advisory

PLANNING TO SELL YOUR COMPANY? THE PROS AND CONS OF ASSET SALES, STOCK SALES AND MERGERS

Once you decide to sell your company and identify a potential buyer, one of the many issues you will have to negotiate with the buyer is how the sale will be structured. The most common structures are a sale of assets, a sale of stock or a merger. Before you get into a negotiation of structure, it is important to understand the pros and cons of each. (For purposes of the discussion below, the term "target company" refers to the company whose business is being acquired.)



SALE OF ASSETS

Many buyers have a strong preference for structuring the acquisition of another company as a purchase and sale of assets. There are several reasons for this. First, it permits the buyer to step up its tax basis in the acquired assets to the purchase price paid for those assets. Secondly, and perhaps more importantly, it permits the buyer to pick and choose which assets it will acquire and which liabilities of the seller it will assume and be responsible for post-closing. That can be particularly important if the buyer only wants to acquire a division or one line of business of the seller but not the whole company. It also gives the buyer flexibility if there are liabilities that the buyer wants to leave with the seller to satisfy post-closing.

From the seller's perspective, an asset sale may be less advantageous, particularly due to the tax implications. If the seller is a taxable corporation (a "C corp"), a sale of assets will typically be subject to two levels of tax: first a tax at the corporate level and then a second tax at the stockholder level when the corporation distributes the after-tax proceeds of the sale to its stockholders.

Tax issues aside, there are sometimes facts and circumstances that make a sale of assets impractical. An asset sale, by definition, results in the transfer of legal title to the seller's assets to a new owner. If the seller has valuable contracts and the counter-party to those contracts will not consent to an assignment, an asset sale would be problematic. The same is sometimes true where the seller has rights that are "grand-fathered" because they were acquired before a change in the law. In those cases, the transfer of title to the assets to a new owner could result in loss of the favored treatment under applicable law.

SALE OF STOCK

A sale of stock, as the name implies, involves a transfer of ownership of the stock or other equity securities of the target company to the buyer. In essence, there is a change of control of the company whose business is acquired, but the underlying assets and liabilities remain with the target company. This structure is often beneficial to the selling stockholders because they typically receive favorable long term capital gain treatment on the sales proceeds. However, with limited exceptions, the buyer is not able to step up its basis in the target company's assets. Regardless of how much is paid to the stockholders of the seller, the buyer's tax basis in the assets held by the company remains the same as it was in the hands of the target company. It is important to take into consideration two other aspects of a stock sale.





First, by operation of law, the buyer takes over control of the target company subject to all of its liabilities, whether they are disclosed or undisclosed. Also, this structure generally does not allow the buyer to pick and choose assets it wants to acquire. Although it does allow for the acquisition of the seller's business without a transfer of title to the underlying assets to a new buyer, it typically requires that 100% of the stockholders agree to participate, since buyers are rarely willing to acquire control of the target company if they have to leave minority stockholders in place.

MERGER

Mergers are perhaps the least common structure used in the purchase and sale of privately held companies. The principal reason for that is that they tend to be more complicated, often involving the formation of an acquisition subsidiary by the buyer. They also require careful consideration of the tax implications. Depending on how the merger is structured, it may be tax free to the target company and its shareholders or partially or fully taxable. It may also be treated as an asset sale or a stock sale for tax purposes. However, under certain circumstances, a merger may be the only alternative to get the deal done. As noted above, if a company has valuable contracts but is unable to get third party consents to transfer them to the buyer, an asset sale will not be possible. Also, many companies have one or more stockholders who either cannot be located at all or who are not willing to sell their shares. Under those circumstances, a stock sale is likewise not possible because buyers typically insist upon buying all of the issued and outstanding stock of the target company. Under those circumstances, a merger is the only viable alternative.

As the name implies, a merger involves combining two corporations into a single corporation. In most states, a merger need only be approved by a majority of the board of directors and a majority of the stockholders of each party. Unanimous approval of the stockholders is not required. The merger agreement dictates which corporation is the surviving entity. It may be either the "buyer" or the target company. As a result of the merger, all of the assets and liabilities of the two constituent companies are deemed to become the assets and liabilities of the surviving company, but title to individual assets does not need to be transferred. Also, the stock of the acquired company is converted, by operation of law, into the right to receive its pro-rata share of the merger consideration (usually cash or stock of the acquiring corporation). As a result, the stock of the target company held by missing or recalcitrant stockholders is automatically cancelled and converted into the right to receive a portion of the merger consideration, whether or not they consent. Therefore, they cannot block a merger.

If we can provide any further information, please contact your PLDO attorney or PLDO Partner and veteran business attorney William F. Miller at 866-353-3310 or email wmiller@pldolaw.com.



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