

### TRANSACTIONAL REAL ESTATE

# Reverse Triangular Mergers and Non-Assignment Clauses



By  
**Peter E.  
Fisch**



And  
**Mitchell L.  
Berg**

From a real estate practitioner's perspective, perhaps the most important issue that arises in connection with a corporate transaction (whether structured as an asset sale, merger or stock sale) is the question of whether consent to the transaction is required under the leases of the target entity.<sup>1</sup> While M&A lawyers have long relied on the reverse triangular merger (RTM) structure—where a subsidiary of the acquirer merges into the target, whose identity remains unchanged despite a change in its ownership—to avoid violating prohibitions on assignment contained in the target's agreements, case law has not always been clear on whether such mergers constitute transfers of the target's contracts "by operation of law."<sup>2</sup> A recent case from the Delaware Court of Chancery, however, suggests that RTMs may not violate prohibitions on lease assignments—even prohibitions that specifically restrict assignments by operation of law—that do not include express restrictions on changes of control.<sup>3</sup>

#### 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.<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup> 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.<sup>7</sup> 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.<sup>8</sup> 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]."<sup>9</sup>

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.<sup>10</sup> 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."<sup>11</sup> 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,<sup>12</sup> but until now, Delaware courts have produced ambiguous precedent on forward triangular mergers<sup>13</sup> 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

PETER E. FISCH and MITCHELL L. BERG are partners at Paul, Weiss, Rifkind, Wharton & Garrison. DANIELLE A. ASH, an associate at the firm, assisted in the preparation of this article.

newly formed public company to which IGEN had transferred all of its intellectual property. The license limited Roche's use of the technology to certain specified fields. To effectuate the transaction, the parties entered into a global consent agreement with Meso, which prohibited all parties from assigning the license "by operation of law or otherwise" without the consent of all other parties.<sup>14</sup> In 2007, wishing to expand its rights to use the technology beyond the scope of the 2003 license, Roche acquired BioVeris by RTM, with BioVeris as the surviving entity.<sup>15</sup>

Meso claimed that the merger violated the non-assignment clause in the global consent. Roche countered that the RTM was no different than a stock transfer because the licensing rights remained with BioVeris both before and after the merger. The court found this argument persuasive, reasoning that Roche's interpretation was supported by Delaware's merger statute and was distinguishable from related Delaware precedent on forward mergers.

First, the court examined Delaware's merger statute, which begins by defining when a merger becomes effective—that is, when "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.<sup>16</sup> The court interpreted this to mean that an assignment by operation of law only affects the non-surviving corporation's rights and obligations.<sup>17</sup> 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.<sup>18</sup> 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."<sup>19</sup>

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.<sup>20</sup> 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."<sup>21</sup>

If Meso's followed by courts in other jurisdictions, the uncertainty as to whether RTM'S violate restrictions on assignment may be significantly diminished.

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.<sup>22</sup> 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.<sup>23</sup> 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 have not addressed the treatment of RTMs under non-assignment clauses, increase the likelihood that the Meso holding will be followed.



1. Peter E. Fisch & Mitchell L. Berg, "M&A Lease Issues: Potential Problems for Multiple Location Businesses," NYLJ (Dec. 29, 2004); Joshua Stein, "Assignment and Subletting Restrictions in Leases and What they Mean in the Real World," 44 REAL PROP. TRUSTS & ESTATES L.J. 2, 2-3 (2009).

2. Milton R. Friedman & Patrick A. Randolph, Jr., FRIEDMAN

ON LEASES §7:3-3[E][2] AT 7-31 (5th ed. 2004), Supplement November 2013 ("The effect of a non-assignment clause on a merger...of a corporate tenant is the subject of meager authority."); Stein, at 13.

3. See *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, C.A. No. 5589-VCP, 62 A.3d 62 (Del. Ch. 2013).

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 *Dodier 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 of an estate of a deceased person, to a legatee, or to a trustee or receiver in bankruptcy. See, e.g., *Francis v. Ferguson*, 159 N.E. 416, 417 (N.Y. 1927) (classifying a transfer of rights to an executor of an estate); *Burns v. McGraw*, 171 P.2d 148, 152 (Cal. Dist. Ct. App. 1946) (classifying a transfer of rights to a legatee); *Standard Operations, Inc. v. Montague*, 758 S.W.2d 442, 444 (Mo. 1988) (classifying a transfer of rights to a trustee in bankruptcy).

6. Shannon D. Kung, *The Reverse Triangular Merger Loophole and Enforcing Anti-Assignment Clauses*, Regarding 103 NW. U.L. REV. 1037, 1040-41 (2009).

7. See id., at 1049-55.

8. See, e.g., *Trubowitch v. Riverbank Canning Co.*, 30 Cal. 2d 335 (1947); *Segal v. Greater Valley Terminal Corp.*, 199 A.2d 48 (N.J. Super Ct. App. Div. 1964); *Standard Operations Inc. v. Montague*, 758 S.W.2d 442 (Mo. 1988).

9. 30 Cal. 2d 335, at 345.

10. See, e.g., *PPG Industries, Inc. v. Guardian Industries Corp.*, 597 F.2d 1090 (6th Cir. 1979) (interpreting Ohio's merger statute in the context of a forward merger); *Star Cellular Telephone Co., Inc. v. Baton Rouge CGSA, Inc.*, 1993 Del. Ch. LEXIS 158 (Del. Ch., 1993); *Tenneco Automotive, Inc. v. El Paso Corp.*, 2002 Del. Ch. LEXIS 26 (2002); *Cincom Sys. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 2009) (upholding and clarifying PPG Industries).

11. 581 F.3d 431, at 438.

12. 8 Del. C. §259(a) ("the rights, privileges, powers and franchises of each of said corporations, and all property, real, personal and mixed, and all debts due to any of said constituent corporations on whatever account, as well for stock subscriptions as all other things in action or belonging to each of such corporations shall be vested in the corporation surviving or resulting from such merger or consolidation").

13. See, e.g., 1993 Del. Ch. LEXIS 158; 2002 Del. Ch. LEXIS 26 (finding that a forward triangular merger did not result in a transfer 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).

14. *Meso*, 62 A.3d 62 at 76.

15. See id. at 65-74.

16. 8 Del. C. §259(a).

17. *Meso*, at 82.

18. Id. at 86.

19. Id. at 83 (citing *Wells Fargo & Co. v. First Interstate Bancorp.* 1996 Del. Ch. LEXIS 3, at \*7 (Del. Ch. Jan 18, 1996)).

20. *Meso*, 62 A.3d 62 at 81-88. See also *SQL Solutions, Inc. v. Oracle Corp.*, 264 A.2d 526 (N.D. Cal. Dec. 18, 1991). In *SQL*, the Northern District of California found that a software technology license with a broad prohibition on assignments was violated by an RTM of the defendant, relying on federal copyright law. The Meso court declined to apply *SQL*'s reasoning and criticized the decision. "The *SQL* Solutions case, however, provides no further explanation for its apparent holding that any change in ownership, including a reverse triangular merger, is an assignment by operation of law. Both stock acquisitions and reverse triangular mergers involve changes in legal ownership, and the law should reflect parallel results." *Meso*, at 88.

21. Id. at 88.

22. See, e.g., *Freeman Mgmt. Corp. v. Shurgard Storage Ctrs., Inc.*, 2007 U.S. Dist. LEXIS 37735, \*9 (Mid. Dist. Tn. 2007); *SQL Solutions*, at \*8 (applying California law because the license at issue specified that it be governed by California law, even though the merged entity was incorporated and domiciled in Massachusetts).

23. Friedman & Randolph, Jr., §7:3-3. v