Reverse Triangular Mergers and Non-Assignment Clauses

By Peter E. Fisch

Non-Assignment Clauses

Most leases prohibit absolute assignments without landlord consent. Mergers pose an interpretive problem because, although the lessee’s interest after the merger transaction is owned by an entity that is different from the original tenant (in the case of a forward merger) or by the same entity but with different equity ownership (in the case of a reverse merger), there is no actual assignment of the lessee’s interest. Rather, the lessee’s interest “vests” in the surviving entity by operation of the merger statute. However, many courts have found that the effect of a merger is to cause an assignment of the target’s leases and other contracts. This view is particularly common where the lease explicitly restricts assignments by operation of law (in this case, the operation of the merger statute) and where—as is the case in a forward merger—the identity of the tenant, not merely its ownership, changes.

In an RTM, the acquiring entity creates a new subsidiary that merges with and into the target company, which survives. The new subsidiary is merged out of existence and only the ownership of the target company changes. Courts disagree on whether this transaction structure produces an assignment “by operation of law.”

Two main approaches have emerged in the case law relating to mergers. The first is a policy-based analysis that seeks to determine whether the transaction has affected the quality, value, or performance of services that are the subject of the contract. Courts applying this approach have concluded on certain facts that a merger is not an assignment by operation of law. For example, in Trubowitch v. Riverbank Canning, the court found that a broad prohibition on assignment in a supply contract was not triggered by a merger of the purchaser. The court reasoned that “No interest of the seller would be served by preventing the rights under this contract for the sale of standard goods from passing to a copartnership continuing the business of the corporation [after the merger].”

The alternate approach looks to the language described above—found in most state merger statutes—that provides for the vesting of property of the merged corporation in the surviving entity. Courts applying this approach often find that forward mergers result in impermissible transfers of rights by operation of the merger statute because the “vesting” necessarily implies a transfer. For example, in Cincom Systems v. Novelis, the court found that a software license that prohibited assignments without the plaintiff’s express approval was violated by a series of forward mergers of the defendant. The court, examining Ohio’s merger statute, reasoned that “The vesting of the license in the surviving entity could not occur without being transferred by the old entity . . . .[T]he transfer was a result of their act of merging.” This reasoning suggests that a different result might ensue in the case of an RTM where there is no vesting of the contract in a different entity.

The Delaware Code includes “vesting” language similar to that in the MBCA, but until now, Delaware courts have produced ambiguous precedent on forward triangular mergers and have not directly addressed whether RTMs result in assignments by operation of law.

‘Meso Scale Diagnostics’

In Meso Scale Diagnostics, plaintiff Meso Scale Diagnostics (Meso) claimed that a 2007 RTM of BioVeris, a public company, into a subsidiary of defendant Roche Diagnostics (Roche), constituted an assignment by operation of law. In 1993, Roche obtained a limited license to use specialty diagnostic technology from the then-patent holder, IGEN International, Inc. (IGEN). Roche then entered into a joint venture with defendant Meso to develop and promote the technology. Following a federal court verdict that Roche had violated the limited license, IGEN terminated the license. In an effort to reacquire its rights to use the technology in 2003, Roche entered into a second license with BioVeris, a
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If Meso is followed by courts in other jurisdictions, the uncertainty as to whether RTM’s violate restrictions on assignment may be significantly diminished. In this regard, practitioners should note that when interpreting an assignment restriction in a lease, a court will likely apply the law of the state specified in the contract, not the governing law under the merger agreement. In the case of most leases, this will be the law of the state where the real estate is located. Accordingly, Meso may not control outside of Delaware. However, where the law of a jurisdiction is unclear or undeveloped, there is a strong possibility that the courts will take Meso into account given the prominence of Delaware jurisprudence in the law of business entities.

In addition, there is substantial existing case law across several jurisdictions which construes non-assignment clauses in leases as restraints on alienation which are to be narrowly construed. The Meso case and some of the other cases cited involved intellectual property rights. The disfavor with which courts view restraints on alienation of interests in real estate may, in states that recognize “the mere change in ownership of a business entity does not result in a transfer by operation of law, reasoning that “[b]oth stock acquisitions and reverse triangular mergers involve changes in legal ownership and the law should reflect parallel results.”

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4. See, e.g., 8 Del. C. §259(a).
5. Many courts have found that an assignment “by operation of law” occurs when the target company’s liabilities change hands. See Stein, at 11; see also Daddiey Realty & Inv. Co. v. St. Louis Nat’l Baseball Club, 238 S.W.2d 321, 325 (Mo. 1951). Case law also indicates that “assignments by operation of law” include a transfer of rights to the executor or administrator of a deceased person, to a legatee, or to a trustee in bankruptcy. See, e.g., Francis v. Ferguson, 159 N.E. 416, 417 (N.Y. 1927) (classifying a transfer in life to a legatee as a transfer in law奇异HEAD the court, in dicta, makes it fairly clear that a forward merger would constitute a transfer by operation of law, reasoning that “the separate existence of all the constituent corporations…except the [entity] into which the other or others of such constituent corporations have been merged” ends and only the merged entity remains. The court interpreted this to mean that an assignment by operation of law only affects the non-surviving corporation’s rights and obligations. Therefore, the court concluded, an RTM is generally not an assignment by operation of law because the surviving corporation experiences only a change in ownership, not a transfer of rights. Using this reasoning, the court distinguished Meso from contrary Delaware case law on the basis that they involved forward triangular mergers where the target company did not survive. It should be noted that the court, in dicta, makes it fairly clear that a forward merger would constitute a transfer by operation of law.

The court also pointed to legal commentary suggesting that RTMs do not result in assignments by operation of law as to the surviving entity, reasoning that such an interpretation was consistent with the reasonable expectations of the parties and inferring that the parties would have relied on this body of legal commentary in determining expectations. The court also noted, as the Chancery court had recognized in prior decisions, that “the only practical effect of the [reverse triangular] merger is the conversion of the property interest of the shareholders of the target corporation.” Finally, the court rejected the policy-based approach under which courts consider whether the non-consenting party was harmed by the transfer. Meso had suggested that the court follow a leading California precedent involving an RTM, SQL Solutions, which had adopted the policy-based approach. The court argued that this approach was inconsistent with Delaware jurisprudence, which provides that a mere change in ownership of a business entity does not result in a transfer by operation of law, reasoning that “[b]oth stock acquisitions and reverse triangular mergers involve changes in legal ownership and the law should reflect parallel results.”

1. See, e.g., 8 Del. C. §259(a). Two significant problems can arise. First, the court may feel compelled to follow “leading” California precedent involving an RTM, with BioVeris as the surviving entity.
2. In 2007, wishing to expand its technology to certain specified fields. To effectuate the transaction, the parties entered into a global license agreement. After the license, Roche acquired BioVeris by RTM, with BioVeris as the surviving entity.
7. See id. at 65–74.
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9. See LEXIS 26 (2002); Stein, at 11; see also Daddiey Realty & Inv. Co. v. St. Louis Nat’l Baseball Club, 238 S.W.2d 321, 325 (Mo. 1951). Case law also indicates that “assignments by operation of law” include a transfer of rights to the executor or administrator of a deceased person, to a legatee, or to a trustee in bankruptcy. See, e.g., Francis v. Ferguson, 159 N.E. 416, 417 (N.Y. 1927) (classifying a transfer in life to a legatee as a transfer in law

11. See id. at 65–74.
13. See, e.g., 8 Del. C. §259(a). The SQL Solutions case, however, provides no further rationale shall be vested in the corporation surviving or resulting from such merger or consolidation.
14. See, e.g., 8 Del. C. §259(a). Many courts have found that an assignment “by operation of law because the consenting party had not been adversely harmed by the merger); Heit v. Tenneco, Inc. 319 F. Supp. 884 (D. Del. 1970) (finding that when a merger becomes effective, all assets of the merged corporations pass by operation of law to the surviving company.
16. See id. at 65–74.
17. See id. at 65–74.
18. See id. at 65–74.
23. Friedman & Randolph, Jr., §7-3.3-v. 6. Shannon D. Kung, The Reverse Triangular Merger Loophole and What they Mean in the Real World,” 44 REAL PROP.

24. See id. at 65–74.
25. See id. at 65–74.
26. See id. at 65–74.
27. See id. at 65–74.
28. See id. at 65–74.
29. See id. at 65–74.
30. See id. at 65–74.