

# The Reverse Triangular Merger is the Favorite, and Often Wrong, Option

by Joel Nied



**A frequently used merger technique is the reverse triangular merger. Despite its popularity, it is a fairly convoluted process. Some even call it awkward.<sup>1</sup> The reverse triangular merger uses three companies, some obscure terms like “transitory subsidiary” and a little bit of “corporate magic.”<sup>2</sup>**

The reverse triangular merger is accomplished by a multi-step process starting with an acquiring corporation forming a subsidiary. The acquirer then funds the subsidiary with securities or cash. Next, the subsidiary is merged into the acquired (target) corporation. The plan of merger states that the target survives the merger and that its shareholders receive the cash or securities of the parent in exchange for their target stock. As a result, the target corporation becomes the subsidiary of the parent/acquirer.

Mergers are used for a variety of reasons instead of asset or stock purchases. Reverse triangular mergers, however, are typically used for the same reasons other forms of mergers are used, plus one other goal: to ensure that the acquired entity is, legally, the same entity it was immediately prior to the merger.

Under most states' laws, the consideration the shareholders of a target receive in a merger, including a reverse triangular merger, can be cash.<sup>3</sup> In other words, despite the convoluted process of the acquirer forming a subsidiary, merging the target into the subsidiary, and sprinkling the whole procedure with a little corporate magic, the ultimate goal is to put cash into the hands of the shareholders of the target. A merger resulting in the shareholders of the target receiving cash is often called a "cash-out merger."

Reverse triangular mergers are popular for a variety of reasons. One of those reasons, however, has nothing to do with a tax benefit, efficiency, or liability reduction. Rather, it is simply a knee-jerk reaction of many practitioners. Like all reflexive actions, it has its origin in utility. People are accustomed to implementing reverse triangular mergers because that complex process is often the only way in many states to effectuate the three goals of 1) a merger 2) that results in the survival of the target entity and 3) provides cash to the target shareholders.

In Delaware, the reverse triangular merger is often the single manner available to accomplish all three goals. Because so many corporations around the country are formed in Delaware, attorneys throughout the nation are well-schooled in the limited merger techniques afforded by the Delaware statute governing corporations — the Delaware General Corporation Law.<sup>4</sup> Through repeated use of the reverse triangular merger, many attorneys have developed a reflex to use that process even in states whose merger statutes afford a more efficient method.

### The Share Exchange

Virginia is one of those states that has a better way to accomplish those goals. It has often been noted by legal scholars that Virginia corporation law is superior to Delaware corporation law.<sup>5</sup> The merger statutes are no exception. While the instinct may be to reach for the reverse triangular merger out of habit, Virginia corporations have a better option: the share exchange.

Someone unfamiliar with the Virginia mergers and acquisitions statutes may think that share exchanges are only useful when an acquirer exchanges shares with the shareholders of a target. Such a person would be guilty of skimming the relevant passages of the Virginia Stock Corporation Act, regardless as to how well they are organized. The share exchange provides much more flexibility. Va. Code Ann. § 13.1-717.A.1. spells out, in simple-to-understand language, the elegant share exchange procedure:

A domestic corporation may acquire all of the shares of one or more classes or series of shares of another domestic or foreign corporation, or all of the eligible interests of one or more classes or series of eligible interests of a domestic or foreign eligible entity, as well as rights to acquire any such shares or eligible interests, in exchange for shares or other securities, eligible interests, obligations, rights to acquire shares, other securities or eligible interests, cash, other property or any combination of the foregoing, pursuant to a plan of share exchange.

The process is simple and flexible: a corporation acquires the shares of another corporation. In exchange for those shares, the acquirer can provide consideration to the shareholders of the target corporation in the form of, among other things, cash.

It seems so much simpler than the reverse triangular merger. There is a reason for that. It is simpler. In fact, the share exchange is simpler than any form of merger. Not only is it simpler, it is arguably the only way to perform a "cash-out merger" in Virginia. In *Barris Industries, Inc. v. Bryan*,<sup>6</sup> the plaintiffs sought to perform a reverse triangular merger: "As reverse triangular mergers are typically explained, Media General as the target is the acquired entity, while one of the plaintiffs will be the acquiring entity."<sup>7</sup> In exchange for their

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shares, the shareholders of Media General Inc. (the target) were to receive \$61.50 per share.<sup>8</sup>

The court, however, ignored the fact that the company controlled by the plaintiffs formed a new subsidiary, planned to fund that subsidiary with cash and merge the target into the subsidiary and then, finally, give all the shareholders of the target cash, thereby removing them all as shareholders of record of the target. Despite the intricate form of the transaction, the court boiled it down to its basic elements. The court stated that Virginia's share exchange statute, not the merger statute, governed: "Any 'cash-out' merger which by its terms forces all shareholders to exchange their shares for other corporate securities or for cash, effects or constitutes a 'share exchange' within the meaning of Article 12 of the Virginia Stock Corporation Act."<sup>9</sup> In other words, regardless as to what the parties call the transaction or which statutes they cite in the articles of merger, the courts will view a cash-out merger as a share exchange pursuant to Va. Code Ann. § 13.1-717.

There is an argument, admittedly a weak one, that the share exchange statute (§ 13.1-717) does not provide the same post-closing certainty as the merger statute (§ 13.1-716). A casual observer comparing Va. Code Ann. § 13.1-721.A.(8) (which describes some of the effects of a merger) to 13.1-721.B. (which describes the effects of a share exchange), may think that the merger statute states the limitations on the rights of the target's former stockholders while the share exchange statute does not. As described below, that interpretation is not only incorrect, it is irrelevant in the case of a cash out merger.

### Rights

To the detriment of an acquirer, and contrary to the frail argument above, a merger provides *more* rights to the former shareholders than does a share exchange. Under both a merger and share exchange, the target shares' rights "are entitled only to the rights provided to them in the [plan of share exchange/plan of merger] or to any rights they may have under Article 15 (§ 13.1-729 et seq.) ...."<sup>10</sup> Under a merger, however, the target shares and shareholders are also entitled to additional rights that are not granted in the case of a share exchange: those granted by "the organic law of the eligible entity."<sup>11</sup> The target's shareholders' rights, ultimately, are irrelevant in the case of a cash-out merger (whether it is a reverse triangular merger or a share exchange) because, at the end of the transaction, the target shareholders will no longer be shareholders. They will be simply cash-holders. With regard to the amount of cash they are entitled to receive, Va. Code Ann. § 13.1-741.1.A. puts the same limitations on a shareholder's remedies for both mergers and share exchanges.

By all accounts, a share exchange is superior to a reverse triangular merger: it is simpler and it arguably affords more protection to the acquirer than a merger. In addition, regard-

less of how the parties to a transaction structure the deal, courts applying Virginia law to a cash-out merger will likely consider it a share exchange. As one observer stated, a share exchange "is subject to the same safeguards as a statutory merger, such as shareholder approval and dissenters' rights. It is a procedure whereby one entity may become the subsidiary of another without the awkward process of a reverse triangular merger."<sup>12</sup>

Attorneys advising Delaware corporations may have no choice but to recommend the awkward reverse triangular merger. Attorneys advising Virginia corporations, however, would be remiss to not advise their clients of the availability of a share exchange when the goal is to cash out the target shareholders. Mergers and acquisition attorneys should fight the mechan-

ical habit of resorting to the reverse triangular mergers when Virginia corporations are involved. Instead, they should opt for the simpler and more elegant share exchange.

*It has often been noted by legal scholars that Virginia corporation law is superior to Delaware corporation law.*

### Endnotes:

- 1 See *Murphy, The New Virginia Stock Corporation Act: A Primer*, 20 *U.Rich.L.Rev.* 67, 121 (1985).
- 2 The Portable MBA in Finance and Accounting, Theodore Grossman, John Leslie Livingstone, John Wiley & Sons, Oct 8, 2009, p. 207. "Through an example of corporate magic known as the reverse triangular merger, the newly formed subsidiary of the acquirer may disappear into ... the target corporation ...."
- 3 See, e.g. DEL. CODE ANN. tit. 8, § 251(b)(5).
- 4 DEL. CODE ANN. tit. 8, § 101 et seq.
- 5 See, e.g., *Wheaton and Nied, Virginia or Delaware? No Reason to Leave the Old Dominion*, *Virginia Lawyer* magazine — June/July 2003, p. 21.
- 6 *Barris Industries, Inc. v. Bryan*, 686 F. Supp. 125 (E.D. Va. 1988).
- 7 *Id.* at 131.
- 8 *Id.* at 126.
- 9 *Id.* at 132.
- 10 Va. Code Ann. §§ 13.1-721.A.(8) and 13.1-721.B.
- 11 *Id.*
- 12 *Murphy, supra*, 20 *U.Rich.L.Rev.* 67, at 121 (1985).



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