Chapter 10
Mergers and Acquisitions

10.1 Introduction

The life of a corporation is typically terminated by its sale or merger. In the event of a sale, the corporate debts are liquidated and the corporate assets are then sold. In the case of a merger, the corporation is "absorbed" into an acquiring firm, which exchanges cash, securities, or a combination of both in order to obtain the assets and liabilities of the acquired corporation. The acquired firm in a merger may continue to exist as a separate subsidiary of the acquiring firm. Since the decision to merge relates to the fundamental nature of the corporation, it often requires shareholder approval, sometimes by a supermajority.

10.2 Classification of Mergers

In the examples that follow, we will consider the hypothetical acquisition of "S Corp," a fictitious small corporation, by "L Corp," a fictitious large corporation. To carry out the transaction, the parties may choose between various operations, including: (1) a Type A (statutory) merger; (2) a "short-form" Type A (statutory) merger; (3) a Type B informal merger; (4) a Type C informal acquisition; or (5) a triangular (subsidiary) merger.

10.2.1 Type A (Statutory) Mergers

The Type A (statutory) merger is achieved by following statutorily prescribed procedures, where a typically large corporation will acquire a comparatively small corporation, with the large corporation being the survivor (the inverse is,

J.M.B. Balouziyeh, *A Legal Guide to United States Business Organizations*,
DOI 10.1007/978-3-642-37907-9_10, © Springer-Verlag Berlin Heidelberg 2013

however, also possible). In our hypothetical, S Corp's shareholders may receive cash, the shares of L Corp, or a combination of both cash and shares.

Since the merger effects a fundamental change in the investment of the shareholders of S Corp and L Corp, the merger will generally need to be approved by the shareholders, unless the acquisition is realized through a Type B merger followed by a short-form Type A merger or by a triangular merger (*see infra.*). Shareholders who are dissatisfied with the merger are entitled to an appraisal remedy, whereby the corporation is judicially ordered to pay the shareholders the fair value of their shares, which is usually the price just before the transaction takes place.

10.2.2 Type A "Short-Form" Statutory Mergers

The short-form Type A statutory merger allows two corporations to merge when one of them owns a sufficiently high proportion (generally, around 90–95 %) of the shares of the other. In states that allow this type of merger, the procedures are simpler than those required for normal Type A statutory mergers. For example, while Type A mergers generally require corporations to undergo a shareholder vote, no such vote is necessary for short-form mergers. Corporations in some states may opt for this procedure when merging with subsidiary corporations.

10.2.3 Type B (Informal or Practical) Mergers

Type B mergers are carried out independently of state law procedures—hence the denomination "informal" or "practical" merger. The merger is realized when L Corp purchases sufficient shares from S Corp shareholders to acquire control of S Corp. In return, S Corp shareholders receive cash, L Corp shares, or a combination of both.

Because there is no formal involvement of S Corp's board, there is no vote on the merger by shareholders of either corporation. Furthermore, there is no appraisal right for S Corp shareholders. S Corp remains intact, but once L Corp acquires a controlling interest, S Corp becomes an L Corp subsidiary. At some point, S Corp may become a part of L Corp through a Type A short-form statutory merger.

10.2.4 Type C (Informal or Practical) Acquisitions

Under a Type C "informal" or "practical" acquisition, also referred to as an "asset acquisition merger," L Corp acquires S Corp's assets in exchange for cash, L Corp securities, or both. Thus, unlike the statutory merger, where L Corp acquires both S

Corp's assets as well as its liabilities, the Type C acquisition permits L Corp to acquire S Corp's assets without becoming the successor to S Corp's known and unforeseen liabilities. S Corp, which is left holding only cash or securities acquired from L Corp, usually then liquidates, distributing the cash and securities to its shareholders and paying off its debts. In some states, S shareholders may have to vote, since most of the assets of their investment are being sold. S Corp shareholders may or may not have appraisal right. In Delaware, for example, they would not have an appraisal right if the price of their stock were increasing.

10.2.5 Triangular (Subsidiary) Mergers

The triangular merger may be used when L Corp is trying to acquire S Corp and state law requires the shareholders of both corporations to vote on the proposed merger, given the resulting fundamental change in shareholders' investments. To avoid the vote, L Corp can create a wholly owned subsidiary corporation that can merge with S Corp by acquiring sufficient stock from S Corp shareholders, in exchange for L Corp stock. Although both parties to the merger must still vote, the only shareholder of the subsidiary corporation will be L Corp, which votes through its board of directors, not through its individual shareholders. Through the triangular merger, L Corp's directors will be able to avoid the vote of its shareholders and the appraisal remedy for unsatisfied shareholders.

10.3 The *De Facto* Merger Doctrine

10.3.1 Overview

The *de facto* merger doctrine provides that, even when a transaction is cast not as a statutory merger, but as a transfer and acquisition of assets, a court may treat it as though it were a statutory merger. Thus, although a transaction is not legally a merger, courts entitle shareholders to all of the traditional protections granted in statutory mergers, such as the right to a shareholder vote before the merger is undertaken and to exercise the judicial right of appraisal when they disagree with the decision to merge.

In a mere acquisition of assets, in contrast, although the right to appraisal is granted in some states (*e.g.*, Pennsylvania), other states either do not allow the appraisal remedy or restrict its use to certain limited circumstances. As mentioned earlier, in some states, such as Delaware, the appraisal remedy is not granted for acquisitions of assets when the value of the stock is increasing and the plaintiff could obtain a better remedy by simply selling his stock. However, if a court treats an acquisition of assets as a *de facto* merger, the appraisal remedy will apply, since

under Delaware law, both statutory and *de facto* mergers automatically grant dissenting shareholders the right to appraisal.

One can thus see the importance of the *de facto* merger doctrine by considering the state of Delaware. Under Delaware law, although shareholders of a corporation have a right to demand the fair value of their shares when they oppose a statutory merger, they do not enjoy this right in an acquisition of assets where the value of the stocks is not rising. Thus, by classifying such acquisitions as *de facto* mergers, thereby treating them as statutory mergers, the states are requiring the mergers to submit to the same legal requirements that apply to statutory mergers.

10.3.2 Test

The "practical effects test" is used in determining whether an acquisition of assets is to be treated as a *de facto* merger. The test considers whether the transfer and acquisition of assets so fundamentally changes the nature of the corporation that its identity has in fact been changed. Consider, for example, *Farris v. Glen Alden Corporation* (Pa. 1958), where the defendant Pennsylvania corporation and List Corporation, a Delaware corporation, sought to combine under a reorganization agreement whereby the defendant would acquire all of List's assets. The plaintiff sued, arguing that the defendant's shareholders were not given notice according to the statutory merger requirements. The issue was whether the transfer of all of the assets of a corporation should be treated as a statutory merger or as an acquisition of assets. The court held that although this transfer did not fulfill the formal requirements of a statutory merger, it should nevertheless be treated as such, given its practical effect in fundamentally changing the identity of the corporation. The acquisition of assets was thus treated as a statutory merger and shareholders were granted all of the corresponding rights.

Courts may also apply equity in deciding when to treat a sale of assets as a merger. Examples of when a court will invoke its equity powers include when shareholders are not given a fair share in an acquisition. Yet under the equal dignity rule, courts are reluctant to cast an operation as a merger when it was fairly and lawfully executed as an acquisition of assets, especially if doing so would cause unnecessary litigation. In *Hariton v. Arco Electronics, Inc.* (Del. 1963), for example, the plaintiff shareholder sued to enjoin a sale of assets, alleging that the sale was really a merger disguised as a sale in order to avoid the right of fair value that Delaware shareholders have under *de facto* and statutory mergers. The court held that a valid transfer of assets should be treated as such; to do otherwise would be to subject the parties to unnecessary litigation. The equal dignity rule permits any result when the means are lawful, regardless of whether shareholders would have received better treatment if the transaction been cast in some other form. Judgment for the defendant was affirmed.

10.4 The *De Facto* Non-merger Doctrine

Some shareholders dissatisfied with the results of a merger have argued that a particular transaction should *not* be cast as a merger, but rather, as an acquisition of assets. Shareholders would make this argument if, for example, under the articles of incorporation, they would have been granted a higher cash-out (buy-out) value under the principle of *redemption* (a corporation's repurchase of its securities from stockholders according to the terms of its securities agreement) than they would have gotten under a merger that forces them to sell their shares at value. The doctrine whereby a court does not treat a transaction as a merger, even though it was cast as such, is known as the *de facto non-merger doctrine*.

As mentioned above, the equal dignity rule provides that, whatever the means through which a merger is effected, it is valid when it follows the respective formalities, regardless of whether a better result for shareholders would have followed from some other operation.

In *Rauch v. RCA Corporation* (2d Cir. 1988), the plaintiff shareholders sued the defendant corporation as well as General Electric, the defendant corporation's majority shareholder, when General Electric merged the defendant corporation into itself. The plaintiffs were paid $40 per share, the amount at which the stock was valued. Had the transaction been cast as a sale of assets followed by a redemption, the plaintiffs would have been paid $100 per share under the articles of incorporation. The plaintiffs challenged the merger, arguing that the court should treat the transaction not as a statutory merger, but rather, as a sale of assets followed by redemption. The court held that in Delaware, mergers are governed by one set of rules and sales of assets followed by redemptions are governed by another. In the present case, the rules and norms required of cash-out mergers were followed. The decision declared that "the various provisions of the Delaware General Corporation Law are of equal dignity, and a corporation may resort to one section thereof without having to answer for the consequences that would have arisen from invocation of a different section." The fact that shareholders would have been entitled to a greater share value under redemption does not change the fact that the transaction was legal. The dismissal of the complaint was affirmed.

10.5 Freeze-Out Mergers

In a freeze-out merger (also termed *cash merger*), majority shareholders acquire 100 % ownership of their corporation by forcing minority shareholders of the corporation to give up their securities in exchange for cash. The majority may acquire full ownership by incorporating a second company that initiates a merger with their corporation. The majority shareholders, dictating the terms of the merger, force minority shareholders to accept cash for their shares, often through employing tender offers.

Certain limitations restrict the right of majority shareholders to acquire full control through freeze-out mergers. A merger is only valid when it is for the benefit of all shareholders and is based on a valid corporate purpose and a fair buyout price. Controlling shareholders may not effect a merger when their sole purpose is to freeze-out minority shareholders. Such an act would be a breach of their fiduciary duty. In *Coggins v. New England Patriots Football Club, Inc.* (Mass. 1986), the plaintiff shareholder challenged the defendant's merger, arguing that it was entered into solely for the benefit of the majority shareholder and that it was therefore unfair. The court held that there had to be a valid corporate purpose to render the merger valid. Yet here, the merger was effected purely for the benefit of the defendant, not for the corporation. However, the court did not void the merger, since doing so would be a harsh remedy in light of the fact that 10 years had passed since it had been realized. The case was instead remanded for determination of rescissionary damages.

The merger must reveal the true value of the minority shareholders' stock. There must be full disclosure of the stock's value and the minority shareholders must be offered a fair price. In *Weinberger v. UOP, Inc.* (Del. 1983), the defendant corporation offered $21 for stock without notifying shareholders that the stock was worth $24. When the plaintiff sued to enjoin the merger, the court held that a freeze-out merger was invalid because of the lack of disclosure of the true value of the stock. Because shareholders did not have all of the requisite relevant information, they did not grant effective consent to the merger. Judgment for the defendant was therefore reversed.

An acquiring corporation may not delay a merger for the sole purpose of avoiding an obligation to pay a contract price. See *Rabkin v. Philip A. Hunt Chemical Corporation* (Del. 1985), where plaintiffs, arguing that a merger was delayed only to avoid a contractually obligatory price, sued to void the merger. The trial court held that the plaintiff's remedy was an appraisal and reversed the earlier dismissal, remanding the case for trial.