

Choosing the Form of Acquisitive Reorganization

INTRODUCTION: FIVE KEY CONCERNS FOR THE DEAL DESIGNER

Mergers and acquisitions often result in a legal *reorganization* of one or both of the partners to the deal. There are several forms of reorganization, each with peculiar advantages and qualifying conditions. Transactions are designed in ways to meet those qualifying conditions and to achieve desired outcomes. This chapter surveys the forms of reorganization, the pros and cons of each, and the qualifying conditions. Through an understanding of the forms of organization, one can see that transaction design has big implications for issues that concern deal designers and senior executives. These implications fall into five large categories:

1. **Taxation.** Is this proposed deal *taxable* or *tax deferred*? To whom is it taxable? What are the tax consequences for the buyer and seller? How large is the tax exposure? Will the seller be subject to double taxation?
2. **Risk exposure.** Will this structure isolate the hidden liabilities of the target from the buyer?
3. **Control.** Will this require a vote of shareholders of the target and/or the buyer? How will the voting control of Newco be affected by this structure?
4. **Continuity.** Which, if any, firm survives as an ongoing entity? What implications does this firm's *continuity* have for the ability to assign leases and licenses, for corporate identity, and for social issues such as headquarters location?
5. **Form of payment.** What form of payment is required to achieve objectives for taxation, risk exposure, control, and continuity?

In the interest of brevity, this chapter will provide the barest answers to these questions. The intent here is to prepare the reader to speak more confidently with tax, accounting, and legal advisory professionals, who should always be consulted for insights on specific problems.

THE FORM OF REORGANIZATION HAS IMPORTANT IMPLICATIONS

The design of mergers and acquisitions has many dimensions of which one of the more complicated is the choice of the form of reorganization. At the outset, it seems odd to call M&A transactions "reorganizations" since that is a term more generally associated with bankruptcies and liquidations. The term is derived from the U.S. *Internal Revenue Code*, which establishes the tax rules for these transactions. The predominance of tax law in this area explains why many analysts and general managers understand reorganization choices so poorly: The tax code is complex.

This aspect of M&A design is important. Tax planning considerations are the focus of considerable professional time and talent in M&A. Hayn (1989) found that about half of all acquisitions are designed to be *tax-free* or only partially taxable. Form of reorganization showed a strong relationship to the abnormal return at the merger announcement: In taxable deals, the acquisition premium is more than twice as high (see Exhibit 19.1). Two effects might explain this, though the explanations are not entirely satisfying: (1) in taxable deals, target company shareholders' taxes are immediate rather than deferred, thus creating a demand for higher payment stimulated by the time value of money; or (2) in taxable deals, the buyer is allowed to step up the tax *basis* of the acquired assets, thus affording a larger depreciation tax shield. This lifts the ceiling amount that the buyer could afford to pay. Perhaps because of the target's bargaining power or a "winner's curse" effect, the buyer *does* pay more in taxable deals.

Hayn found that two tax effects were significant in explaining the size of announcement returns. In tax-free deals, net operating loss carryforwards and tax credits expiring within two years of acquisition were positively related to the announcement returns of target and buyer. In taxable acquisitions, the most significant variable was the *step-up in basis* of the assets to fair market value.

The evidence suggests that an even greater percentage of acquisitions of privately held companies tend to be structured to defer paying tax.¹ Even the elimination or deferral of a relatively small percentage of tax exposure can materially affect internal rates of return to investors. Research suggests that tax effects figure importantly in all segments of all M&A transactions.

EXHIBIT 19.1 Cumulative Abnormal Returns to Buyers and Targets According to Tax Status of the Deal (Days -1,0)

	Taxable	Tax-Free	Partially Taxable
Target firms	18.6%	8.2%	11.1%
	n = 178	n = 181	n = 116
Buyer firms	2.2%	1.1%	2.1%
	n = 308	n = 134	n = 76

Note: All cumulative abnormal returns were significantly positive at the 0.95 level.

Source of data: Reprinted from the *Journal of Financial Economics*, 1989, Carla Hayn, Table 3, Cumulative Abnormal Returns to Buyers and Targets According to Tax Status of the Deal (Days -1,0), from "Tax Attributes as Determinants of Shareholder Gains in Corporate Acquisitions," pp. 121-153. Copyright © 1989, with permission from Elsevier.

It remains a question of active debate whether tax considerations *cause* acquisitions. Scholes and Wolfson² analyzed changes in the volume of merger and acquisition activity before and after changes in the tax laws passed in 1981 and 1986, and concluded that the evidence "very strongly" suggested that these changes affected M&A activity. M&A is associated with three possible tax benefits:

1. The exploitation of net operating loss (NOL) tax carryforwards and other tax credits.
2. The step-up, or increase, in the basis or value of assets on which such tax shields as depreciation expense are computed.
3. The exploitation of debt tax shields through increased financial leverage.

Scholes and Wolfson argue that each of these benefits can be realized through means other than M&A, possibly at lower transactional cost. However, targeted studies by Auerbach and Reishus (1988a,b,c) suggest that NOLs, basis step-up, and leverage changes are probably significant in only a small number of mergers.

The fundamental conclusion must be that tax exposure probably matters immensely in the detailed design of individual transactions even though the macroeconomic impact of the exploitation of tax shields through mergers may not be large.

Internal Revenue Code Creates Choices

Before surveying the various forms of acquisition, it is useful to consider the general drivers or considerations that create these alternatives. The following six items will be the most important in the deal designer's work, though the Internal Revenue Code admits a wide range of possible considerations.

1. **Tax liability: immediate or deferred.** Tax deferral is usually referred to as "tax free" though this is clearly not the economic reality of the tax code. The basic rule is that where a gain occurs, there is either tax today or tax tomorrow, but generally not "no tax." Tax-deferred transactions require stock-for-stock deals. If only cash or debt is used, selling shareholders generally have an immediate tax liability. With a blend of stock, cash, and debt, the tax liability is more complicated. Tax deferral also matters to the buyer: Generally where the seller gains the benefit of deferral, the buyer forgoes the depreciation tax shield created by the step-up in basis. This trade-off in benefits for the buyer and seller sets up a tussle for negotiations.
2. **Exposure to the target's liabilities.** Some buyers want the target's assets, but not the target's known (and unknown) liabilities. Transactions can be structured in ways to shield the buyer from the target's liabilities.
3. **Need for a shareholder vote.** Usually the sale of a company entails the vote of the target's shareholders. Mergers require a vote of the buyer's shareholders, too. Also, the buyer's shareholders may have to authorize new shares needed to consummate a transaction.³ Shareholder votes complicate life for deal designers, as they add yet one more dimension of transaction risk (i.e., that the buyer's shareholders will not approve the deal). Generally, deal designers seek to avoid buyer shareholder votes.
4. **Survival of the target company.** In some circumstances, it is important that the target company survive as a corporate entity. In many instances, key contracts,

warranties, and choice retail leaseholds are not assignable to another company, even if that other company is the new owner. In these cases, it will be important for the target company to continue to exist, even if in name only.

5. *Permissible form of payment.* Deal designers often prefer to tailor the payment as a blend of cash, debt, and/or stock. The tax code offers some flexibility to deal designers, though the implications of different blends should be understood before undertaking the transaction.
6. *Limitations on other actions.* Managers want more flexibility rather than less, other things equal. The choice of form of transaction can affect flexibility. For instance, there can be no tax-free deals within two years of a spin-off (i.e., before or after) without incurring tax on the distribution of the stock of the entity spun off or meeting a narrow exception.⁴

How to Choose?

As a road map of the alternatives available to the deal designer, Exhibit 19.2 shows how these choices must result from decisions on the first three dimensions (tax exposure, exposure to liabilities, and the need for a vote). The other three (survival, form of payment, and limitations) are more complex and will be discussed in the text that follows. The main implication of Exhibit 19.2 is that the choice of form of transaction will emerge from the needs and constraints of the buyer and seller. Knowing the goals of the counterparties in the negotiation is indispensable.

DEALS THAT ARE IMMEDIATELY TAXABLE TO THE SELLING SHAREHOLDERS

From the seller's standpoint, a sale of stock is preferable to selling assets. This is because a sale of assets incurs tax liabilities at two levels (one, a gain at the corporate level, and the other at the shareholder level when securities are sold or liquidated). A sale of stock incurs tax only at the shareholder level. Also, a sale of stock may be easier since some asset purchases may entail bills of sale or deeds for each asset or class of assets.

Purchase of Assets, Substantially Using Cash or Debt Securities

In a *cash purchase of assets* (see Exhibit 19.3), the buyer exchanges its cash for the assets of the target. The target's liabilities are not transferred to the buyer without explicit agreement (one example would be the transfer of the commitment to honor product warranties). After the transaction, the target may liquidate or remain as a holding company for other contemplated investments.

The tax consequences to the seller from an asset purchase are to realize an immediate gain or loss on assets equal to the difference between the allocated sale price and book value of each asset. Arguably, shareholders are taxed twice on any gain: once when the corporation pays a tax on the gain, and again if the proceeds are distributed to shareholders in the form of a dividend or liquidating distribution.⁵ This double taxation is avoided by structuring the transaction as a pur-

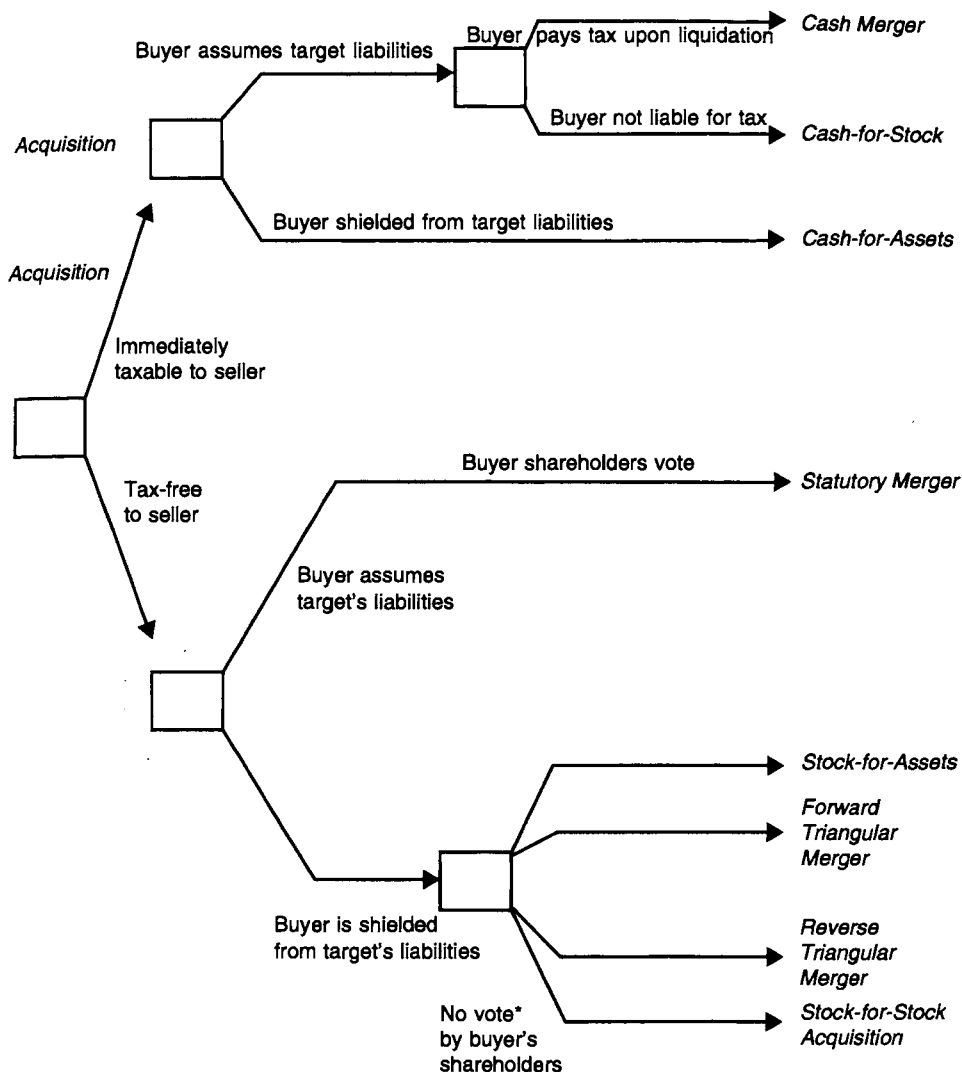


EXHIBIT 18.2 Decision Tree of Choice of Form of Transaction

*Merger statutes ordinarily do not require buyer's shareholders to vote upon a merger between a buyer's *subsidiary* and a target. However, the rules of stock exchanges and legal counsel may prompt buyers to seek the concurrence of their shareholders where such mergers are material. Also, buyer shareholders may be required to vote to authorize the creation of new shares of stock to be offered in the transaction.

chase of stock (described in the section on voting stock-for-assets acquisition later in this chapter).

From the buyer's standpoint, the taxable purchase of assets has no immediate tax consequences. The taxable basis of the assets becomes the fair market value of consideration paid for the assets. Typically, the fair market value is allocated among all asset classes, including intangibles. The buyer will maximize its tax shields from the purchase if the purchase price can be allocated substantially to

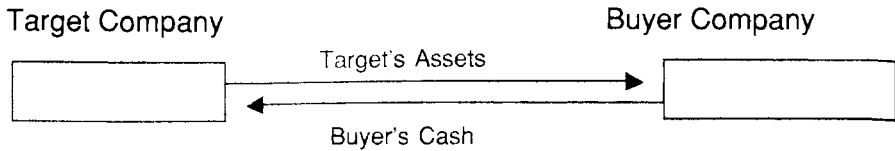


EXHIBIT 19.3 Purchase of Assets with Cash

inventory and assets that are depreciable or amortizable for tax purposes. Thus, the values of assets can be stepped up in their tax basis through the cash purchase of assets.

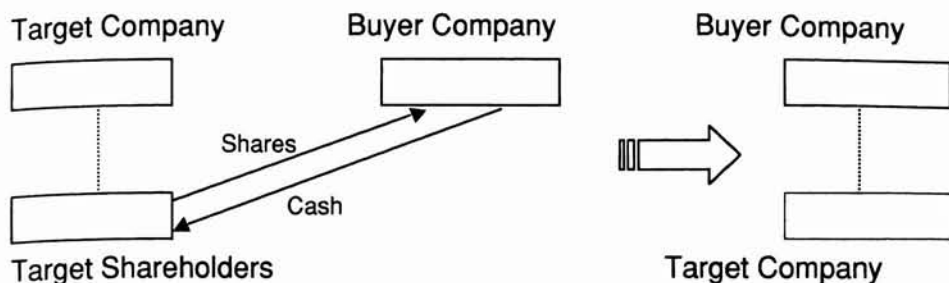
When the purchase price exceeds the allocated basis of the inventory and other tangible and intangible assets,⁶ the remainder is allocated to goodwill, which for deals since 1993 has been deductible for tax purposes, as an expense amortized over 15 years. This tax shield from goodwill amortization would appear to offer an incentive for purchase transactions. For example, suppose that the buyer pays \$5 million for a target whose fair market value of assets amounts to \$4 million. The difference, \$1 million, must be allocated to goodwill and be amortized for tax purposes⁷ over 15 years. Thus, the amortization will give an annual deductible expense of \$66,666⁸; if the marginal tax rate is 40 percent, this deduction will reduce the buyer's tax expense by \$26,666 per year. At a discount rate of 10 percent, this stream of tax savings has a present value of \$202,823—this is a source of value to the buyer (but only if the buyer has taxable income that can be shielded). Generally, the buyer will want to allocate the fair market value (FMV) of the purchase in ways to shield taxes on ordinary income (e.g., toward inventory). In tax jurisdictions where there is a difference between income tax rates and (lower) capital gains tax rates, the seller will want to allocate the FMV to create capital gains rather than ordinary income (e.g., by allocating FMV toward capital assets such as land, plant, and equipment). This creates a possible allocation conflict between the buyer and seller, which is usually settled through negotiation in advance of closing of the transaction. On a sale of assets, the buyer and seller must file with the *Internal Revenue Service (IRS)* a statement of the values ascribed to the various assets.

Purchase of Stock, Substantially Using Cash or Debt Securities

In a *cash purchase of stock* (see Exhibit 19.4), the buyer exchanges its cash for shares of the target's voting common stock. The target company remains in existence. The buyer will be shielded from the target's known and unknown liabilities unless a claimant can penetrate the separation of entities (i.e., the corporate veil that separates parent and subsidiary).

There is no "double taxation" in this transaction, as it occurs directly between the buyer and the target company's shareholders. The selling shareholder recognizes a gain or loss on the sale of stock, equal to the difference between the fair market value of consideration received and the stockholder's investment basis.

The buyer can treat the purchase as a straightforward purchase of stock, or can elect to treat it as a purchase of assets by declaration to the Internal Revenue Service. This special election alternative (called a "Section 338 election") has results

**EXHIBIT 19.4** Purchase of Stock with Cash

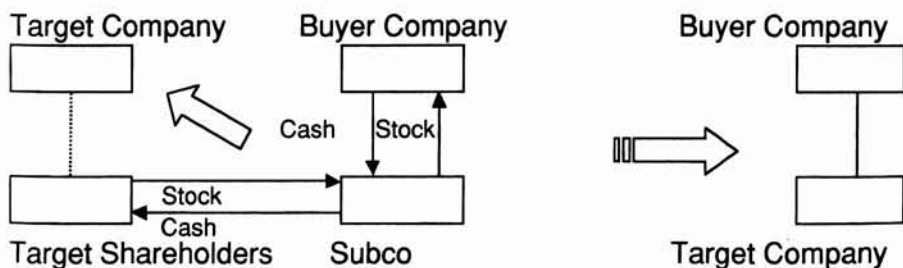
Note: With the transaction structures in Exhibits 19.4 and 19.5, the buyer may step up the tax basis of the target company assets by making a Section 338 election. By this means, a purchase of stock can produce the tax benefits to the buyer of a purchase of assets.

similar to an outright purchase of assets including an allocation of purchase price, increased by taxes paid upon the election, and the liabilities assumed in the transaction. This election may increase the actual cost to the buyer from possible gains in liquidation by the target company. Knowledgeable buyers will anticipate this added cost in their negotiation of the purchase price.

Triangular Cash Mergers

An alternative to the direct purchase of either stock or assets is for the buyer to form a subsidiary (called "Subco"), capitalize it with cash sufficient to acquire the target's stock, and have the target merge with Subco in either of two structures:

1. **Reverse triangular merger.** In a *reverse triangular cash merger* (see Exhibit 19.5), Subco merges into the target. The target company survives, as do its tax attributes and liabilities. The IRS views the transaction as a simple purchase of shares.
2. **Forward triangular merger.** In a *forward triangular cash merger* (see Exhibit 19.6), the target merges into Subco. The target company ceases to exist, along with its tax attributes, although its liabilities have been transferred to Subco. The final target company tax return reflects the sale of assets, the gain on which is taxed at the company level. The IRS views this as a purchase of assets. A step-up in asset basis follows to the buyer.

**EXHIBIT 19.5** Reverse Triangular Cash Merger (Buyer Purchases Target Stock with Cash)

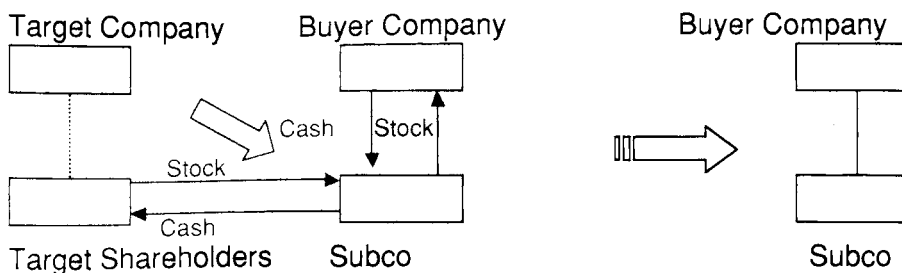


EXHIBIT 19.6 Forward Triangular Cash Merger (Viewed by the IRS as Equivalent to a Sale of Assets)

Cash mergers have one advantage over direct purchases of stock: No minority shareholders remain. Absent a merger, minority shareholders cannot be forced to change their status (though it is possible to do a *minority "freeze-out"*⁹ if the buyer owns over 90 percent of the shares). As long as they remain in existence, Subco must submit annual reports to shareholders, hold shareholder meetings, elect a board of directors by formal shareholder voting, and so on—all of these are opportunities for nettlesome intervention by dissident shareholders. As long as the buyer can attract a voting majority of the target's shareholders, the merger can be effected and the dissenting shareholders forced to exit (though many states permit appraisal rights for dissenting shareholders to determine whether they received fair value for their shares).

One disadvantage to the seller of the forward cash merger is that the proceeds of the transaction are, in effect, taxed twice.¹⁰ The buyer must know who is paying taxes on the proceeds of the sale. Also, the buyer must consider the length of time required to publish a merger proxy statement and hold a meeting of the shareholders—these are virtually always required for target firms because merger alters the legal identity of the firm.¹¹ This may take six months. In contrast, a direct purchase of shares or assets could be consummated in considerably less time, such as a period of one to three months.

DEALS THAT DEFER TAX TO THE SELLING SHAREHOLDERS

The Internal Revenue Code recognizes three classes of transactions as eligible for the deferral of tax expense to the selling shareholder. These are (1) statutory merger or consolidation, (2) voting stock-for-stock acquisition, and (3) voting stock-for-assets acquisition.

Statutory Merger or Consolidation ("A" Type Reorganization)

In a *statutory merger* (see Exhibit 19.7), one company absorbs the other. These are so-called "A" type reorganizations because they conform to Section 368 (a)(1)(A) of the Internal Revenue Code. Target shareholders exchange their shares in return for the buyer's stock plus other consideration, such as cash or notes called "*boot*." The payment in stock is tax deferred to the target shareholders, but boot is immedi-

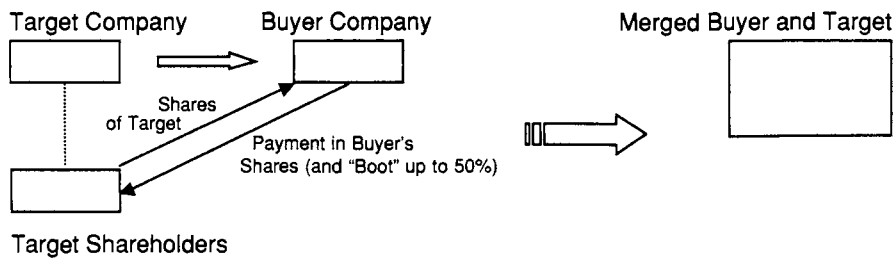


EXHIBIT 19.7 Statutory Merger

ately taxable to the extent of any taxable gain. The target company ceases to exist. The buyer assumes the liabilities of the target. Asset ownership is transferred relatively cost effectively. Under merger statutes in most states, a majority vote of the shareholders is required to approve the merger. Once approved, all shares in the target company become buyer shares—target shareholders turn in their old shares to the buyer's transfer agent and receive new shares in return. No minority target shareholders remain, though they do have appraisal rights in most states.

In a statutory *consolidation* (see Exhibit 19.8), two or more corporations combine into one new corporation ("Newco").¹² The preexisting corporations cease to exist as legal entities. The formation of a completely new entity may be warranted by business and legal reasons. For instance, in a so-called "merger of equals" it may be impolitic for one company to survive and the other to cease.

The statutory merger or consolidation is thought to be the most flexible of the tax-free structures from a deal design point of view. The IRS recognizes these as tax free as long as there is sufficient "continuity of interest" by the selling shareholders, which requires that at least 50 percent of the merger consideration is paid in stock of the acquiring company (preferred, common, voting, or nonvoting)—the balance is boot. The selling shareholder will be taxed immediately on any gain represented in the transaction to the extent of the boot. This structure will be attractive where the buyer seeks to pay only partially with stock, the seller needs cash, and minority or dissident shareholders must be eliminated. Statutory mergers were often the form of transaction underlying hostile tender offers, structured as a cash "front-end" payment for the first 50 percent of shares tendered, and

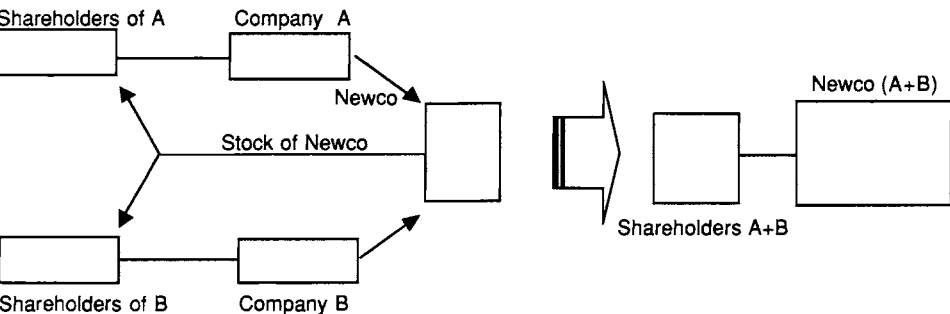


EXHIBIT 19.8 Statutory Consolidation

shares for the remaining 50 percent. In recent years, securities laws and regulations have restricted this format in hostile transactions in the belief that they are coercive. Finally, unwanted assets may be sold shortly in advance of the transaction without jeopardizing the tax-free status.

The disadvantages of this transaction structure are that merger or consolidation requires a shareholder vote on both the buyer and target sides. Shareholder votes are time-consuming and costly, and add an element of transaction risk. Also, with this transaction the buyer may not choose selectively which liabilities to assume.

Forward Triangular Merger ("A" Type Reorganization)

As with the cash forward triangular merger described earlier, the *forward triangular merger* ("A") (see Exhibit 19.9) entails the merger of the target company into a subsidiary of the buyer (Subco). To qualify as a tax-free transaction, the subsidiary must acquire "substantially all" of the target's assets (e.g., at least 70 percent of the fair market value of gross assets and 90 percent of the FMV of net assets). Under this rule, asset sales just prior to the transaction may threaten favorable tax treatment. Also, there can be no tax-free deals within two years of a spin-off (i.e., before or after). As with the statutory merger, payment must consist of at least 50 percent of the parent corporation stock. The balance, or boot, may be tailored to meet the requirements of selling shareholders.

This structure has two advantages over the statutory merger. First, it insulates the buyer company from the target's liabilities by isolating those liabilities in a subsidiary. Second, it does not require a vote of the buyer's shareholders (though shareholders of the target must still approve the transaction).

Reverse Triangular Merger ("A" Type Reorganization)

As with the cash reverse triangular merger, the tax-free form of *reverse triangular merger* ("A") (see Exhibit 19.10) entails the merger of the buyer's subsidiary into the target, leaving the target company in existence as a subsidiary of the buyer and eliminating minority shareholders of the target. In order to qualify as a tax-free transaction, at least 80 percent of the consideration must be paid in

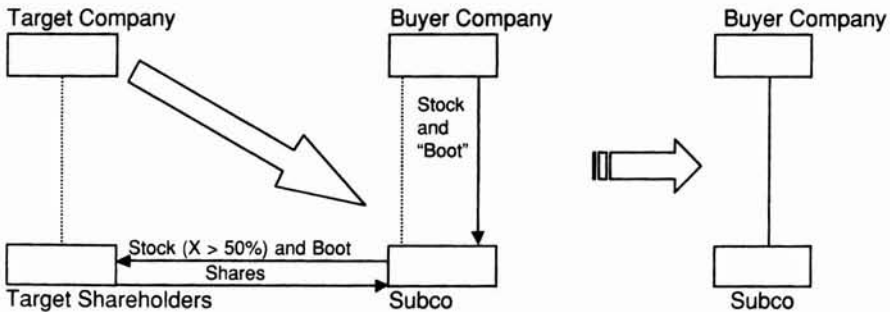
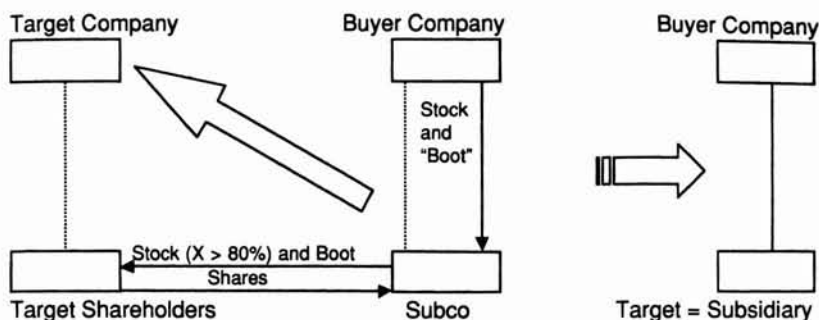


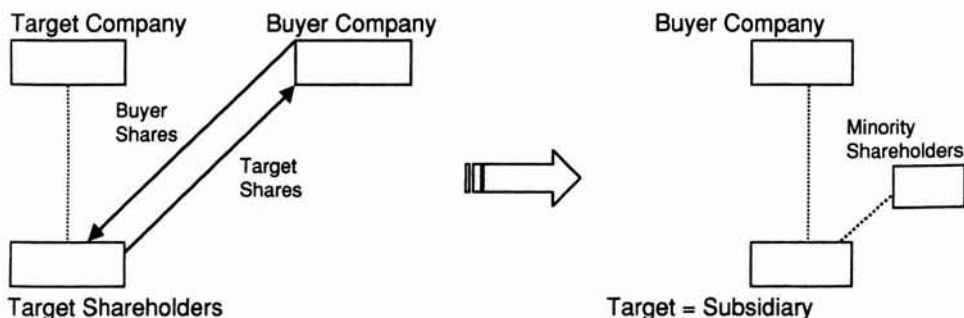
EXHIBIT 19.9 Forward Triangular Merger ("A" Type Reorganization)

**EXHIBIT 19.10** Reverse Triangular Merger ("A" Type Reorganization)

the buyer's parent corporation *voting stock* (either common or preferred). Also, the buyer must control "substantially all" of the target's assets. This form of transaction limits the buyer's use of spin-offs and asset sales just prior to the transaction. As with the other mergers, a vote of the target's shareholders is required, though a vote of the buyer's is not necessary. The liabilities of the target are isolated in a subsidiary.

Voting Stock-for-Stock Acquisition ("B" Type Reorganization)

To qualify as a tax-free transaction in a stock-for-stock deal (see Exhibit 19.11), the buyer must exchange only voting, common, or preferred stock, and after the transaction must control at least 80 percent of the votes. No boot payments are allowed. No merger occurs, as the target is retained as a wholly (or partially) owned subsidiary. The target survives as an entity. Therefore, the target's liabilities are isolated from the buyer. Also, no shareholder votes are required. Given the 80 percent rule, the *voting stock-for-stock acquisition* ("B") permits the existence of minority shareholders in the target company. The purchaser need not acquire control at once; this form permits a "creeping acquisition." In comparison, the reverse triangular merger gives results similar to the stock-for-stock acquisition, but permits boot and eliminates minority shareholders.

**EXHIBIT 19.11** Voting Stock-for-Stock Acquisition ("B" Type Reorganization)

Voting Stock-for-Assets Acquisition ("C" Type Reorganization)

In this last type of tax-free transaction (see Exhibit 19.12), the buyer offers shares of its voting stock in return for substantially all of the assets of the target company. Up to 20 percent of the fair market value of the consideration may be paid in cash or securities other than common stock. The target company must liquidate after the transaction and distribute the shares in the buyer to the target shareholders in liquidation. Liabilities assumed in the *voting stock-for-assets acquisition* ("C") count as boot when cash or other consideration is given in the exchange.

The main advantage of this form of transaction is that the buyer has flexibility about the medium of payment, subject to the 20 percent rule. Also, the buyer has flexibility in choosing whether to assume any of the target's liabilities. The buyer's shareholders do not necessarily need to vote to approve the transaction, unless the buyer's stock is listed on an exchange or additional stock must be authorized to complete the acquisition. As with the other types of reorganizations, a Subco may be used.

The stock-for-assets acquisition may incur sizable legal and administrative costs to transfer numerous individual assets. Tax-free status requires that at least 70 percent of the fair market value of the gross assets, and 90 percent of the FMV of net assets of the target company be transferred. Finally, to the extent that the target shareholders receive boot they will recognize an immediate tax on the gain, if any.¹³

SUMMARY AND IMPLICATIONS FOR THE DEAL DESIGNER AND SENIOR EXECUTIVE

As the discussions of the various forms of transaction reveal, the deal designer faces a varied menu of possible structures. Each has advantages and disadvantages. Therefore, the decision maker will need to weigh the trade-offs associated with each type of transaction as they apply to the situation at hand. Exhibit 19.13 summarizes some salient points of each transaction type for the reader.

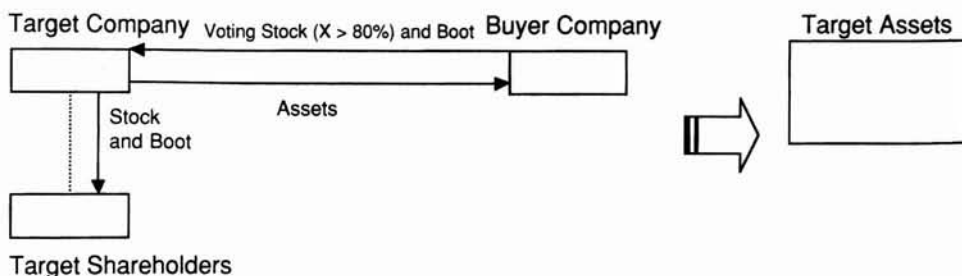


EXHIBIT 19.12 Voting Stock-for-Stock Acquisition ("C" Type Reorganization)

EXHIBIT 19.13 Summary of Features of Various Transaction Types

	Tax Implications for Seller and Buyer	Buyer's Exposure to Target's Liabilities	Need for Target Shareholder Vote	Need for Buyer Shareholder Vote	Minority Freeze-Out?*	Does the Target Company Survive?	Form of Payment
Cash purchase of assets	Immediately taxable to seller. Step-up for buyer.	Low	Maybe	No	No minority	Uncertain	No restriction. Usually cash.
Cash purchase of stock	Immediately taxable to seller. Step-up for buyer.	High	No	No	No	Yes	No restriction. Usually cash.
Cash merger	Immediately taxable to seller. Step-up for buyer.	Low if target merged into a sub buyer.	Yes	Maybe	Yes	No if forward triangular merger. Yes if reverse triangular merger.	No restriction. Usually cash.
Statutory merger or consolidation ("A" Reorganization)	Tax-free to seller. [†] No step-up for buyer.	High	Yes	Yes	Yes	No	Buyer's stock and typically no more than 50% boot

(Continued)

EXHIBIT 19.13 (Continued)

	Tax Implications for Seller and Buyer	Buyer's Exposure to Target's Liabilities	Need for Target Shareholder Vote	Need for Buyer Shareholder Vote	Minority Freeze-Out?*	Does the Target Company Survive?	Form of Payment
Forward Triangular Merger ("A" Reorganization)	Tax-free to seller. [†] No step-up for buyer.	Low—limited by sub	Yes	No [‡] —unless need to authorize more shares	Yes	No	Buyer's stock and typically no more than 30% boot.
Reverse Triangular Merger ("A" Reorganization)	Tax-free to seller. [†] No step-up for buyer.	Low—limited by sub	Yes	No [‡] —unless need to authorize more shares	Yes	Yes	Buyer's voting stock of at least 80% and the rest in boot.
Voting Stock-for- Stock ("B" Reorganization)	Tax-free to seller. [†] No step-up for buyer.	Low—limited by sub	Maybe	No [‡] —unless need to authorize more shares	No	Yes	100% in buyer's voting stock.
Voting Stock-for- Assets ("C" Reorganization)	Tax-free to seller. [†] No step-up for buyer.	High for liabilities that convey with the assets	Maybe	No [‡] —unless need to authorize more shares	No minority	No	At least 80% buyer's voting stock in value and the rest in boot.

* A minority freeze-out seeks to eliminate *direct* interests in the target firm held by a minority of shareholders (who are possibly dissidents) following the completion of the deal. This is ordinarily accomplished by merging the target into the buyer.

† "Tax-free" is common usage for "tax deferred until disposition or sale of the stock." Also, any boot in the "tax-free" transactions may create an immediate tax liability to the extent of any gain implicit in the boot.

‡ Stock exchanges and legal counsel may require a vote of the buyer's shareholders on material transactions. Asset sales and spin-offs could create adverse tax consequences.

This survey raises several large implications for the deal designer and senior executive:

- **Transaction choice can affect control.** The buyer's flexibility in operating Subco can be affected by the structure of the transaction. Many seasoned acquirers avoid structures that create minority shareholders in a newly acquired subsidiary—laws and court decisions in most developed countries protect the rights of the minority in ways that may limit the freedom of the majority (the buyer).
- **Transaction choice can affect exposure to risk.** Known and unknown risks embedded in the target can be contained through careful deal design.
- **Transaction choice is interdependent with the choice about form of payment.** To achieve the tax-deferred status of the deal, it will usually be necessary to pay substantially in stock.
- **Transaction choice can create (or destroy) value.** In the give-and-take of bargaining, the choice of transaction structure can capture benefits and impose costs on the buyer and target. Exhibit 19.14 invites the reader to consider the valuation effects of transaction choice. Some transaction types offer tax savings—the value of these can be estimated using standard discounted cash flow methodology. Other transactions offer great flexibility, in the form of voting control, designing the transaction payment, and/or in freeing the buyer from liabilities of the seller. These are various kinds of embedded options, and will tend to be more valuable the greater the uncertainty under which the deal designer is working. Option pricing theory is not easily adapted to estimating the value of these options, but it is sufficient to know that options are always valuable, even if out of the money.

EXHIBIT 19.14 Transaction Choice and Valuation Analysis of Acquisitions

The fundamental rule for buyers is to accept a transaction proposal if the target company is worth more than what the buyer pays.

$$V_{\text{Firm}} \geq V_{\text{Payment}}$$

Transaction choice would add factors to each side of the inequality. On the left-hand side, one could add an estimate of the value of transaction-specific benefits, such as the present value of tax savings and the value of hidden options. On the right-hand side, one could add a factor that recognizes possible change in payment *incremental* to the specific transaction alternative—for instance, this might reflect higher payment to cover the seller's immediate tax obligation. The enhanced rule for buyers is:

$$V_{\text{Firm basic}} + V_{\text{Transaction benefits}} \geq V_{\text{Base payment}} + V_{\text{Payment due to this transaction form}}$$

Since the basic estimates of value and payment do not vary with transaction choice, the transaction designer can simplify the decision rule about transactions: *Accept a transaction alternative if its benefits are greater than its costs.*

$$V_{\text{Transaction benefits}} \geq V_{\text{Payment due to this transaction form}}$$

But since there are at least eight types of transactions to choose from, the deal designer needs to *choose the transaction alternative that creates the most value.*

$$\text{Value created through transaction choice} = V_{\text{Benefits specific to this transaction form}} - V_{\text{Incremental transaction payment}}$$

In short, transaction choice is riddled with value-creating effects. Well-informed counterparties in a merger negotiation may attempt to appropriate some (or all) of the value created by transaction choice. To some extent, this reflects the zero-sum nature of U.S. tax policy: Sooner or later, someone has to pay the tax on profits. Sellers know this, and may ask for a higher payment from the buyer if their gain is immediately taxable. *Buyers should be cautioned not to overpay for the benefits of a specific transaction type. Choose the form of transaction that maximizes value creation.*

- **A careful understanding of the buyer's and seller's goals should drive transaction choice.** None of the eight transaction forms reviewed here is best in any absolute sense. What matters is their reasonableness in light of the wants and needs of the counterparties in the merger negotiation. This implies that the careful deal designer must observe the classic "commandment" of negotiation, *know thy counterparty.*
- **Obtain counsel.** This is a complex aspect of M&A. Laws, regulations, and practices change steadily. *No transaction should be consummated without prior review by tax and legal experts.*

NOTES

1. An article in *Mergerstat Review* (1989) argued that "a privately held business has one owner or a handful of shareholders, usually members of the owner's family. Hence, their concern for tax liability is much greater. Furthermore, in many instances, management owners remain with the company, expecting to contribute to the future growth of the newly merged entity, and thereby profiting from the stock's appreciation." (Page 51)
2. See Scholes and Wolfson (1992), page 515.
3. Active buyers will often seek advance authorization of new shares from their shareholders, well before a specific transaction is contemplated. Where buyers have sufficient shares in treasury, a vote to authorize new shares will be unnecessary.
4. The buyer should always determine whether the target has been party to a spin-off within the two-year window before or after the transaction, and if so should perform an analysis as to whether a taxable event may take place.
5. Historically, the double taxation could be avoided if the corporation liquidated and distributed all assets to shareholders within a 12-month period. However, the Tax Reform Act of 1986 eliminated this treatment.
6. The value of intangible assets such as patents and R&D is amortizable over 15 years for tax purposes.
7. Tax treatment of goodwill stands in contrast to accounting treatment. Under FAS 141 and 142, goodwill is not amortized for financial reporting purposes, though it must be tested annually for impairment and written off as necessary.
8. This is equal to \$1 million divided by 15 years.
9. In a minority freeze-out, the buyer obtains shareholder approval for a merger of the target into Subco, thus eliminating a minority interest in the target.
10. In a forward cash merger, the target company, in effect, sells its assets and liquidates. Taxes are paid by the target on any gain in the sale, and again by the

shareholder upon receipt of the liquidating dividend. In a reverse cash merger, the buyer receives stock in the target, and shareholders are exposed only once to a gain on the sale of the stock. But the buyer can elect to have the transaction treated as a purchase of assets—in which case the buyer must be responsible to pay the tax on the inherent gain on the underlying assets.

11. Whether a proxy statement and shareholder vote are required of the buyer will depend on various considerations, driven largely by size. For transactions that are large relative to the size of the buyer, stock exchange rules and some state laws will require a vote of the shareholders.
12. Throughout this book, “Newco” is used generically to indicate the firm that emerges from a merger or acquisition. In Exhibit 19.8, “Newco” is used in the narrow legal sense to indicate an entirely new legal entity.
13. Boot is commonly thought of as cash or notes. Stock warrants are a form of boot as well. But these are deemed to have zero value for tax purposes, and therefore carry no tax liability.