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THE APPLICABILITY OF ANTI-ASSIGNMENT CLAUSES IN REVERSE TRIANGULAR MERGERS: AN AMERICAN APPROACH

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Abstract: Reverse Mergers have grown as viable and profitable means of attaining public status in U.S. With a tightening of the laws surrounding the technique, the prospects of fraud have become minimal and Reverse Mergers have become a promising vehicle to take small companies public in U.S. In this direction the American markets Model for the small business issuer sets an example. As the trend has grown immensely in terms of its popularity and investments it has attracted many legal issues. One of the most controversial issues during the execution Reverse Merger deal is of applicability of anti-assignment clauses in Reverse Triangular Mergers. In this context the present article analysis the problem posed by reverse Triangular Mergers and various approaches adopted in U.S.

Keywords: Reverse Merger, Reverse Triangular Mergers, Anti-Assignment Clauses, Reverse Merger Contracts

Introduction:

One aspect of every acquisition that often receives little prominence in business discussions, but nevertheless impacts timing, cost and the parties' ability to consummate a "smooth" transaction, is the potential necessity of assigning contracts[1] from a target company to the acquiring company in order to assure that the contracts will remain in effect for the acquiror's benefit post-closing. Particularly when a large portion of a target company's value is in the contracts sought to be acquired, (e.g., customer contracts, key technology licensing agreements, low cost leases or supply agreements or other key agreements), the assignability of contracts may be critical to successful consummation of the acquisition. As a result, the buyer's ability to acquire a contract, whether expressly or by operation of law, and the related need to obtain the consent of a third party in some cases, is an important consideration prior to and during an acquisition[2]. Thus the assignment of contractual rights in the context of M&A transactions ranks as one of the most complex areas of contemporary corporate law. However one can still continue to have a clause demanding the third party consent besides having an anti-assignment clause. This depends upon the structure and drafting of the contract .Sometimes this clause may frustrate provisions of any statue, which allows vesting of assets and liabilities to a merging and surviving entity by operation of law. Besides this, anti-assignment clause can be effectively avoided depending upon following factors such as (1) the form and structure of the deal (2) the concerned merger statute, their interpretation, applicability and case law; (3) the careful drafting of the anti-assignment clause (4) the types of contract rights involved (5) any equitable considerations which may impose adverse consequences to the nonmerging party. And in this context Reverse Triangular Merger plays a critical role in evading anti assignment clauses.

Methodology

The method of study is doctrinal. During its doctrinal course the study has taken note of the latest developments and trends in the field through different literary sources available

[1] The "anti-assignment" clauses found in many contracts, such as "This agreement, and the rights hereunder, may not be assigned without the consent of X," is a crucial provision for parties looking to transfer a contract and contract rights.

[2] Albert J. Li, *Understanding Anti-Assignment Clauses and their Implications on Your Acquisition*, July 12, 2004, C:\Users\admin\Desktop\ANTI-ASSIGNABILITY CLAUSE\Understanding Anti-Assignment Clauses and their Implications on Your Acquisition – Martindale.com.html (Last accessed February 7, 2015).

The Scope and the Issue:

In a reverse triangular merger, the acquiring entity creates a subsidiary that merges with and into the target company; the target company survives and the subsidiary disappears. The former target company's shareholders receive acquiring entity voting stock in exchange for their target company stock, and the acquiring entity becomes the sole shareholder of the target company. Thus, in a reverse triangular merger, only the ownership of the target company changes. The target company continues to exist and continues to own its own properties and assets following the merger, and no assets are transferred or contracts assigned to the acquiring entity. Many commentators believe that this structure legitimately avoids constraints inherent in anti-assignment clauses by eliminating the need for third-party consent to close the transaction. As a result of these considerations, the reverse triangular merger is commonly used in acquisitions involving banks, insurance companies, public utilities, and other highly regulated industries.[3]

Interestingly when a original party to the contract changes, then nonmerging third parties have no obligation to uphold their contractual duties despite of anti-assignment clauses. This is so in a forward triangular merger, where the acquiring entity replaces the original party to the contract i.e., the target company, which ceases to exist and becomes a new party to the target company's preexisting contracts. However this may result in violation of a contractual anti-assignment clause, thereby preventing transfer of a contract without consent from the nonmerging party. If the nonmerging party unilaterally rejects transferring its contractual rights to the acquiring entity, the success of the M&A transaction could be jeopardized. On the other hand, because the target company survives in a reverse triangular merger, such a merger does not fall prey to the uncertainty forward triangular mergers face with respect to anti-assignment clauses[4] since the original party in the Reverse Triangular Merger continue to exist even after the completion of the merger, therefore resulting in no change of ownership. Therefore anti-assignment clauses in target contracts are not triggered. Yet the position of anti-assignment clause in Reverse Triangular Merger is not clear. Even in Unites States itself, there exist inconsistent interpretations among the states resulting in confusion about the efficacy of anti-assignment clauses. Ambiguous and inconsistent court rulings discourage the sound business decisions and contractual deal between the parties.

The level of uncertainty surrounding the legal efficacy of anti-assignment clauses in reverse triangular agreements is further accentuated by the asymmetrical treatment of assignability issues across jurisdictions. Some courts have adopted a formalist interpretation of these statutes and held that mergers, whether forward or reverse, do not constitute an assignment of contractual rights

[3] Tad Ravazzini, *The Amalgamating Reorganization Provisions: The Asymmetry in Treatment of Forward and Reverse Triangular Mergers and Other Problems*, 26 Golden Gate U. L. Rev. (1996). http://digitalcommons.law.ggu.edu/ggulrev/vol26/iss3/4

[4] W.W. Allen, *Validity of Anti-Assignment Clause in Contract*, 37 A.L.R.2d 1251, 1253 (1954).

Other courts seek to resolve the question of whether a merger violates a contract's nonassignment provision by analyzing the extent to which the alleged "assignment" would adversely impact the contracting party seeking to enforce the provision. Still other courts have found that an assignment "by operation of law" occurs when the identity of the target party changes by forward merger. The due diligence process and consent analysis for RTM transactions must change accordingly to account for the risks associated with contracts prohibiting assignment "by operation of law," as well as license agreements implicating intellectual property interests. Further, parties entering into license agreements and other commercial contracts should take a close look at those contracts' non-assignment provisions and consider the extent to which mergers or other acquisitions should be addressed with specificity[5].

In U.S., courts in different states apply the same principle and can reach surprisingly conflicting results. A review of the relevant case law and secondary authority reveals two lines of analyses regarding anti-assignment clauses in the reverse triangular merger context.

A. The "California" Approach

It is imperative to discuss two important decisions of Californian Courts in order to understand the Californian approach as far as this anti-assignability issue is concerned. In the most popular SQL Solutions, Inc. v. Oracle Corp., case[6] , It was held that , "an assignment or transfer of rights does occur through a change in the legal form of ownership of a business." Thus Reverse Triangular Mergers triggering anti-assignment clauses by operation of law in California. The same was further favored in DBA Distribution[7], where the federal court held that a RTM constitutes an assignment by operation of law under New Jersey law, citing the New Jersey merger statute, which, the court noted, "provides that the property belonging to each of the constituent corporations 'shall be vested in the surviving or new corporation.'" The court was of the opinion that through a Reverse Triangular Merger when a company becomes a wholly-owned subsidiary, a fundamental Change in its ownership occurs. Making SQL solutions proposition valid in California case. Unfortunately these decisions shall effect the deal transactions immensely, causing unnecessary delay and uncertainty in deals. The result is that it is inevitable for any deal to seek third-party consents on contracts because the assumption RTM do not amount to assignments by operation of law does not hold valid in California.

[5] Daniel C. Glazer, Daniel P. Ashe, *Mergers and Acquisitions: Effects of Mergers on Non-Assignable Agreements*, THE NEW YORK LAW JOURNAL, Volume 246—NO. 9, July , 2011.

[6] No. C-91-1079 MHP, 1991 WL 626458, at *3 (N.D. Cal. Dec. 18, 1991). : SQL.
a licensee of Oracle software, became a wholly owned subsidiary of a direct competitor of Oracle as a result of an RTM. The Oracle-SQL license agreement prohibited SQL from transferring or assigning the license without Oracle's consent.

[7] DBA Distribution Services, Inc. v. All Source Freight Solutions, Inc., 2012 WL 845929 at 4 (D.N.J. Mar. 13, 2012).

B. The "Delaware'' Approach

Interestingly even in *Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH*[8], it was held by Delaware Chancery Court held that the acquisition of a company in a reverse triangular merger may trigger an anti-assignment clause and therefore violate a prohibition on assignment by operation of law. Although it was only a preliminary ruling yet it triggered many issues questioning the nature and outcome of both forward and reverse triangular mergers. Surprisingly In 2013 The Delaware Chancery Court in its Meso final verdict held that reverse triangular mergers do not result in the assignment of a target corporation's contracts by operation of law. The court stated that, "[g]enerally, mergers do not result in an assignment by operation of law of assets that began as property of the surviving entity and continued to be such after the merger. In support of its position, the court cited Section 259(a) of Delaware's General Corporation Law which sets forth the consequences of a RTM for the constituent corporations. The court observed that, under Section 259(a), a RTM results in the transfer of the non-surviving corporation's rights and obligations to the surviving corporation by operation of law, but does not constitute an assignment by operation of law as to the surviving entity because that entity is the same legal entity as the original contracting party"[9].

C. Statutory Approach in U.S.

There are few states[10] in U.S. who have implemented the 1984 version of the ABA Model Business Corporation Act[11] , which states that "the title to all real estate and other property and rights owned

[8] C.A. No. 5589-VCP (Del. Ch. April 8, 2011).

[9] Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH, 62 A.3d 62 (Del. Ch. Feb. 22, 2013).
In 2007, Roche acquired a company called BioVeris in a transaction structured as a reverse triangular merger. Meso alleged that Roche's purpose in acquiring BioVeris was to improperly obtain certain intellectual property rights to use electrochemiluminescence ("ECL") technology in violation of a global consent that had been entered into by Roche, Meso and other parties in connection with a 2003 transaction. That global consent transaction prohibited assignments, "in whole or in part, by operation of law or otherwise" of rights to the technology. Roche had previously contracted for rights to this technology from a company called IGEN International Inc., which was subsequently acquired by Roche. Before the IGEN acquisition, however, IGEN transferred all of its intellectual property rights, subject to outstanding license rights, to newly created BioVeris Corp., a public company. Allegedly in an effort to obtain nonlicensed rights to this technology, Roche ended up purchasing BioVeris in the reverse triangular merger. Meso alleged that the acquisition of BioVeris, and the attendant acquisition of the remaining technology rights, violated the anti-assignment provisions of the global consent. John C. Levy, "Delaware court's decision could affect reverse triangular mergers'', Minnesota Lawyer, October 2011.

[10] Like Iowa, Kentucky, Massachusetts and Michigan.

[11] the Model Business Corporation Act (the "Model Act"), was adopted in 1984 by the Committee on Corporate Laws of the American Bar Association (the "ABA Corporate Laws Committee"). Twenty-five states have subsequently adopted all or significant parts of the Model Act. Since 1984, the Model Act has undergone a number of significant revisions, many reflecting experience with the Model Act in the various adopting states, as well as significant technological advances affecting shareholder and director communications. Allen C. Goolsby & Louanna O. Heuhsen, *Corporate and Business Law*, UNIVERSITY OF RICHMOND LAW REVIEW , November 2005, Volume 40, Issue 1.
The MBCA was created after World War II in 1950 due to variation in how states defined corporations. The variation and uncertainty resulted in many lawsuits in which a promoter was sued personally for obligations ostensibly incurred in the name of the nascent corporation. The widespread adoption of the MBCA brought some

by each corporation party to the merger are vested in the surviving corporation without reversion or impairment[12]" and which includes a comment that "[a] merger is not a conveyance, transfer, or assignment. It does not give rise to claims of reverter or impairment of title based on a prohibited conveyance, transfer, or assignment. It does not give rise to a claim that a contract with a party to the merger is no longer in effect on the ground of nonassignability, unless the contract specifically provides that it does not survive a merger." Thus in those states who have adopted this model Revrese Tringular Mergers are do not constitute an assignment, though specific state statutes should be reviewed when determining their affect in connection with particular transactions because states often adopt model acts with modifications. Colorado has gone a step further than the 1984 Model Act and has adopted a merger statute that states that, "[a] merger does not constitute a conveyance, transfer, or assignment. Nothing in this section affects the validity of contract provisions or of reversions or other forms of title limitations that attach conditions or consequences specifically to mergers." [13]Some states, such as Alabama and Illinois, have promulgated merger statutes that include language or variations of language from the 1969 version of the ABA Model Business Corporation Act (the "1969 Model Act"). However the 1969 Model Act is not clear as to whether a merger constitutes an assignment of an agreement by operation of law and states that, in connection with a merger, the assets of each constituent entity "shall be taken and deemed to be transferred to and vested in such single corporation without further act or deed." It is ambiguous whether RTMs and forward triangular mergers would be treated similarly under such statutes despite their fundamental differences. There have been some anomalous decisions in states with such statutes. Alabama's merger statute, for instance, includes such language, but at least one appellate court there has ruled that a merger does not constitute a transfer or assignment by operation of law[14].

Conclusion

Courts in U.S. have failed to address the issue of anti-assignment clause specifically in the context of Reverse Mergers. Based on the above discussions and case analysis it can be said that, a Reverse Triangular Merger should not violate an anti-assignment clause. However, no case can be considered to be standardized bench mark on this issue since every case depends upon the facts, nature, form of acquisition, transaction, intention of the parties and the particular state merger law.

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clarity to such confusion and other corporate law issues. Most states are now guided by the Revised Model Business Corporation Act (RMBCA), a revised version of the MBCA. Available at http://en.wikipedia.org/wiki/Model_Business_Corporation_Act (Last accessed February 7, 2015).

[12] SECTION 6. 7-56-606, Colorado Revised Statutes, is amended to read: 7-56-606. Effect of merger, conversion, consolidation, or share or equity capital exchange. HOUSE BILL 07-1135, Concerning Business Entities Regulated Under Title 7 Of The Colorado Revised Statutes, available at http://www.cobar.org/docs/Sparkman%20Handout%202.pdf?ID=2821 (Last accessed February 7, 2015).

[13] *Id.*

[14] Phil Stamatakos and Ismail Alsheik , *Delaware: Reverse Triangular Mergers Don't Result in Assignment, Deal Lawyers* , May-June 2013, available at http://www.jonesday.com/files/Publication/cbf51798-b5ac-4c5d-9f12-4d6df6140890/Presentation/PublicationAttachment/3543ed07-49ce-4711-82d5-a6c01a1c712f/Delaware.pdf (Last accessed February 7, 2015).

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