

M&A Double Take: Why Two Mergers Are Better than One

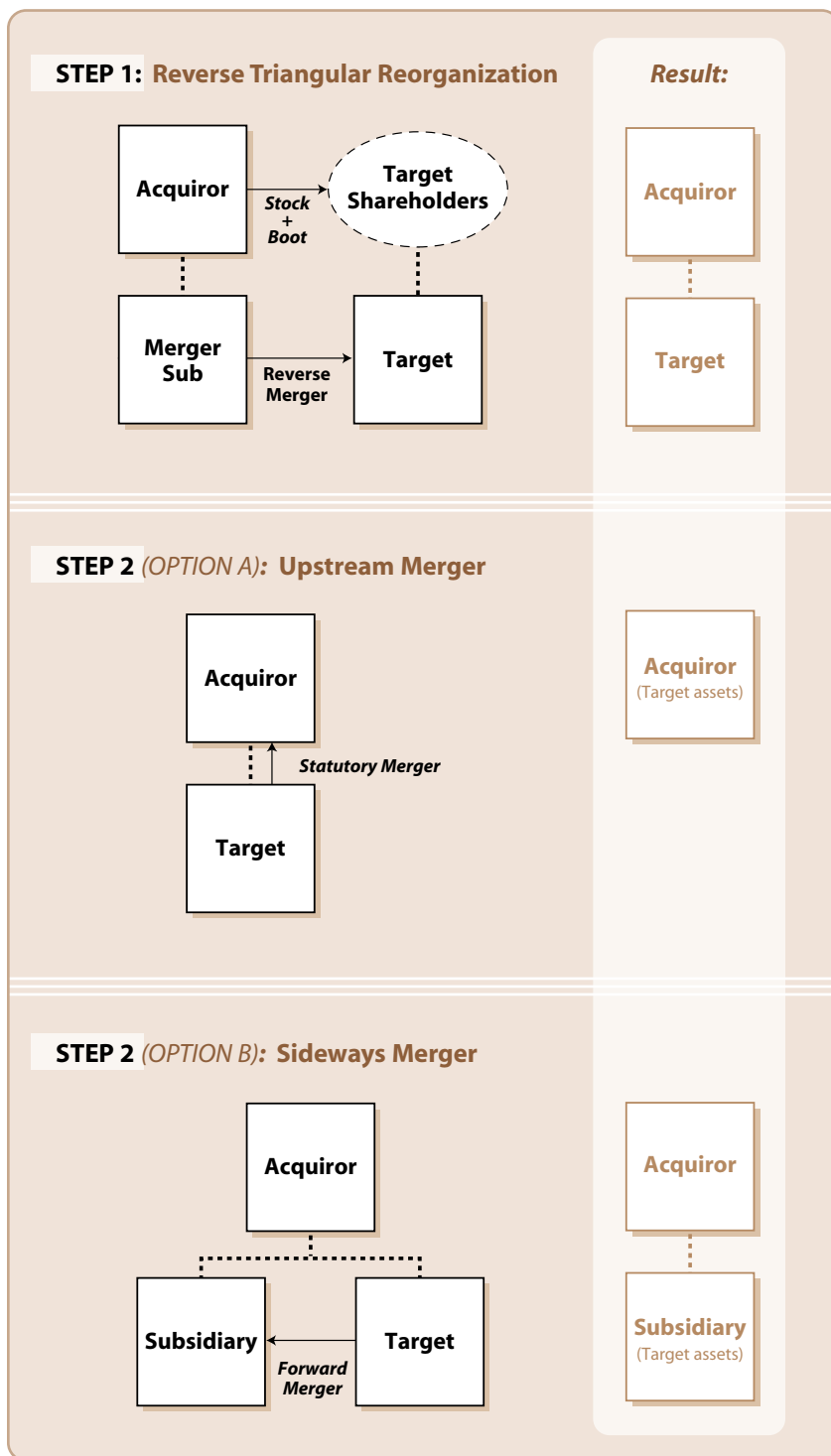
Overview

A recent IRS Revenue Ruling has significantly changed the tax landscape for M&A transactions. In our view, parties to merger transactions may now legitimately avoid many of the constraints traditionally inherent in tax-free reorganizations by utilizing certain back-to-back merger structures. In particular, we believe these new structures can generally be used to effectively eliminate:

- The relatively strict 20% limitation on cash (or other non-stock consideration) in a tax-free reverse triangular merger;
- The requirement in a tax-free reverse triangular merger that “substantially all” the assets of the target corporation be acquired; and
- Corporate-level tax exposure in the event a forward merger (direct or triangular) is found to be taxable by the IRS.

The technique to achieve these results involves the use of two mergers. The first merger entails an acquisition of the target corporation’s stock by way of a reverse triangular merger. The second merger is either an “upstream” merger of the target into the acquiror, or a “sideways merger” of the target into another subsidiary of the acquiror. Conveniently, the second merger can be consummated immediately after the first merger, or can occur later (for example, after necessary contractual consents have been obtained).

A more detailed analysis of this new IRS Ruling is presented on the following pages. Should you have any questions, please feel free to contact any of the attorneys listed at the end of this Alert.



Detailed Analysis

IRS Revenue Ruling 2001-46¹ (the “Double Merger Ruling”) is one of a series of recent IRS rulings designed to address the rise of multi-step, acquisition transactions. As indicated in a comment letter provided by Cooley Godward to the Treasury Department last week,² we believe this new ruling effectively provides a road map to eliminate:

- The relatively strict 20% limitation on cash (or other non-stock consideration) in a tax-free reverse triangular merger;³
- The requirement in a tax-free reverse triangular merger that “substantially all” the assets of the target corporation be acquired;⁴ and
- Corporate-level tax exposure in the event that a forward merger (direct or triangular)⁵ is found to be taxable by the IRS.

As detailed below, these results can generally be achieved through the use of back-to-back mergers: an acquisition of the target corporation’s shares by way of a reverse triangular merger followed by either an “upstream” merger of the target into the acquiror, or a “sideways merger” of the target into another subsidiary of the acquiror. The second merger can be timed conveniently, occurring either immediately after the first merger, or later (for example, after any necessary consents are obtained).⁶

The Double Merger Ruling

A tax-free reverse triangular merger under Section 368(a)(2)(E) of the Internal Revenue Code⁷ is frequently the vehicle of choice for acquirors for a variety of reasons. For example, because the target survives the merger with the acquiror’s subsidiary, no assets are transferred or contracts assigned. This minimizes the third party consents required to close the transaction. The triangular structure also isolates the acquiror from any pre-existing target liabilities and, in some circumstances, eliminates the need for the acquiror’s stockholders to approve the transaction (though approval of the target stockholders will still be required).⁸

However, a tax-free reverse triangular merger has traditionally had at least two distinct disadvantages:

- A requirement that at least 80% of the target stock be acquired solely for acquiror voting stock, thereby limiting the use of nonvoting stock and “boot” (nonqualifying merger consideration such as cash or warrants) in the transaction, (we will refer to this restriction as the “20% boot limitation”) and
- A requirement that the acquiror obtain substantially all of the target’s assets,⁹ which limits the target’s ability to engage in certain transactions, including distributions, redemptions or spin-offs made in connection with (or close in time to) the acquisition.

On September 25, 2001, the IRS released the Double Merger Ruling. In that Ruling, an acquiror purchased a target corporation by means of two consecutive mergers. First, all of the target’s outstanding stock was acquired in a reverse triangular merger (the “Acquisition Merger”) in which the merger consideration consisted of 30% cash and 70% stock. Second, the target (by then a subsidiary of the acquiror) was merged upstream into the acquiror (the “Upstream Merger”).

Viewed in isolation, the Acquisition Merger would not have qualified as a tax-free reorganization, because the cash paid (30%) to the target stockholders exceeded the 20% boot limitation. Nevertheless, the IRS determined that the Acquisition Merger and the Upstream Merger should be collapsed together and viewed as a single merger of target into acquiror for tax purposes. As a result, the transaction qualified as a tax-free reorganization under Section 368(a)(1)(A) of the Code (also referred to as an “A” reorganization).

Because Code Section 368(a)(1)(A) does not contain a 20% boot limitation, the Double Merger Ruling blesses the use of an Upstream Merger to effectively render Code Section 368(a)(2)(E)’s boot limitation inapplicable. Applying the rationale of the Double Merger Ruling, we also believe the 20% boot limitation can be avoided if the second merger, in lieu of an Upstream Merger, is a merger of the target into another acquiror subsidiary, including a newly-formed subsidiary (a “Sideways Merger”).¹⁰ Of course, the “continuity of interest requirement,” which applies to all tax-free reorganizations

and generally requires that approximately 45% of the aggregate consideration consist of stock, must still be satisfied.¹¹

The Double Merger Ruling should ease some of the difficulty that currently exists in selecting the optimal deal structure. An acquiror who prefers a reverse triangular merger to avoid the extra consents and resulting delays that a forward merger might entail can now structure the acquisition as two consecutive mergers, an Acquisition Merger followed by either an Upstream Merger or a Sideways Merger, and achieve both a speedy closing and a cash-rich deal.¹²

In order to ensure that the Double Merger Ruling applies, most tax lawyers will require that the transaction documents expressly provide for both the Acquisition and the Upstream or Sideways Mergers. Moreover, although the Upstream or Sideways Merger can take place after closing, it must in fact occur, at some point, for the target stockholders to receive tax-free treatment. While there are no precise time limits, we expect most tax lawyers to require that the Upstream or Sideways Merger occur no later than one year after the Acquisition Merger.¹³

Avoiding Other Restrictions on Reverse Triangular Mergers

Proper use of back-to-back mergers can also avoid other constraints applicable to tax-free reverse triangular mergers that do not apply to direct “A” reorganizations. For example, an “A” reorganization does not have the Code Section 368(a)(2)(E) requirement that the acquiring corporation obtain “substantially all” of the target’s assets. Accordingly, in a situation where the target has recently spun-off a significant line of business, for example, an Acquisition Merger followed (pursuant to the acquisition agreement) by an Upstream Merger would turn the transaction into an “A” reorganization, thereby avoiding the “substantially all” requirement and allowing the parties tax-free treatment.¹⁴

Minimizing Corporate Level Tax Risk on a Forward Merger

A back-to-back merger structure also has significant advantages for a transaction that is otherwise susceptible of being structured

as a forward merger (either a straight “A” reorganization, or a forward triangular merger eligible for tax-free treatment under Code Section 368(a)(2)(D)). First, some background. Forward mergers (be they straight or triangular) are subject to two levels of tax if they are subsequently found to be taxable. In addition to a stockholder level tax, there is a tax at the corporate level, because the target corporation is deemed to have sold all of its assets, generally at their fair market value. As a practical matter, because the acquiror is the successor to the target, this corporate tax becomes the acquiror’s tax liability.

By contrast, a taxable reverse triangular merger triggers only a single level of tax, paid at the stockholder level. We now believe this unique advantage of reverse triangular mergers (no corporate level tax) should also be effectively available to a forward merger, if the forward merger is immediately preceded by a reverse triangular merger.¹⁵ Generally, it will not be difficult to interpose a reverse triangular merger in an otherwise forward structure. Moreover, additional stockholder votes, consents, delays or risks (tax or otherwise) are unlikely to ensue.

The technique begins with the acquiror undertaking a reverse triangular merger and issuing the same consideration to the target stockholders as originally planned. Next, the acquiror causes the target (now a subsidiary

of acquiror) to merge either into the acquiror or its subsidiary in a forward merger (straight or triangular).¹⁶ These two mergers can occur virtually simultaneously. Once employed, we believe this technique should eliminate any corporate level tax exposure if the IRS successfully challenges the transaction’s status as a tax-free reorganization. Accordingly, we recommend that parties consider a reverse triangular merger prior to a forward merger if there is any doubt as to the forward merger’s tax-free treatment.

Conclusion

As a result of the Double Merger Ruling, corporations have increased flexibility in structuring tax-free acquisitions. The best of both worlds is now generally available to acquirors willing to undertake back-to-back mergers:

- The more lenient requirements of a forward merger (e.g. lower boot limitations), and
- The limited downside of a reverse triangular merger (only a stockholder level tax) if the IRS later rules the transaction taxable.

Accordingly, we recommend that in any tax-free transaction, the parties consider whether a back-to-back merger structure is appropriate.

Should you have any questions regarding Revenue Ruling 2001-46,¹⁷ or the merger

structures discussed above, please contact any of the attorneys listed below. ■

Contact Information

T A X

Broomfield, CO **720/566-4000**
 Daniel P. Meehanmeehandp@cooley.com
 Jennifer C. Rootrootjc@cooley.com

Kirkland **425/893-7700**
 Lea Anne Storumstorumla@cooley.com

Palo Alto, CA **650/843-5000**
 Glen A. Kohlkohlg@cooley.com
 Robert H. (Buff) Miller millerrh@cooley.com

Reston, VA **703/456-8000**
 Daniel P. Meehanmeehandp@cooley.com

San Diego, CA **858/550-6000**
 Lea Anne Storumstorumla@cooley.com

San Francisco, CA **415/693-2000**
 Susan C. Philpotphilpotsc@cooley.com
 Bill Morrowmorrowwb@cooley.com
 Lea Anne Storumstorumla@cooley.com

M & A

Palo Alto, CA **650/843-5000**
 Richard E. Climanclimanre@cooley.com
 Keith A. Flaumflaumka@cooley.com
 Suzanne Sawochka Hooper
hooperss@cooley.com
 David A. Lipkinlipkinda@cooley.com

San Diego, CA **858/550-6000**
 Carl R. Sanchezsanchezcr@cooley.com

Notes

¹ 2001-42 I.R.B. 1.

² 2001 TNT 194-17.

³ A reverse triangular merger involves a merger between the target and a subsidiary of the acquiring corporation where the target corporation survives, and the acquiring corporation issues stock, cash, or a combination of each to the target stockholders. Reverse triangular mergers are also referred to as “reverse subsidiary mergers.”

⁴ Generally, this is interpreted to mean at least 70% of the target's gross assets and at least 90% of the target's net assets measured by fair market value on the closing date.

⁵ In a forward merger, the target merges either directly into the acquiring corporation, or into a subsidiary of the acquiring corporation, with the acquiror (or the acquiror's subsidiary) surviving.

⁶ This second merger is internal to the acquiror consolidated group; the target's former stockholders do not participate in the second merger, having relinquished their ownership of target in the initial merger. As noted above, the occurrence of the upstream or sideways merger can be delayed to allow the parties to obtain necessary contractual consents. However, if there is significant risk that third party consents may never be forthcoming, the parties may be limited to a traditional reverse triangular merger structure.

⁷ All references to the “Internal Revenue Code” or the “Code” refer to the Internal Revenue Code of 1986, as amended.

⁸ In certain circumstances, a vote by the acquiror's stockholders will be required regardless of structure.

⁹ For this purpose, acquiror is generally deemed to obtain those assets held by target at the time of the merger.

¹⁰ Moreover, we believe either form of the back-to-back merger technique can be used in the context of the increasingly popular tender offer/merger structure, thereby creating a three step transaction: first a tender offer, and then a reverse merger followed by an Upstream or Sideways Merger.

¹¹ The continuity of interest requirement is the only limitation on the amount of boot payable in an “A” reorganization.

¹² The back-to-back merger structure will also allow the parties more flexibility to employ contingent stock arrangements such as earnouts or price guarantees.

¹³ Acquirors concerned about isolating target corporation liabilities may not be in a position to complete an Upstream Merger, and thus would be better served by a Sideways Merger. And, as noted in footnote 6, if there is significant risk that third party consents may not be forthcoming, the parties may be limited to a traditional reverse triangular merger structure.

¹⁴ A Sideways Merger would not avoid the requirement that acquiror obtain substantially all of target's assets. For tax-free treatment, the Acquisition Merger/Sideways Merger combination depends upon Code Section 368(a)(2)(D), which also contains a “substantially all” requirement.

¹⁵ Our view is based on our analysis of the interaction of prior authorities with the Double Merger Ruling. See, e.g., Revenue Ruling 90-95, 1990-46 I.R.B. 5. However, IRS has not specifically addressed this issue.

¹⁶ When structuring any merger transaction, the well-advised acquiror will consider where (within its consolidated group) it intends to deploy the target's assets post acquisition. This advice is especially important in multi-step transactions. Failure to consider this issue when determining the preferred structure could, for example, result in tax considerations dictating a delay in the implementation of the acquiror's asset redeployment strategy.

¹⁷ This alert does not address all implications of Revenue Ruling 2001-46, in particular, its implications to taxable transactions. Under certain circumstances, an Upstream Merger can turn an otherwise taxable Acquisition Merger into a tax-free transaction. To the extent that this is problematic, one possible solution is a state law liquidation, instead of a merger, to combine the assets of target and acquiror.

Alert!

Cooley Godward LLP

Five Palo Alto Square
3000 El Camino Real
Palo Alto, CA 94306

ATTORNEYS AT LAW

Broomfield, CO

Kirkland, WA

Menlo Park, CA

Palo Alto, CA

Reston, VA

San Diego, CA

San Francisco, CA

www.cooley.com

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