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MERGERS AND ACQUISITIONS

Effects of Mergers On Non-Assignable Agreements


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In 1991, the federal district court for the Northern District of California ruled in *SQL Solutions Inc. v. Oracle Corp.*[1] that the acquisition of a company pursuant to a reverse triangular merger (RTM) constituted a breach of a non-assignable agreement under which the company licensed certain software. No subsequent reported cases reached a similar conclusion in the context of an RTM (in which the target company survives the merger as the buyer's subsidiary), leading many M&A and IP practitioners to view *SQL Solutions* as an outlier. However, the Delaware Chancery Court's recent denial of a motion to dismiss in *Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH*[2] casts new doubt on whether M&A lawyers can rely on an RTM acquisition structure to avoid violating prohibitions on assignment contained in the target company's contracts.

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Mergers and Assignments

In general, a buyer can acquire a target company in one of three ways: asset purchase, stock purchase or merger. Asset acquisitions by definition constitute an assignment of the target company's contracts to the buyer. Stock acquisitions do not violate anti-assignment provisions because the target company remains the same legal entity—and a party to the non-assignable agreement—before and after the sale.

Mergers do not lend themselves to such a straightforward analysis. Only one of two legal entities survives a merger transaction, with the surviving entity assuming all of the extinguished entity's assets, rights and liabilities. The buyer survives a forward merger, whereas a reverse merger is a transaction in which the target survives. In a variation of this structure commonly referred to as a triangular (or "subsidiary") merger, the buyer effects the merger transaction through a wholly owned acquisition subsidiary, which results in the surviving entity (typically the target) becoming the buyer's subsidiary.

Mergers are creatures of state law, and the majority of state merger statutes follow the ABA Model Business Corporation Act (MBCA), which provides for a seamless "vesting" of contractual rights in the survivor "without reversion or impairment." Delaware's state merger statute—which does not follow the MBCA—also is influential because so many corporations incorporate under Delaware law; it too includes automatic "vesting" language.

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. Other courts seek to resolve the question of whether a merger violates a contract's non-assignment 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 implication of federally established intellectual property rights, such as patents and copyrights, can add an additional wrinkle to a court's analysis. Many courts have found that an intellectual property owner has the right to maintain control over the range of parties to which it grants licenses. When an intellectual property licensee is a party to a merger, state merger law must be considered in light of this federal interest in protecting intellectual property owners. Accordingly, in certain contexts licensees of federally protected intellectual property rights have been prohibited from assigning the applicable license agreements without the licensors' consent.

In *PPG Industries v. Guardian*,[3] for example, the Sixth Circuit found that Guardian's acquisition of Permaglass pursuant to a forward merger violated the prohibition on assignment contained in Permaglass' patent license agreement with its licensor PPG. After noting that federal law controlled the assignability of patent licenses, the court stated that "[a] transfer is no less a transfer because it takes place by operation of law rather than by a particular act of the parties. The merger was effected by the parties and the transfer was a result of their act of merging."

The Sixth Circuit came to a similar conclusion 30 years later in *Cincom Systems Inc. v. Novelis Corp.*[4] In *Cincom Systems*, a software licensee was merged into a sister company pursuant to a corporate restructuring. The court reiterated its holding in *PPG* and explained that, regardless of whether state law would otherwise permit the transfer despite the agreement's prohibition on assignment, federal interests dictated that any transfer would be impermissible absent an express agreement to the contrary. The fact that Novelis,

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the parties' ultimate corporate parent, beneficially owned the merged entities both before and after the restructuring was immaterial. Rather, "the harm is the breach of the terms of the license: the violation of the federal policy (or contract term) allowing the copyright or patent holder to control the use of his creation."

'SQL Solutions'

The Northern District of California took the protection of federal intellectual property rights one step further in *SQL Solutions*. 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.

The federal district court noted that California law adheres to the "adverse impact" analysis of contracts in mergers, namely: "[i]f an assignment results merely from a change in the legal form of ownership of a business, its validity depends on whether it affects the interests of the parties protected by the non-assignability of the contract." However, the *SQL* court failed to address the question of whether the purported transfer harmed Oracle, holding instead that (1) Oracle had a federally protected copyright interest in the licensed software, and (2) California law must be construed in a manner that does not conflict with these interests. Accordingly, the court found that the mere consummation of the transaction as an RTM, without more, violated the license agreement's prohibition on assignment.

Later cases did not revisit this issue in the context of RTMs, and conventional deal wisdom developed—especially outside the Ninth Circuit—that the question of whether a merger violates non-assignment clauses contained in the target company's intellectual property licenses and other contracts depends on whether the target survives the transaction. As *PPG* and *Cincom Systems* demonstrate, forward mergers present substantial risk that they will be deemed an assignment and thus a breach of non-assignment provisions in the target's license agreements. Many triangular mergers are structured as RTMs specifically to mitigate this risk by ensuring that the target survives as the party of record in its contracts both before and after the transaction. As a result, until the recent *Meso Scale* case, many M&A practitioners conducting due diligence on a target company's contracts prior to an RTM have not viewed non-assignment provisions in those contracts as a material obstacle to consummating the merger.

'Meso Scale Diagnostics'

The *Meso Scale* case arose from a series of complex transactions involving Roche's non-exclusive licensing rights to "ECL" diagnostic technology. After losing its original limited-scope license, Roche acquired a new license from the then-patent holder (and co-defendant) IGEN in 2003. As part of that transaction, Roche acquired IGEN, and IGEN transferred its intellectual property assets to a new public company, BioVeris. The parties required plaintiff Meso Scale's consent to complete the transaction because Meso Scale held an exclusive license to exploit ECL technology in areas outside the scope of Roche's license. The Global Consent to which all the parties agreed contained a provision that prohibited both direct assignments and those "by operation of law."

Roche desired to further expand its use of ECL technology and acquired BioVeris pursuant to an RTM in 2007. Meso Scale filed suit, claiming the RTM violated the anti-assignment provision of the Global Consent. In support of its motion to dismiss, Roche argued in favor of the conventional wisdom, i.e., no assignment occurred because an RTM is functionally equivalent to a stock sale in the sense that the target entity is the same legal entity before and after the transaction. The court found this analogy persuasive, but not conclusive.

> M&A and IP practitioners should take heed. 'Meso Scale' is far from an unqualified endorsement of 'SQL Solutions,' but the outcome is the same: M&A buyers now have less certainty that structuring an acquisition as an RTM will avoid non-assignment provisions in the target's contracts.

Instead, the court found the language restricting assignments "by operation of law" to be vague and open to different interpretations to be considered in later stages of the litigation. In the context of Roche's motion to dismiss, where the court must afford the party opposing the motion "the benefit of all reasonable inferences," one interpretation the court found reasonable was that the non-assignment clause prohibited Roche's RTM acquisition of BioVeris. In particular, the court appeared receptive to Meso Scale's portrayal of the acquisition as a creative approach to avoiding the consent requirement in the Global Consent, rather than a true acquisition of BioVeris.

Meso Scale noted that, among other things, Roche closed down BioVeris' offices, fired all of its employees and effectively reduced it to a shell company with intellectual property assets. The court found that such actions could allow a reasonable person to conclude that Roche was simply doing by RTM what it was prohibited from doing by assignment and that preventing such a result without Meso Scale's consent was the parties' intent in agreeing to the Global Consent's non-assignment provision.

Interestingly, the court did not rely on or even address the federal nature of the intellectual property interests at stake, unlike *SQL Solutions* and various cases involving forward mergers. In fact, the court specifically stated that its ruling was not informed by *SQL Solutions*:

> [*SQL Solutions*] deserves only limited weight, however, for several reasons. First, as a decision from another jurisdiction, it is not binding on this Court. Second, the status of the *SQL Solutions* opinion as an unreported federal district court case renders it nonbinding in California courts, as well, the state whose law was relevant to the court's analysis. And, in any event, the court's reasoning is open to question.

Given the early stage of the *Meso Scale* litigation, it is possible that future opinions will shed additional light on the Delaware Chancery Court's views. Nonetheless, M&A and IP practitioners should take heed. *Meso Scale* is far from an unqualified endorsement of *SQL Solutions*, but the outcome is the same: M&A buyers now have less certainty that structuring an acquisition as an RTM will avoid non-assignment provisions in the target's contracts. Importantly, the *Meso Scale* court did not rely on federal intellectual property principles, which makes the court's ruling potentially more broadly applicable than *SQL Solutions*.

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 federal 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.

1. C-91-1079 MHP, 1991 U.S. Dist. LEXIS 21097 (N.D. Cal. Dec. 18, 1991).
2. C.A. No. 5589-VCP (Del. Ch. April 8, 2011).
3. 597 F.2d 1090 (6th Cir. 1979).
4. 581 F.3d 431 (6th Cir. 2009).