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EXECUTING THE DEAL

COMPLIANCE REQUIREMENTS

2016 | SEMINAR REFERENCE BOOK

Executing the Deal
Compliance Requirements

Seminar Reference Book

TABLE OF CONTENTS

I. Introduction

Mergers and acquisitions (M&A) play an important role in the global economy. There were over 44,000 deals worldwide in 2015, valued at nearly $4.5 trillion. These deals are often quite complex and challenging to complete. Some deals fall through before completion. And those that are completed may or may not be considered successful by the parties.

Although nothing can assure a successful transaction, a review and acknowledgement of potential issues at the beginning of the process may reduce those challenges and the related difficulties that can appear after the deal is complete.

II. Deal Overview

The deals discussed herein involve the acquisition or divestiture of a company. Below are definitions of some key deal terms and concepts.

Acquisition - An acquisition may be defined as "The act of becoming the owner of certain property. Taking with or without consent, especially a material possession obtained by any means."

Merger - A merger is generally defined as a combination of two or more business entities in which the assets, businesses and liabilities of all the entities are transferred to one, which continues in existence, while all the others cease to exist. Because it is a statutory transaction the requirements of the business entity laws of the parties' states of formation must be followed for the merger to become legally effective.

The Terms "Mergers" and "Acquisitions" Are Not Interchangeable - A merger is a statutory transaction that may be used to acquire another company. It is one method of acquisition but it is not the only method. There are also non-statutory and other statutory methods. The two main non-statutory methods are the share acquisition and the asset acquisition.

Share Acquisition - A share acquisition occurs when an acquirer purchases the shares of a corporation. The result of a share acquisition is that the acquired corporation becomes a subsidiary of the acquirer. The purchase price may be cash, stock in the acquirer, or other property. When the acquirer purchases the membership interests of an LLC or ownership interests of another form of unincorporated business entity, the transaction is generally referred to as an interest acquisition.

Asset Acquisition - An asset acquisition occurs when one business entity purchases all, or substantially all of the target's assets, other than in the ordinary course of business. After the transaction is completed, the target retains its separate existence. Its assets consist of the proceeds of the sale and any assets not sold. The purchase price may be in cash, stock or other ownership interests, or other property.

An asset acquisition differs from a share or interest acquisition in two significant ways. First, in an asset acquisition, the target does not become a subsidiary of the acquirer. Second, the purchase price is paid to the target business entity, not to the target's owners.

Divestiture – A divestiture may be defined as the act or process of disposing of or selling an asset, subsidiary, business unit or other property by a company. It may take various forms including a spin off, equity carve-out, or direct sale of assets.

III. Deal Transaction Vehicles

Executing a deal may require the parties to enter into one of the following statutory vehicles. Some of these may be used to actually effect the acquisition or divestiture. Others may be involved in other aspects of the larger deal.

General Merger - A "general" merger is one effected pursuant to the "general merger statute." This is the basic merger provision of any business entity act. It is "general" in the sense that it applies to any merger, rather than a specific transaction, such as the merger of a wholly-owned or nearly wholly-owned subsidiary into its parent.

The general merger statutes provide a domestic entity with the authority to enter into a merger. They also set forth the type of business entities it may merge with or into. In addition, the general merger statutes describe the documents that have to be filed to effect the merger, set forth who has to approve the plan of merger, prescribe the legal effect of the merger, state whether and when the plan may be abandoned or amended, and state whether dissenters' rights are available and how they can be obtained.

Parent-Subsidiary Up-Stream Merger - A parent-subsidiary up-stream merger is a merger of a subsidiary business entity into its parent business entity, with the parent business entity surviving.

In order to simplify the procedure when there are no, or almost no minority shareholders, business corporation statutes authorize what is called a short-form merger. In general, only mergers where the parent owns at least 90% of each class of voting stock of the subsidiary may be effected using the short-form procedure.

Typically in a short-form merger, only the parent's board of directors has to approve the plan of merger. The subsidiary's board does not have to approve. In addition, neither the parent's shareholders nor the subsidiary's shareholders have to approve the plan. Approval of the subsidiary's shareholders is considered unnecessary because the parent owns enough shares to ensure approval. Approval of the parent's shareholders is unnecessary because the transaction will not materially change their interests. When an unincorporated entity is involved the governing statutes should be consulted to determine if a short form procedure is available. If not, than the general merger statute must be used.

Parent-Subsidiary Down-Stream Merger - A parent-subsidiary down-stream merger is a merger of a parent into its subsidiary. The subsidiary survives and the parent disappears. Some corporation statutes provide that where the parent owns at least 90% of the voting stock of the subsidiary, the subsidiary's board of directors is not required to approve the plan of merger. However, when the parent disappears, approval of the merger by the parent's shareholders will be required.

Triangular Mergers - A triangular merger involves three business entities - a parent (the acquirer), its subsidiary, and the entity to be acquired (the target). In general, the subsidiary will be newly formed for the sole purpose of assisting the parent in acquiring the target. In a triangular merger, the merger is between the subsidiary and the target. The acquirer is not a constituent to the merger. When an acquisition involves a statutory merger, a triangular merger is often the vehicle of choice.

In a forward triangular merger, the parent forms a shell subsidiary that has no assets or liabilities of its own. The target and subsidiary merge, with the subsidiary surviving and the target disappearing. The target's owners may receive as the merger consideration, ownership interests in the acquirer, cash, or other property.

The effect of the transaction is that the target becomes a wholly-owned subsidiary of the acquirer. However, because the merger was between the target and the subsidiary, the acquirer does not assume the target's liabilities. Had the acquirer directly merged with the target, the acquirer would, by operation of law, have received its liabilities. This is the main reason for entering into a forward triangular merger - to allow the acquiring entity to acquire the target without assuming its liabilities.

In a reverse triangular merger, the subsidiary merges into the target, with the target surviving and the subsidiary disappearing. The acquirer, as the subsidiary's owner, receives as merger consideration all of the target's ownership interests. The target's owners, in exchange for giving up their interests in the target, may receive as the merger consideration, ownership interests in the acquirer, cash or other property.

The end result of the transaction is that the target becomes a wholly-owned subsidiary of the acquirer without the acquirer assuming the target's liabilities. In addition, because the target survives the merger, both the acquiring and acquired business entities remain in existence. Therefore, the reverse triangular merger is useful where the loss of identity of a constituent would cause problems - such as where the target was organized under a special statute in which organization is difficult or where it possesses rights, licenses, or contracts that do not permit assignment.

Conversion - A statutory conversion is not a method of acquisition. Nevertheless it may be part of the larger deal. A conversion has two possible purposes. It may be used by one form of business entity to change to another form of business entity. In addition, some business entity laws provide that a domestic entity may convert to a foreign entity of the same type. In these states, the conversion transaction may be used to change a state of organization.

The legal effect of a conversion is prescribed by law. The statutes generally provide that when a conversion takes effect: (1) the converting entity continues to exist without interruption, but in the organizational form of the converted entity; (2) all property owned by the converting entity continues to be owned by the converted entity; (3) the liabilities and obligations of the converting entity continue to be liabilities and obligations of the converted entity; and (4) a proceeding pending by or against a converting entity may be continued by or against the converted entity without any need for substitution.

IV. Deal Transaction Issues

There are many issues to be addressed in any merger, acquisition, or divestiture and a great deal of information to gather. Below are just some of the issues that need to be addressed.

A. Issue – Know the Entity

Before the decision is made to enter into a deal, the constituents engage in a process called due diligence. A main goal during this period is getting to know, as clearly and comprehensively as possible, who the parties are.

Information gathering is an important part of the process. A potential acquirer will want to know as much as possible about the target's assets, liabilities, properties, business operations, customers, etc. to determine if the acquisition makes sense and if so at what price. Knowing where the target is doing business – both within and without the United States - is important as well. Among other reasons, it will tell the acquirer what laws it has to comply with and where certain filings will have to be made. And it is not only necessary to investigate the target but the target's subsidiaries and affiliates too.

In addition, the seller will want to know about the buyer for various reasons, including to determine its ability to pay the sales price. In addition, the filings required to effect statutory transactions such as mergers and make sure state records are accurate post-merger cannot be completed without knowing the parties – the type of entities, states of formation, states of qualification, and so on.

B. Issue – Good Standing

It should be determined if the deal constituents are in good standing (*i.e.,* validly or certifiably in existence) in their formation states and in the foreign states in which filings will be made.

This is important because (1) states may reject filings for business entities that are not in good standing, and (2) if a company has fallen out of good standing it may be a red flag – that is, an indication of possible problems with finances or management.

A business entity may fall out of good standing for a number of reasons. A common reason is the failure to file an annual report and/or pay franchise taxes. If a constituent is not in good standing, steps may be taken to restore it to good standing status. If the constituent is suspended, but has not yet been dissolved or revoked, good standing may be restored by filing all delinquent reports and paying all taxes and penalties due. However, if the constituent has been dissolved or revoked, it may not only have to comply with the delinquent requirement and pay penalties and interest, but it may also have to apply to the state for reinstatement.

A constituent's good standing can be checked by contacting the state's business entity filing office. Verbal confirmation can be obtained, or, if desired, a good standing certificate can be ordered.

It is also important to find out if annual reports or taxes will be due between the date the good standing was checked and the date the transaction will be effective. If these reporting or tax requirements are not met, the business entity can still lose its good standing status. This could cause a state to reject a filing, thereby delaying the merger process.

Additional concerns are (1) whether any subsidiaries and affiliates are in good standing and (2) whether constituents, subsidiaries, and affiliates are in good standing in foreign countries where they may be formed.

C. Issue - Special Purpose Entities

It should also be determined if the deal requires the formation of any special purpose entities. Many mergers and acquisitions involve use of special purpose entities – that is, a business entity formed specifically for that deal. In a triangular merger, for example, a subsidiary must be formed. In addition, lenders may require a bankruptcy remote entity to place certain assets being used as collateral for loans. Or an acquirer may choose not to obtain record ownership to certain assets and may form a separate company, transfer the assets to the SPE, which then licenses the use of the assets back to the acquirer.

Forming a subsidiary generally involves the following steps: (1) checking and reserving the name, (2) completing and filing the formation document, (3) choosing a registered agent, (4) holding an organizational meeting (if a corporation), and (5) drafting bylaws (if a corporation) or an LLC agreement (if an LLC).

Other issues include determining whether the SPE needs to be qualified to do business in any foreign states and whether any independent directors or independent members or managers are required.

D. Issue - UCC

UCC Article 9 allows for the filing of a financing statement (UCC-1) to secure interests in collateral. The acquirer will be concerned with all of the financing statements in which the target is the debtor or secured creditor. Obtaining this information is necessary to determine the target's financial condition and so that the acquirer can determine the assets and liabilities it will be acquiring if the deal is completed.

This information is obtained by conducting a UCC search. The parties will also want to make sure that any additional financing statements, or amendments, continuations, transfers or terminations of existing financing statements, that are necessary, are filed in a timely manner. This is to ensure that security interests remain perfected after the deal. Whether filings are required depends upon various factors such as whether there were changes to the debtor, secured party, or collateral.

E. Issue - Business Licenses

Most businesses require one or more business licenses to operate. Licenses may be required by state, federal, and/or local government agencies. An acquirer will want to determine the extent to which a target is subject to, and has complied with the licensing requirements and has obtained all the licenses and permits required to carry out the operations of the target and its subsidiaries.

The steps required include researching the business license requirements of the jurisdictions in which the target operates and verifying with each licensing authority that the target's license is active. In order to ensure no interruptions in conducting business after the deal is executed, the acquirer will want to make sure it has obtained any licenses the target did not have, has made all required renewal or amendment filings, and cancelled licenses that will not be needed. This is important as there can be substantial penalties for operating a business without the proper licenses.

If the deal results in expansion activities, such as the launching of new products, services or business locations, new licenses may be required. Contraction activities, on the other hand, may require the cancellation of licenses.

F. Issue - Intellectual Property

Intellectual property (IP), such as trademarks, service marks, copyrights, patents, and domain names, is an important part of many mergers and acquisitions. An acquirer will want to thoroughly investigate the extent and quality of a potential target's IP assets. This investigation may also uncover whether there are any intellectual properties that the target needs that it might not have.

After obtaining an accurate picture of the IP assets the target has, the acquirer will want to determine if the target has taken steps to protect its rights to those assets. For example, has it registered its trademarks with U.S. Patent and Trademark Office? Has it copyrighted its products and materials?

It is also important to determine if any of the target's IP assets are infringing on anyone else's rights. The target may be in litigation already or may become subject to litigation in the future. It is important for the acquirer to be aware of any potential liabilities it may be assuming if it completed the deal. In addition, the acquirer will want to discover if anyone else is infringing on any of the target's IP assets that the acquirer may be obtaining. Resolving these disputes can be very expensive and can take years.

Post-deal, the acquirer will want to make sure all required federal, state, and international filings are made to indicate that the acquirer is now the holder of the IP rights and interests. The failure to do so can result in the loss of legal protections.

G. Issue - Anti-Money Laundering

It is also important to inquire as to whether any company involved in the deal (including subsidiaries and affiliates) is doing business in a foreign country or with foreign nationals. Ask, for example, is the company selling, manufacturing, distributing, servicing or otherwise doing business outside the United States or with foreign nationals? One reason why is to make sure that foreign laws are being complied with. However, another reason involves anti-money laundering laws.

The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States.

As part of its enforcement efforts, OFAC publishes a list of individuals and companies owned or controlled by, or acting for or on behalf of, targeted countries. It also lists individuals, groups, and entities, such as terrorists and narcotics traffickers designated under programs that are not country-specific. Collectively, such individuals and companies are called "Specially Designated Nationals" or "SDNs." Their assets are blocked and U.S. persons are generally prohibited from dealing with them.

Check the OFAC list to make sure that none of the entities involved in the deal are doing business with a SDN. Lawyers who assist in deals that might involve SDNs should also be aware of ethics rules regarding assisting clients in illegal or fraudulent activities and confidentiality of information.

H. Issue – Timing

An underlying issue is when to take the steps involved in these deals. Some must be done before the deal can be completed – such as making sure each constituent is in good standing, or forming a subsidiary to affect a triangular merger. Others must be done after the deal is complete – such as making filings to indicate that the acquirer became the owner of certain assets after consummation of the deal. However, some actions may be done either before or after the deal is consummated.

Timing is also a concern when filing documents to effect the statutory transactions – such as mergers, conversions, qualifications, or withdrawals – that might be involved in a deal. Filing office backlogs or document rejections can delay the effective dates of these transactions. There are some mechanisms available to avoid these problems – such as the use of delayed effective dates in the documents being filed, or obtaining preclearance of the documents before delivering them for filing.

V. Conclusion

Mergers, acquisitions, and divestitures involve a significant amount of due diligence. There is a great deal of information to be discovered and potential problems to be addressed. And while the potential acquirer will always want to know as much about a target as possible there are also deals when it is just as important for the target to know the acquirer.

This webinar reference book has discussed just a few of the issues that need to be addressed in a typical deal. Proper planning can help anticipate and solve many of the problems that the constituents and their counsel may face.

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