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Private Acquisition Structures

Resource type: **Practice Note** Status: **Maintained** Jurisdiction: **USA**

This Note provides an introduction to the three structures used in private acquisitions: asset acquisition, stock acquisition and merger.

Practical Law Corporate & Securities

Contents

There are three principal ways to acquire a business:

- Asset acquisition.
- Stock acquisition.
- Merger.

This Note provides an introduction to these three structures.

Choosing which structure to use involves many factors. Buyers and sellers often have competing interests; understanding each factor and its impact on the parties is essential for any business attorney. These factors include:

- Commercial issues.
- Process and consents.
- Tax issues.

This Note assumes that the parties involved in the transaction are private **C-corporations** and unless otherwise indicated, addresses only US federal income tax issues. Factors such as legal requirements, tax considerations and consents may differ depending on the type of entity involved.

For a discussion of public mergers and acquisitions, see Practice Notes, Public Mergers: Overview and Tender Offers: Overview.

Asset Acquisitions

In an asset acquisition, the buyer acquires specific assets and liabilities of the target company as listed in the asset purchase agreement. After the deal closes the buyer and seller maintain their corporate structures and the seller retains those assets and liabilities not purchased by the buyer. See Practice Note, Asset Acquisitions: Overview for a more detailed discussion of the asset acquisition process.

Commercial Issues

Buyer

Buyers may favor asset acquisitions for a number of reasons, including:

- The flexibility to pick and choose specific assets and liabilities.

- No wasted money on unwanted assets.
- Lower risk of assuming unknown or undisclosed liabilities.
- Often better tax treatment than stock acquisitions (see Asset Acquisitions: Tax Issues).

Buyers should keep in mind, however, that they could inadvertently fail to purchase important assets. For example, if a buyer purchases a specific business division and leaves out a key supply agreement, it may not be able to operate the purchased business. This risk does not exist in stock acquisitions and mergers as the buyer acquires all of the target company's assets, rights and liabilities. In addition, valuing and identifying specific assets can be difficult and time consuming.

Successor Liability

Even when a deal is structured as an asset sale, buyers may become liable for assets not specifically listed in the asset purchase agreement. This is referred to as **successor liability** and can be imposed by courts in certain situations, such as:

- When the purchaser expressly or impliedly assumes certain liabilities.
- If the transaction is deemed a **de facto merger** under state law.
- If the transfer was fraudulent or intended to defraud creditors.
- If the purchaser is a "mere continuation" of the seller.
- If certain claims are involved (for example, product liability or environmental claims).

In addition, under some state and local tax laws, the buyer may be responsible for certain taxes of the seller.

Seller

Sellers may not like asset sales for two main reasons:

- They are left with known and unknown liabilities not assumed by the buyer.
- They usually receive better tax treatment when selling stock (see Stock Acquisitions: Tax Issues).

Process and Consents

Process and Third Party Consents

Asset acquisitions are typically more complicated and time-consuming than stock acquisitions because:

- Assigning specific assets requires separate transfers with different mechanics and formalities.

- Numerous third party consents are often required since most agreements contain anti-assignment clauses (stock acquisitions only require consents when **change of control clauses** are present).
- Some states have **bulk sales laws** that must be complied with or the buyer will assume additional liabilities. In general, bulk sales laws require certain notifications be made to the seller's creditors before the deal closes.

Corporate Consents

Asset acquisitions typically involve the following corporate consents:

- Seller board consent.
- Seller stockholder consent if a company is selling "all or substantially all" of its assets (if required by the laws of the state in which the seller is organized).
- Buyer board consent for material transactions.

In addition, many states provide **appraisal rights** to the seller's stockholders if all or substantially all of the assets are sold (see Appraisal Rights and Corporate and LLC Consents Required for Mergers and Acquisitions Checklist).

Consents

Whether board and stockholder consent is required for a particular transaction is often a matter of corporate law. It is important to review the laws of the states of formation of all parties to a transaction when considering structure. In addition, a party's constituent documents (for example, its by-laws and stockholder agreements) may require additional consents. If a party is a public company, the applicable stock exchange rules must also be considered (for example, stockholder consent may be required if stock is issued as consideration).

Tax Issues

Although a buyer generally acquires a private company's assets with cash or notes (or some combination of the two), other consideration such as the buyer's or its affiliate's stock may be used. If stock of the buyer or its affiliate is used as consideration, the asset acquisition is treated as a taxable transaction unless it is structured to qualify as a **tax-free reorganization** (see Box, Stock as Consideration). For more information about tax-free reorganizations, see Practice Notes, Tax-Free Reorganizations: Acquisitive Reorganizations and What's Market: Tax-free Transactions.

Private company asset acquisitions generally are structured as taxable transactions for business reasons, unless the buyer (or its affiliate) is a public company. One business reason is that there generally is no market for the stock of private companies so sellers are often not willing to accept it as consideration.

This Note assumes that the asset acquisition is structured as a taxable transaction.

For further discussion of the tax considerations involved when buying or selling the assets of a target company, see Practice Note, Asset Acquisitions: Tax Overview.

Buyer

The buyer receives a **cost basis** in the acquired assets. That is, the buyer acquires a **basis** in the acquired assets equal to the purchase price paid plus certain other items. In a stock acquisition, the target company's basis in its assets generally remains unchanged (see Stock Acquisitions: Tax Issues and Practice Note, Stock Acquisitions: Tax Overview).

The cost basis that the buyer receives in the acquired assets is often higher than the basis that the target company had in those assets (referred to as a **stepped-up basis**). If the target company's basis in its assets exceeds their fair market value, an asset acquisition results in a "step-down" in the basis of the acquired assets (see Practice Note, Asset Acquisitions: Tax Overview).

Basis is used, among other things, to calculate **depreciation** and **amortization** deductions, as well as income, gain or loss on the sale or other disposition of the assets. A stepped-up basis benefits the buyer by enabling it to take greater depreciation and amortization deductions on such assets and by reducing the amount of taxable income or gain (or increasing the amount of loss) on a later sale or other disposition of the assets.

Buyers generally prefer to structure a transaction as an asset acquisition if they receive a stepped-up basis in the acquired assets. In certain circumstances, the parties can elect to treat a stock acquisition as an asset acquisition for US federal tax purposes (see Stock Acquisitions: Tax Issues).

Pre-Closing Income Taxes of the Target Company

In an asset acquisition, the buyer is ordinarily not responsible for pre-closing income taxes of the target company unless such taxes are expressly assumed. However, under some state and local laws, the buyer may be responsible for certain taxes of the target company under the applicable successor liability statutes (see Box, Asset Acquisitions: Successor Liability and Practice Note, Asset Acquisitions: Tax Overview).

Seller

The target company generally recognizes taxable income, gain or loss on the sale of its assets. In addition, the target company's stockholders generally recognize taxable income, gain or loss on the distribution of any proceeds from the sale. This potentially results in double taxation (at the entity and stockholder level), rather than a single level of taxation (at the stockholder level) in a stock acquisition (see Stock Acquisitions: Tax Issues). For this reason, sellers generally prefer to structure a transaction as a stock acquisition.

In certain circumstances, double taxation can be avoided:

- If the target company is a **partnership**, **limited liability company** (LLC) (that is, taxed as a pass-through entity) or an **S-corporation**, any taxable income, gain or loss realized from the sale of the assets generally passes through to (in other words, be taxed directly to) the target company's **partners**, **members** or stockholders, avoiding the entity level tax in most cases.
- If the target company has **net operating losses** (NOLs) or other tax attributes, the entity level tax may be reduced or eliminated.
- If the proceeds from the sale are not distributed out to the target company's stockholders, the stockholder level tax is avoided. In addition, if a target company stockholder is a corporation that owns 80% of the target company, taxable gain or loss generally is not recognized by that stockholder on a **liquidating distribution** of any proceeds from the sale.

A seller is more likely to agree to structure a transaction as an asset acquisition if the target company is a partnership, LLC or S-corporation. This is because the asset acquisition results in only a single level of taxation (at the stockholder level) as opposed to potential double taxation (at the entity and stockholder level) if the target company is a C-corporation.

For a discussion of the tax issues that arise when the target company is US partnership, LLC or S-corporation, see Practice Note, Taxation of Pass-through Entities. For more information on the US federal income tax classification rules that apply to US corporations, partnerships and LLCs, see Practice Note, Choice of Entity: Tax Issues.

Sales, Use and Other Transfer Taxes under State Law

In addition to potential double taxation, many asset acquisitions are subject to sales, use and other transfer taxes under state law. The seller generally is responsible for these taxes as a matter of law but they may be shifted to the buyer by contract. Stock acquisitions generally do not result in sales, use or other transfer taxes. It is advisable to consult with a state law tax specialist when structuring an acquisition.

Stock Acquisitions

In a stock acquisition, the buyer acquires the target company's stock directly from the selling stockholders. The buyer acquires all of the target company's assets, rights and liabilities. Following the transaction the target company maintains its corporate existence and becomes a subsidiary of the buyer. See Practice Note, Stock Acquisitions: Overview for a more detailed discussion of the stock acquisition process.

Commercial Issues

Buyer

Buyers cannot select specific assets and liabilities when purchasing stock, and assume all of the target company's assets, rights and liabilities as a matter of law. Although this additional liability creates risk for buyers, a stock acquisition is good for buyers desiring to acquire a **going concern**.

To shield themselves from target company liabilities, buyers often:

- Maintain the target company as a separate subsidiary.
- Merge the target company with a subsidiary in a forward or reverse triangular merger (see Mergers).
- Negotiate certain contractual protections into the stock purchase agreement, such as indemnities and **escrow** provisions.

Another consideration is that a buyer cannot get 100% control unless all of the target company's stockholders agree to sell their stock. As the number of stockholders increases, so does the potential for hold-outs, lengthy negotiations and other complications. Buyers that do not acquire 100% control may end up owning the target company with other stockholders who may be difficult to deal with. Buyers faced with many stockholders may therefore choose a merger or a stock acquisition followed by a **short-form merger** (if possible).

Short-form Mergers

If a buyer acquires less than 100% of the target company's stock (but generally at least 90%), it may be able to use a short-form merger. This procedure allows the buyer to acquire the remaining minority interests without a stockholder vote and purchase all of the target company's stock. This merger process occurs after the stock sale closes; it is not a negotiated transaction. For information on negotiated mergers, see Mergers.

Short-form mergers are governed by statute, so check the corporate law of the states of formation of the parties if considering this option. In addition, as with negotiated merger transactions, short-form mergers typically provide appraisal rights to the minority stockholders.

For examples of short-form merger certificates for a Delaware corporation, see Standard Documents, Certificate of Ownership and Merger (DE): Parent into Subsidiary and Certificate of Ownership and Merger (DE): Subsidiary into Parent.

Seller

Sellers often prefer to sell stock since they are not left with any contingent liabilities. In addition, sellers typically receive better tax treatment when selling stock as opposed to assets (see Stock Acquisitions: Tax Issues).

Process and Consents

Process and Third Party Consents

Stock acquisitions are usually simpler than mergers and asset acquisitions. Unless an agreement specifically contains a change of control clause, there is generally no need for third party consents. In addition, as opposed to mergers, there are relatively few statutory requirements applicable to stock acquisitions. However, negotiations can be time-consuming if there are numerous selling stockholders (*see above*).

Corporate Consents

Since buyers acquire stock directly from the stockholders, there are typically no formal stockholder consents or target company board consents required (unless the target company is a party to the stock purchase agreement). If the transaction is material, the buyer's board needs to approve it but buyer stockholder consent is not usually required. As with each type of deal structure, it is important to check the constituent documents of both parties for any additional requirements (see Box, Consents).

Tax Issues

Although a buyer generally acquires a private company's stock with cash or notes (or some combination of the two), other consideration such as the buyer's or its affiliate's stock may be used. If stock of the buyer or its affiliate is used as consideration, the stock acquisition is treated as a taxable transaction unless it is structured to qualify as a tax-free reorganization (see Box, Stock as Consideration). For more information about tax-free reorganizations, see Practice Notes, Tax-Free Reorganizations: Acquisitive Reorganizations and What's Market: Tax-free Transactions.

Private company stock acquisitions generally are structured as taxable transactions for business reasons, unless the buyer (or its affiliate) is a public company. One business reason is that there generally is no market for the stock of private companies so sellers are often not willing to accept it as consideration.

This Note assumes that the stock acquisition is structured as a taxable transaction.

For more information on the tax considerations involved when buying or selling the stock of a private company, see Practice Note, Stock Acquisitions: Tax Overview.

Buyer

The target company's basis in its assets generally remains unchanged after a stock acquisition. In an asset acquisition, the buyer often receives a stepped-up basis in the acquired assets (see Asset Acquisitions: Tax Issues and Practice Note, Asset Acquisitions: Tax Overview).

Instead, the buyer receives a cost basis in the target company's stock. That is, the buyer receives a basis in the target company's stock equal to the purchase price paid plus certain other items. Basis in the target company's stock is used to calculate the buyer's taxable income or gain (or the amount of any loss) on a later sale or other disposition of the stock.

Buyers generally prefer a stepped-up basis in the target company's assets to a cost basis in a target company's stock and therefore typically prefer to structure a transaction as an asset acquisition (see Asset Acquisitions: Tax Issues and Practice Note, Asset Acquisitions: Tax Overview). In certain circumstances, the parties can elect to treat a stock acquisition as an asset acquisition for US federal tax purposes. This is usually accomplished by making a **Section 338(h)(10) election**. If a Section 338(h)(10) election is made, the buyer often receives a stepped-up basis in the target company's assets. A Section 338(h)(10) election generally is made only if the target company is a private company. This is because, in most instances, the target company needs to be at least 80% owned by a US corporate seller. For more information on Section 338(h)(10) elections, see Practice Note, Stock Acquisitions: Tax Overview.

However, if there is a "step-down" in the basis of the assets in a stock acquisition with a Section 338(h)(10) election, buyers prefer to structure a transaction as a stock acquisition without a Section 338(h)(10) election (see Practice Notes, Stock Acquisitions: Tax Overview, and Asset Acquisitions: Tax Overview).

For more information on tax elections to treat stock acquisitions as asset acquisitions, see Practice Note, Stock Acquisitions: Tax Overview.

Seller

Target company stockholders generally recognize a taxable gain or loss on the sale of their stock. This results in a single level of taxation (at the stockholder level), rather than potential double taxation (at the entity and stockholder level) in an asset acquisition (see Asset Acquisitions: Tax Issues). For this reason, sellers generally prefer to structure a transaction as a stock acquisition.

Sales, Use and Other Transfer Taxes under State Law

Unlike asset acquisitions, stock acquisitions generally do not result in sales, use or other transfer taxes. However, a few states impose a stock transfer tax and a few states impose a real estate transfer tax on the sale of a controlling interest in a real property entity. It is advisable to consult with a state law tax specialist when structuring an acquisition.

Mergers

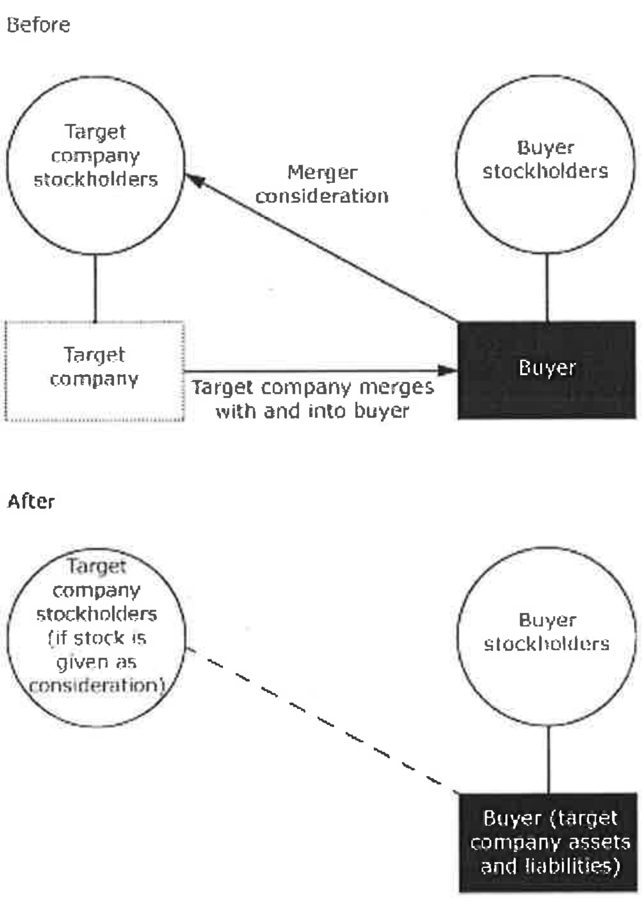
A merger is a stock acquisition in which two companies combine into one legal entity. The surviving entity assumes all assets, rights and liabilities of the extinguished entity. The merger process is governed by the laws of the states of formation of the parties.

The principal categories of mergers are direct mergers and indirect mergers. Direct mergers are typically structured as forward mergers (they can also be structured as reverse mergers so that the target company survives, but this is not common). Indirect mergers are structured as forward triangular mergers or reverse triangular mergers and are often used by buyers to shield themselves from target company liabilities. Foreign buyers often choose indirect mergers when acquiring the stock of a US entity to reduce their exposure to target company liabilities. For a more detailed discussion of the private merger process, see Practice Note, Private Mergers: Overview.

Forward Merger

In a forward merger, the target company merges with and into the buyer, the buyer assumes all of the target company's assets, rights and liabilities by operation of law and the target company ceases to exist as a separate entity.

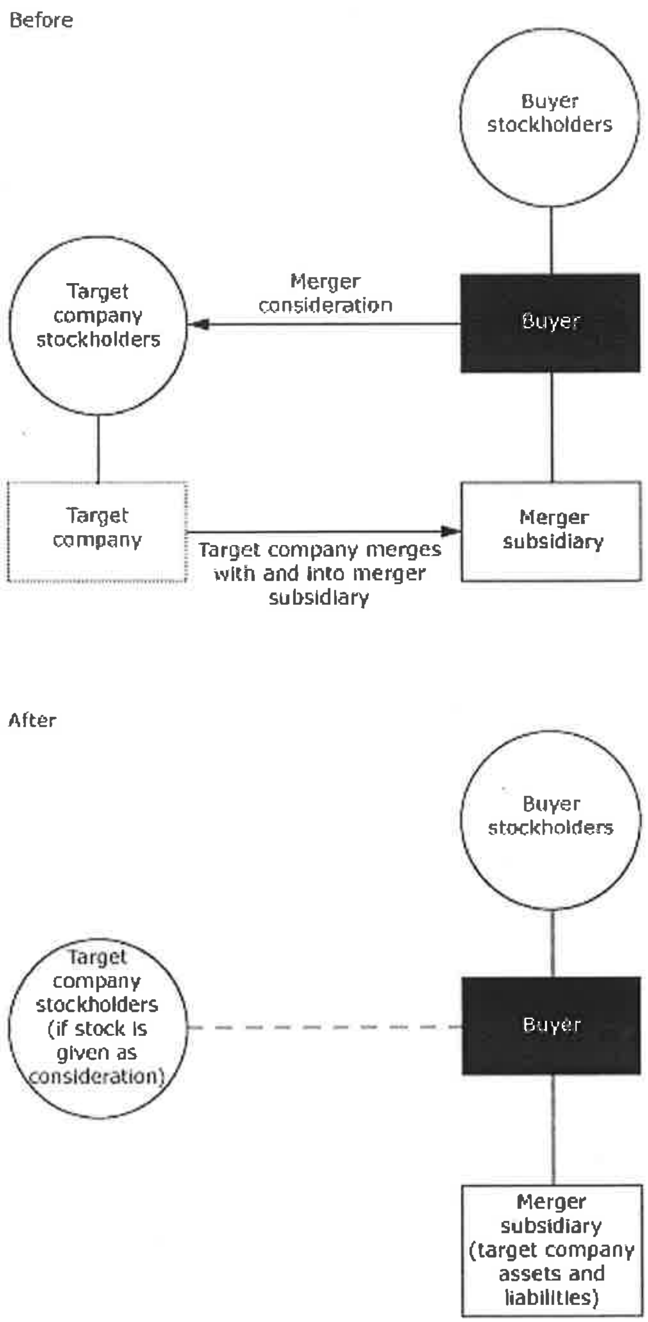
The following diagram represents a forward merger:



Forward Triangular Merger

A forward triangular merger is an indirect merger where the buyer uses a merger subsidiary (which can be an existing or newly formed subsidiary) to acquire the target company. The target company merges with and into the merger subsidiary, the merger subsidiary assumes all of the target company's assets, rights and liabilities by operation of law and the separate existence of the target company is extinguished.

The following diagram represents a typical forward triangular merger:

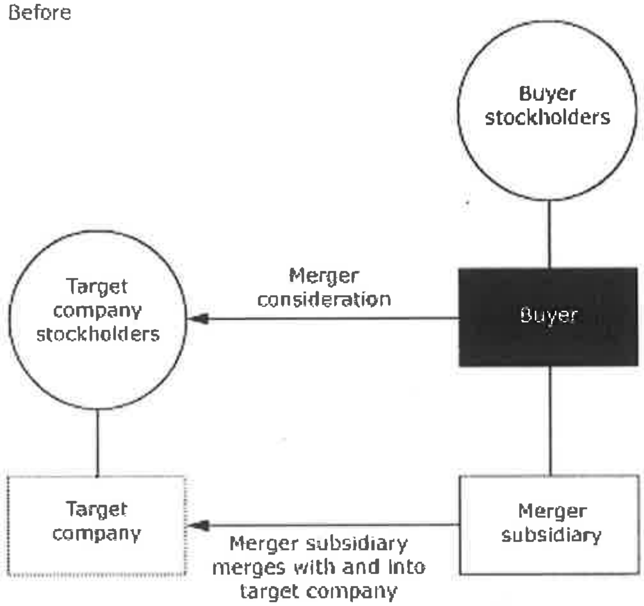


Reverse Triangular Merger

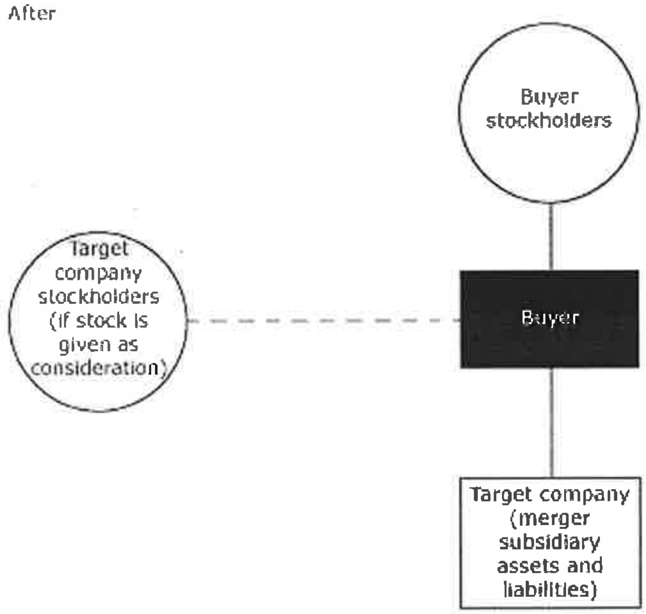
In a reverse triangular merger (also an indirect merger), the buyer's merger subsidiary is merged with and into the target company and the target company survives the merger and becomes the buyer's subsidiary. The principal advantage to this structure is that it typically does not require third party consents since the target company is the surviving entity (unless the relevant agreements contain change of control provisions). In 2013, the Delaware Court of Chancery confirmed that reverse triangular mergers would not constitute an assignment by operation of law (see Legal Update, Delaware Court of Chancery Holds that Reverse Triangular Mergers Do Not Trigger "Assignment by Operation of Law" Provisions). However, not all states take this approach. In *SQL Solutions, Inc. v. Oracle Corp.*, a California district court held that a reverse triangular merger can result in an assignment by operation of law (see *SQL Solutions, Inc. v. Oracle Corp.,* 1991 WL 626458 (N.D. Cal. Dec. 18, 1991)).

The following diagram represents a typical reverse triangular merger:

Before



After



Commercial Issues

Mergers typically only require majority consent from the target company's stockholders for the buyer to obtain 100% of the stock (subject to any additional requirements that may exist in a company's constituent documents, such as class voting rights for a series of stock). For a buyer to acquire 100% control in a stock acquisition, all of the stockholders must agree to sell (however, buyers may be able to acquire 100% of the stock in a short-form merger (see Box, Short-form Mergers)). A merger is therefore a good choice for buyers that want to acquire a going concern that has many stockholders, especially when some of them may be opposed to selling their stock.

Buyers must also consider that they will assume all of the target companies' assets, rights and liabilities as a matter of law, whether disclosed or not. In this regard, mergers are similar to stock acquisitions.

Process and Consents

Process and Third Party Consents

Mergers are governed by state law and involve detailed filing requirements (such as the preparation and filing of articles or certificates of merger). In addition, unless the merger is structured as a reverse triangular merger, the parties will often have to obtain the same third party consents as in an asset acquisition since the target company will be merged out of existence and agreements therefore need to be transferred to the surviving entity. Even with reverse triangular mergers, there may be instances when third party consent requirements are triggered (see Reverse Triangular Merger).

Corporate Consents

Since mergers are governed by statute (see Box, Consents), required board and stockholder consents are dictated by the laws of the states in which the parties to the merger are formed. However, mergers typically involve the following corporate consents:

- Board consents from the buyer and target company.
- Consent from at least a majority of the target company's stockholders.
- Consent from at least a majority of the buyer's stockholders (required for direct mergers).
- Appropriate board and stockholder consents from merger subsidiaries (not required for direct mergers).
- Any additional consents required by a company's constituent documents (for example, a special vote of a class of stock may be required).

Appraisal Rights

The corporate laws of most states provide that dissenting stockholders to a merger can petition the court to force the buyer to pay them "fair value" for their shares. This process often adds additional time, complexity and expense to a merger. Some states also provide appraisal rights in the sale of all or substantially all of a company's assets. For more information on appraisal rights, see Practice Note, Appraisal Rights.

Tax Issues

The structure of a merger determines its tax treatment. For tax purposes, forward mergers and forward triangular mergers generally are treated as asset acquisitions and reverse triangular mergers generally are treated as stock acquisitions.

Depending upon the circumstances, a merger can be structured as a taxable transaction or as a tax-free reorganization.

Private mergers generally are structured as taxable transactions for business reasons, unless the buyer (or its affiliate) is a public company. One business reason is that there generally is no market for the stock of private companies so sellers are often not willing to accept it as merger consideration.

For a further discussion of the tax considerations involved in structuring a private merger, see Practice Note, Mergers: Tax Overview. For a discussion of tax-free mergers, see Practice Notes, Tax-Free Reorganizations: Acquisitive Reorganizations and What's Market: Tax-free Transactions.

Stock as Consideration

Stock issuances raise important considerations, such as:

- Additional corporate consents may be required. For example, if the buyer is a public company additional stockholder consents may be required by applicable exchange rules.
- Federal and state securities law issues. Buyers issuing stock must satisfy federal and state securities laws by ensuring, among other things, they issue publicly registered stock or satisfy an exemption from registration.
- Increased market risk to sellers. Cash results in a fixed value. Sellers receiving stock are subject to the ups and downs of the market.
- Dilution to the buyer's stockholders. When a company issues stock, its existing stockholders could end up with a smaller percentage ownership than they had before the issuance.
- Buyer's stockholders may be entitled to **pre-emptive rights**. Stockholders are often granted the right to purchase stock issued by the company to protect their percentage ownership interest. Issuances related to acquisitions are often excluded from this right, so a careful review of the buyer's corporate documents is necessary.
- Structuring a transaction as a tax-free reorganization is more restrictive, complicated and time-consuming.

Structure Determines Success

Selecting the best structure is critical to the success of any acquisition. Attorneys must constantly weigh competing legal, tax and business considerations against the desires of the parties and their clients. Structuring a deal requires creativity, planning and flexibility. If done well, the expectations of buyers and sellers can be met and, in those rare cases, exceeded.

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