makes a formal public offer directly to the Target's shareholders because with a public company the Target's shareholders are always too numerous to deal with separately. Where the Buyer is offering to pay in stock, a tender offer is called an *exchange offer*.

A stock purchase (but not a tender offer) in many ways is the simplest form of acquisition. Assuming that all of the outstanding stock of the Target is acquired by the Buyer, the Target becomes a wholly owned subsidiary of the Buyer, and the Buyer effectively acquires control of all of the assets and, as a practical matter, assumes all of the liabilities of the Target. (Technically, the Buyer does not assume these liabilities itself and they remain at the Target level, but unless the Buyer wants to abandon its new wholly owned subsidiary, as a practical matter it normally would make sure those liabilities get paid.) No change is made in the assets or liabilities of the acquired business as a direct consequence of the acquisition of the Target's stock.

Merger

If a private company has so many shareholders that it is impractical to get everyone to sign the stock purchase agreement, or if there are dissidents, then the usual choice is a merger.

For Targets that are public companies, a merger is used because a public company has a large number of shareholders and it is not feasible for all of the shareholders to sign a stock purchase agreement. An alternative is a *two-step* acquisition where the Buyer first acquires through a stock purchase

a majority of the Target's outstanding stock from the Target's shareholders in a tender or exchange offer, and then follows that up with a *squeeze-out merger* approved by Buyer as majority shareholder. In that case, the minority shareholders are forced to take the acquisition consideration in the *back-end merger* by virtue of the statutory merger provisions (unless they exercise their *appraisal rights*, which they rarely do).

Two-step acquisitions where the Buyer buys less than a majority of the outstanding Target stock are sometimes used in public transactions because such a purchase can be wrapped up quickly. In that case, depending on the percentage of the Target's outstanding stock that the Buyer purchases, the Buyer can make it more difficult for an interloper to come in and steal the deal from the Buyer. The interloper has that opportunity in public deals since compliance with the Securities and Exchange Commission (SEC) regulatory process is very time consuming. Those particular regulations generally do not apply to private acquisitions.

A merger is a transaction that is created by the relevant business corporation statutes in the states of incorporation of the parties. Statutes applicable to other types of entities, such as limited liability companies, govern mergers involving those entities. We assume throughout this book that both the Target and the Buyer are Delaware corporations. The majority of business corporations of any size are Delaware corporations. Other states' business corporation statutes (and the Model Business Corporation Act) differ in details from Delaware's, but in the acquisition arena, the common theme is that the merger provisions of a statute permit two corporations to merge one into the other so that all of the assets and liabilities of the disappearing corporation in the merger get added to the assets and liabilities of the surviving corporation by operation of law.

With minor exceptions, mergers require the approval of both the board of directors (at least in Delaware) and the shareholders of the merging corporations. The famous Delaware takeover cases involving rival bidders arose in situations where the Target's board of directors had approved the merger and a merger agreement had been signed by the Target and the Buyer, but the merger could not close immediately because of the need for shareholder approval and/or antitrust approval. Between the time of signing the merger agreement and shareholder approval, the rival bidder made its upset offer.

The relevant merger provisions of the state business corporation statutes specify the requisite shareholder vote, usually a majority. Sometimes the Target's corporate charter, as an anti-takeover device, specifies a super-majority vote or a separate vote by the different classes or series of stock outstanding.

Also by operation of law and as agreed in the merger agreement between the Buyer and the Target, the outstanding stock of the Target is automatically converted into cash, stock, notes, or a combination thereof (or other

property) of the Buyer or its corporate parent. This technique, therefore, is the vehicle for the Buyer to acquire 100 percent ownership of the Target, which is generally imperative for reasons we discuss later. In either a one-step merger or a two-step merger involving a stock purchase followed by a squeeze-out merger, all of the stock held by each shareholder of the acquired corporation gets converted into the merger consideration, whether a particular shareholder voted for the merger or not.

The one exception is so-called appraisal rights created by the statutory merger provisions. Under certain circumstances, the Target's shareholders can object to the merger terms and seek an appraisal of their shares in a court proceeding. This rarely occurs because of the expense involved versus the dollars that may or may not be gained, but it is a threat that must be considered in structuring the transaction.

Asset Purchase

In an asset purchase, the Buyer acquires all or selected assets of the Target and assumes all, a portion, or none of the liabilities of the Target pursuant to an asset purchase agreement. Most state statutes require shareholder approval of a sale of "all or substantially all" of the assets of the Target. As we will see, there are a number of reasons why a deal may be structured as an asset purchase, principally tax. In some cases, such as where the Buyer is acquiring only a division or a product line from an established business with multiple divisions and product lines that are not separately incorporated, an asset purchase is the only practical way to accomplish this objective.

STRUCTURING CONSIDERATIONS: OVERVIEW

We now discuss the principal structuring parameters that determine whether a stock purchase, merger, or asset purchase is the appropriate acquisition structure. In most cases, tax considerations are the starting point, and so it is important for business lawyers to understand the basic tax aspects of acquisitions. Tax considerations are discussed at length in Chapter 4. Non-tax-structuring considerations are discussed in Chapter 3. This section provides an overview.

Tax

Acquisitions can be done on a tax-free (meaning tax-deferred) or taxable basis. Ordinarily, a shareholder recognizes taxable gain or loss upon the sale

of the shareholder's stock, whether the consideration paid is cash, a note, other property, or some combination thereof. Congress acknowledged that, under certain circumstances, where a shareholder continues the investment through equity in another corporation, imposing a tax on the sale of a corporation or a merger of corporations could inhibit otherwise economically beneficial transactions.

For example, shareholders owning corporation A might be willing to sell their shares to corporation B for cash in a taxable transaction, but not for B shares if a tax were due. Corporation B has insufficient cash. The A shareholders might not have sufficient cash to pay a tax if their only proceeds were illiquid B shares. Also, if corporation B continues the business previously operated by corporation A, it might be said that the A shareholders have simply continued their investment in another form and so should not be subject to tax.

A series of tax code sections permit the deferral (not elimination) of the tax realized by shareholders when corporations combine in transactions that meet certain requirements. These so-called reorganization (or tax-free reorg) provisions contain specific technical statutory requirements that are amplified by judicially imposed requirements designed to implement the Congressional intent that tax be deferred only when a shareholder's investment and business continue in a new form.

In the most fundamental terms, in order to qualify as a tax-free reorganization, a significant portion of the acquisition consideration must be voting stock of the Buyer. The required percentage ranges up to 100 percent for certain reorganization structures. The percentage is lowest for an "A" reorg, which relates to non-subsidiary mergers and *forward* subsidiary mergers (explained later), and substantially higher for reverse subsidiary mergers, stock-for-assets deals, and stock-for-stock exchanges. The portion of the acquisition consideration that is not stock is called *boot* and its receipt is taxable. Therefore, most reorganizations are only partially tax-free.

Unfortunately, the reorganization provisions do not permit tax-deferred combinations between partnerships (or limited liability companies taxed as partnerships) and corporations. These entities can typically convert to corporations on a tax-deferred basis (under an unrelated set of tax code provisions), but they cannot convert to corporations on a tax-deferred basis as part of a plan to combine with a corporation under the reorganization rules. This means that a partnership or a limited liability company (LLC) taxed as a partnership must plan in advance for possible exit strategies, so that a conversion to a corporation, if desired, is done well before a plan to combine with a particular corporation is formulated.

Buyers and Targets have different and conflicting tax objectives with respect to acquisitions. From the *Target's* perspective, the shareholders

of the Target want the acquisition to be tax-free to them if it is a stock transaction, which is a practical necessity where the shares are illiquid and cannot be sold to pay the tax. In a taxable transaction, the Target's shareholders want to get long-term capital gain treatment and not recognize ordinary income at higher rates. A tax-free deal allows the Target's shareholders to defer recognition of their gain until they sell the new shares. In the event of a shareholder's death, the cost basis of the assets of that shareholder can be stepped up to their then-fair market value, thus permanently avoiding income tax on that gain. In a taxable transaction, the taxable gain is measured by the value of the consideration received over the tax basis in the shares or assets being sold (cost less depreciation, if any).

The Target's shareholders most acutely want to avoid a deal that creates double tax—that is, taxation first at the corporate level and then at the shareholder level. In other words, a transaction is not tax efficient if the Target corporation pays tax on its gain and the shareholders of that corporation pay tax on the after-tax proceeds distributed to them. Double tax happens in an asset purchase, with certain exceptions—the Target pays a tax on its gain from a sale of its assets, and, when the proceeds are distributed to its shareholders, another tax is due from the shareholders on their gain. This potential for double tax is the reason that asset purchases are relatively rare. An asset purchase sometimes can be accomplished without double tax if there are sufficient tax loss carryforwards available to shelter the Target corporation's gains or if the acquired entity is a flow-through entity that doesn't itself pay tax, like a partnership or LLC.

From the *Buyer's* perspective, the principal tax concern relates to the tax basis that the Buyer receives in the Target's assets. The Buyer wants what is known as a *step-up* in basis, since a higher tax basis in depreciable/amortizable assets allows greater depreciation deductions that will shelter other income going forward or will reduce the amount of gain when the assets are sold. The opposite of a step-up in basis is *carryover basis*, which means that the assets have the same tax basis in the hands of the Buyer as they did in the hands of the Target. In a tax-free deal, there is carryover basis. In a taxable asset purchase, there is a step-up in basis, but unless the Target has loss carryforwards or is a flow-through entity, there is double tax. Taxable mergers can go either way, depending on the form of the merger. So you can see the points of contention between Buyer and Target developing already.

Let us approach it from another direction—the basic tax consequences of the three different structures. In a *stock purchase*, the Target's shareholders sell their stock directly to the Buyer. The Target itself is not selling anything, so the Target pays no tax and therefore double tax is avoided. You can accomplish a stock-for-stock tax-free deal, but the requirements are strict, as previously noted. Stock deals are tax adverse for the Buyer from

the limited perspective that there is carryover basis, and not a step-up in basis, in the Target's assets. There are some esoteric exceptions here for stock purchases of a corporation out of a consolidated tax group and for Subchapter S corporations using a so-called Section 338 election. The election effectively treats the stock purchase as an asset purchase for tax purposes.

As for *mergers*, there are taxable and tax-free mergers. A taxable merger can be structured to resemble a stock purchase or an asset purchase. We will discuss different merger structures in Chapter 3 and their tax consequences in Chapter 4.

In a taxable *asset purchase*, if the Buyer acquires selected assets at a gain from the Target, the Target pays tax on the gain. If the proceeds are then distributed to the shareholders of the Target, then there is double tax if the transaction is followed by a liquidation (assuming that there is a gain on the liquidation of the stock). If the proceeds are distributed as a dividend and the corporation stays in business, a tax would be payable by the Target's shareholders on the dividend, assuming there are corporate earnings and profits. From the Buyer's tax perspective, taxable asset deals are good because there is a step-up in tax basis. (There are tax-free asset deals, but they are quite rare.)

Corporate Law

The corporate law parameters for an acquisition start with whether the Buyer wants to, or is forced to, acquire selected assets of the Target and whether the Buyer wants to avoid the assumption of certain or all liabilities of the Target.

Where the Buyer wants to acquire the entire business, asset purchase structures are generally not used if there is double tax. They are also more complex mechanically. As we said earlier, the next choice in this situation is a stock purchase. Buyers almost always want to acquire all of the outstanding stock of the Target in a stock acquisition, as opposed to a majority of the stock. That is because if there remain minority shareholders, any transactions between the Buyer and its new subsidiary that has minority stockholders are subject to attack for being unfair to the minority shareholders—a potential legal mess that Buyers generally (but not always) want to avoid. Also, funds flow is restricted from the subsidiary to the parent because if the subsidiary wants to pay a dividend to the parent, it must also pay it as well to the minority shareholders, which may not be desirable. For these reasons, Buyers will then choose to do a single-step merger or a partial stock purchase followed by a squeeze-out merger.

Another corporate law consideration in the choice of structure is the need to obtain consents from counterparties to contracts of the Target and/or

from government entities. Commercial contracts generally prohibit the contract from being assigned by a party without the consent of the other party. In an asset purchase, what is required for the Buyer to get the benefits of the contract is an assignment to the Buyer of the contract rights of the Target under the particular contract. The need to obtain these consents creates the possibility of delays and also creates the possibility of a holdup by the other contracting party, which extracts some monetary or other concession as the price for its consent.

One way the need for consents can sometimes be avoided is by doing a stock purchase. In a stock purchase, because the contracting corporation remains in place and unchanged except for its ownership, it generally is not considered to be assigning its contract rights for purposes of requiring consents from counterparties. To avoid this loophole, some contracts require consent for an assignment and also give the counterparty termination or other rights in a *change in control* transaction—in other words, an acquisition by stock purchase or any form of merger.

Similar to a stock purchase in this regard is what is known as a *reverse triangular merger* where a subsidiary of the Buyer merges into the Target, with the Target being the surviving corporation. Just as in a stock purchase, a reverse triangular merger is not generally considered an assignment of the Target's contracts since the Target remains in place unchanged except for its ownership.

Securities Laws

The impact of the securities laws on acquisitions is discussed in detail in Chapter 3. In short, the issuance by the Buyer of its stock or other securities (or a vote by the Target's shareholders to approve a deal where they are to receive stock or securities of the Buyer) is considered a purchase and sale of securities requiring either registration with the SEC or an exemption from registration. State securities (or blue sky) laws may also be applicable.

Antitrust and Other Regulatory Considerations

One issue that has to be analyzed at the outset is what, if any, regulatory approvals are required for the acquisition. The need for regulatory approvals affects the timing, certainty of completion, covenants, and closing conditions of the deal.

The need for regulatory approval can arise for two reasons. First, one or both of the parties are in a regulated industry where acquisitions are scrutinized for compliance with applicable legal requirements, such as the acquisition of broadcasting assets. Second, the size of the parties and the

size of the transaction may trigger filing requirements under the antitrust laws. Although all deals are subject, in theory, to being overturned because of antitrust concerns, the principal antitrust hurdle in the acquisition arena is the Hart-Scott-Rodino Antitrust Improvements Act (HSR, or Hart-Scott).

In acquisitions of a specified size (approximately \$80 million or greater) and where the parties themselves exceed specified size hurdles (approximately \$160 million or more in sales or assets for one, and approximately \$16 million or more for the other), a filing with, and clearance by, the federal government is required. Some large deals get scrapped or modified because of antitrust review, but for most smaller deals, an HSR filing requirement is merely an expensive nuisance and unwelcome delay.

Acquisition Accounting

In the not-too-distant past, accounting considerations were frequently as important as tax considerations in structuring acquisitions. That is because there were two forms of accounting for acquisitions by the acquirer with drastically different consequences. In so-called *purchase accounting*, the acquirer reset the fair market value of the acquired assets and any related goodwill had to be depreciated, sometimes over a relatively short period. In the other form, a *pooling of interests*, there was no change in the book basis of the acquired assets and no amortization of goodwill. This was considered highly desirable, since it was difficult to do accretive acquisitions with goodwill amortization creating significant book expense going forward. The requirements for qualifying for a pooling were quite strict (e.g., the acquisition consideration had to be solely for voting stock). There were multiple other requirements as well.

This has all changed, and now there is only one form of accounting treatment for acquisitions. Post-acquisition assets have a new book basis tied to fair market value, and goodwill is not written off unless it is, or becomes, impaired. There is also something called *recapitalization accounting*, discussed in Chapter 3.