Special Focus: Legal Services

Eight Potential Pitfalls of Merger Transactions

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A MERGER IS A CORPORATE TRANSACTION negotiated by two or more corporations which is effectuated in accordance with state statutory law and consummated by the adoption by each corporation of a plan of merger and the filing of certain documents with state officials. For a merger to be effective, the adoption of a plan of merger by the board of directors of each constituent corporation is required, as well as, in most instances, the approval of a majority of the shareholders of each constituent corporation.

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If a plan of merger is adopted by the board of directors of each constituent corporation and approved by the requisite number of shareholders of each corporation, the shares of the target corporation (target) will be exchanged for shares in the surviving corporation (survivor). Depending upon state law, some states—including New Jersey—entitle dissenting shareholders to receive cash in an amount equal to the fair market value of their shares in the target in lieu of shares in the survivor.

In New Jersey, a merger is effectuated by each constituent corporation filing a Certificate of Merger with the Secretary of State of New Jersey. When these certificates are filed, the share exchange is deemed consummated, the assets and liabilities of the target will be deemed transferred to the survivor and the merger will be consummated.

Prior to entering into any merger transaction, it is prudent for each constituent corporation to conduct a thorough review and analysis of the business, assets and liabilities of the other constituent party(ies), commonly known as a due diligence review. During this process, many of the possible "pitfalls" of a merger transaction may be discovered, and a review of the risks are reviewed and evaluated. Following is a summary of potential pitfalls:

1. *Personal and real property.* As a result of the merger, the survivor will acquire all of the assets of the target. The survivor will also acquire all of the defects in title, existing security interests in favor of third parties, encumbrances and liens against the property resulting from actions taken by the target prior to the merger. Counsel for the survivor should undertake title searches of real estate and lien and judgment searches against the target to determine the existence of any defects in title or liens. All of the leases for personal property and real estate will be assumed by the survivor as part of the merger. These leases must be reviewed by counsel for the survivor in order to ensure that they are transferable without the consent of the lessor or landlord. If such consents are required, it is best that the survivor enter into negotiations early on in the merger process to determine the continued viability of the merger.

2. *Intellectual property.* Counsel for the survivor must investigate the ownership rights in and to the intellectual property used by the target in the conduct of its business and the transferability of the target's intellectual property. All license agreements to which the target is a party must be reviewed to determine whether they are transferable in the merger or whether a merger may constitute an event of default or breach under such license agreements. One must also investigate and assess any pending or threatened infringement claims commenced by or against the target.

3. *General liabilities.* Counsel must review all loan documents to determine whether the merger will cause acceleration of the target's debt. Existing product liability claims must be investigated and insurance coverages must be examined to ensure that there is continuity of insurance coverage for the pre- and post-merger entities. The financial statements of the target must be scrutinized by the accountants for the survivor to identify future or contingent liabilities that may be identified in footnotes contained in the financial statements.

4. *Material contracts.* All material contracts must be reviewed by counsel to the survivor. Customer and supplier relationships must be reviewed to determine if the contracts will survive the merger and the duration of the agreements.

5. *Litigation.* The target must fully disclose any litigation with which it is involved, and that litigation must be analyzed and assessed as the rights and liabilities attendant to

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that litigation will become the responsibility of the survivor.

6. *Environmental.* The survivor will have potential liability for compliance, spills and releases of hazardous substances by the target prior to the merger. A complete examination of the target's site, methods and procedures must be undertaken by an independent environmental consulting firm. This is generally referred to as a Phase I examination. If this examination turns up potential problem areas, then a more detailed Phase II examination should be conducted on the premises of the target. It should also be noted that the merger may trigger compliance with the Industrial Site Recovery Act (ISRA). If the transaction is subject to ISRA, the involvement of the New Jersey Department of Environmental Protection will invariably lengthen the time between the due diligence period and the culmination of the merger.

7. *Employee benefit plans.* By the merger, the survivor will be assuming the target's liability for its employee benefit plans and the target's joint and several liability for group plans in which the target's employees participate. The survivor will also be exposed to unfunded pension liabilities. All stock option agreements and employee benefit plan agreements must be reviewed to determine the rights of the target's employees under those plans, and to determine whether the merger will accelerate the rights of any employees to additional stock options or to payment of deferred compensation arrangements.

8. *Tax matters.* The accountants and counsel for the survivor should identify the target's tax obligations to federal, state, local and foreign governments. The acquisition review must include, but is not limited to, income tax, sales or use tax, franchise tax, workers' compensation, unemployment tax and FICA withholding taxes. The merger documents will provide that the target is responsible for any and all taxes attributable to operations prior to the date of the merger. Nonetheless, as between the taxing authority and the survivor, the survivor will be held liable for taxes attributable to periods prior to the merger. Although this article does not permit us space to discuss other areas that should be scrutinized—including labor matters, involvement of securities laws, antitrust laws, analysis of foreign operations and investments—these should be of concern to the survivor.

How does the survivor protect itself from the pitfalls and attendant risks? First and foremost by doing a comprehensive legal and financial accounting due diligence review before entering into the merger agreements. The due diligence review may expose problem areas that can be remedied prior to entering into the contract, and those that cannot be remedied may affect the ultimate negotiation of purchase price. Secondly, the merger agreement should be drafted so that the owners of the target are responsible for the accuracy of the representations made in all of the areas that have been discussed here.

The agreement should contain an indemnification section so that in the event any of the representations or warranties of the owners or the target prove to be inaccurate, the owners will be responsible for reimbursing the survivor for any losses it suffers as a result of those inaccuracies. It is customary to set aside a portion of the cash consideration as an escrow to be utilized to fund reimbursement in accordance with the indemnification clause.

Many of these concerns can be eliminated if the transaction is structured as an asset purchase rather than a merger. However, the tax benefit of a merger often precludes the use of the classic asset purchase. ■

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