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Corporate Alert April 2013

Delaware Chancery Court Holds that a Reverse Triangular Merger Is Not an Assignment by Operation of Law

On February 22, 2013, the Delaware Chancery Court in *Meso Scale v. Roche*[1] restored a degree of certainty to M&A planning by holding that the acquisition of a company through a reverse triangular merger (RTM) did not constitute an assignment by operation of law. The plaintiff, Meso Scale, had argued that the merger of Roche's acquisition subsidiary into target company BioVeris Corporation violated an anti-assignment clause in an agreement between BioVeris and Meso Scale. The Court's decision reaffirmed the traditional understanding of practitioners and commentators that an RTM does not involve an assignment, but the opinion also confirms that the parties' intent will be part of the analysis where the anti-assignment clause at issue is ambiguous.

Anti-Assignment Clauses and Change of Control Provisions

Anti-assignment provisions prohibit a party from assigning its rights and obligations under a contract without the consent of the other party. Change of control provisions give one party to a contract certain rights (e.g., the right of consent, the right to additional payment, or the right of termination) in the event that ownership or control of the other changes hands. Agreements sometimes contain both provisions or may combine both concepts into a single clause. A key consideration for any acquisition is whether the preferred choice of transaction structure will trigger any such restrictions found in the target company's contracts. Legal analysis of the issue depends on the transaction structure to be used in the acquisition and the specific language of the relevant contractual provision(s).

Choice of Acquisition Structure

The three basic acquisition structures are asset purchases, stock purchases and mergers. Asset purchases, by definition, require assignment of any contract included in the sale. Stock purchases do not involve an assignment (the target company remains the contract party post-acquisition) but do involve a change of control. Mergers, on the other hand, are governed by state corporation law and are less straightforward. The operative language of most statutes provides that the property and rights of the non-surviving entity seamlessly "vest" in the survivor, which courts have generally held to be a transfer by operation of law and not an assignment. Interpretive issues arise, however, when contractual anti-assignment language appears intended to cover something broader than traditional assignment, such as clauses prohibiting "assignment by operation of law or otherwise." Practitioners have traditionally assumed that reverse triangular mergers—in which the acquirer forms a new shell subsidiary and merges it into the target company, with the shell disappearing and the target surviving—would not violate such language because the target at all times remains the contract party, as is the case in a stock sale.[2] As a result, reverse triangular mergers have historically been one of the most popular acquisition structures.

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[1] *Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH*, C.A. No. 5589-VCP (Del. Ch. Feb. 22, 2013).

[2] By contrast, forward mergers—in which the target disappears and the acquirer or its shell subsidiary survives—could clearly be implicated by such a provision.

The *Meso Scale* Case

This traditional assumption, however, was upended in a 2011 preliminary ruling by the Chancery Court in *Meso Scale*. The case involved certain BioVeris intellectual property in which Meso Scale had an interest and a related consent agreement prohibiting assignment by BioVeris "in whole or in part, by operation of law or otherwise" without Meso Scale's consent. Roche acquired BioVeris in 2007 through an RTM, apparently for the primary purpose of obtaining these and other intellectual property rights, and promptly shut down BioVeris's operations post-merger, effectively leaving it an IP holding company. In denying Roche's 2011 motion to dismiss, the Court found that the "by operation of law" language could reasonably have been intended to cover reverse mergers in which the surviving target was treated as a mere shell.

The Chancery Court took up the issue again in Roche's 2012 motion for summary judgment, but this time held that an RTM does not amount to an assignment under Delaware law. Its holding began with an examination of Section 259 of the Delaware General Corporation Law, which sets forth the effects of a merger:

> When any merger or consolidation shall have become effective under this chapter, for all purposes of the laws of this State the separate existence of…all such constituent corporations *except the one into which the other or others of such constituent corporations have been merged*…shall cease….

The Court found the italicized portion to suggest that the surviving corporation does not effect any assignment. The Court also determined that such an interpretation of the anti-assignment provision in the BioVeris agreement was consistent with the reasonable expectations of the parties, because leading commentators had long stated that RTMs do not constitute assignments by operation of law. The Court distinguished two Delaware cases finding that the phrase "assignment by operation of law" would commonly be understood to include a merger, because those cases had involved forward mergers, in which the rights at issue transferred from the non-surviving party to the surviving entity. The Court also refused to follow the approach adopted by a California district court in the 1991 case *SQL Solutions, Inc. v. Oracle Corp*[3] (which held that an RTM constituted a transfer of rights under a software license), because it turned on a California law principle that a mere change in the legal form *of ownership* of a business could result in an assignment depending upon whether it affects the parties protected by the anti-assignment provision. The Chancery Court noted this principle would extend to stock acquisitions, which Delaware jurisprudence firmly established did not involve an assignment. Finally, the Court noted that Meso Scale could have negotiated for a change of control provision, but had failed to do so.

Some Practical Guidance

The chief significance of the *Meso Scale* decision is its reestablishment of the general understanding that an RTM does not constitute an assignment in Delaware. This means that M&A attorneys may continue to utilize the RTM under Delaware law to avoid obtaining consents in the case of non-assignment provisions in the target's contracts. The case has a number of additional practical implications:

- *Importance of Careful Drafting:* In noting that Meso Scale had failed to negotiate for a change of control provision, the Court's decision validated the distinction between assignment versus change of control. When negotiating agreements, each contract party should therefore make sure it understands the scope of any proposed anti-assignment language and consider its impact on choice of transaction structure in any potential future sale of its or the counterparty's business.

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[3] 1991 WL 626458 (N.D. Cal. Dec. 18, 1991).

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The parties may wish to set forth a separate change of control provision if such restriction is desired.

- *Intent of the Parties:* The Court's reasoning included an analysis of the intent of the parties under Delaware's "objective theory" of contract interpretation. Therefore, while the *Meso Scale* case stands for the general proposition that RTMs do not violate anti-assignment provisions, the intent of the parties will still be relevant. A contract provision that more strongly blurs the line between assignment and change of control could yield a different result.

- *Applicable Law:* *Meso Scale* establishes the rule for RTMs in Delaware, but it should be noted that the Chancery Court's analysis focused specifically on the language in DGCL Section 259 and Delaware's line of cases on stock acquisitions. Though Delaware corporate jurisprudence is often persuasive in other jurisdictions, other courts could reach different results, particularly in light of cases such as *SQL Solutions*. Acquisition planning (and contract drafting) should therefore always involve an analysis of the effects of mergers under all relevant laws.

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Peter J. Schaeffer	**212.336.2313**	**pjschaeffer@pbwt.com**
Andrew P. Beame	**212.336.2704**	**apbeame@pbwt.com**
Burke Blackman	**212.336.2674**	**bblackman@pbwt.com**

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