

## THE REVERSE TRIANGULAR MERGER LOOPHOLE AND ENFORCING ANTI-ASSIGNMENT CLAUSES

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### INTRODUCTION

By almost any yardstick, 2007 was a record-setting year for merger and acquisition (M&A) deal volume.<sup>1</sup> In 2007, M&A activity levels in the United States hit a record \$1.57 trillion and worldwide deals totaled a staggering \$4.5 trillion, a 5.5% and 24% increase, respectively, over the previ-

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<sup>1</sup> Matthew Karnitschnig, *For Deal Makers, Tale of Two Halves*, WALL ST. J., Jan. 2, 2008, at R10.

ous records set in 2006.<sup>2</sup> Not since 2000, when stock prices fueled an intense burst of accelerated M&A activity, has the global M&A market reached such phenomenal highs.<sup>3</sup> The boom of M&A activity has been driven by shifting consumer consumption habits, increasing investment from cash-rich private equity firms, and the convergence of media, communications, and technology industries.<sup>4</sup> In light of the skyrocketing M&A deal volume in the United States, corporate practitioners have focused their attention on strategically minimizing transaction risks while maximizing sustainable value.<sup>5</sup>

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<sup>2</sup> See *id.* (explaining that in 2007, the number of M&A deals totaled 42,364, whereas in 2006, the number of M&A deals totaled 38,602); Alexander Wessendorff, *Global M&A Record 2007 Amounted to \$4.5 Trillion and 24 Percent Above 2006*, CNNMONEY.COM, Jan. 30, 2008, <http://money.cnn.com/news/newsfeeds/articles/newstex/AFX-0013-22005075.htm>; see also *M&A Deals Hit Record \$1.57 Trillion in 2007*, Dealbook, Dec. 21, 2007, <http://dealbook.blogs.nytimes.com/2007/12/21/ma-deals-hit-record-157-trillion-in-2007/>; Grace Wong, *Deals, Deals—and More Deals*, CNNMONEY.COM, Apr. 2, 2007, [http://money.cnn.com/2007/04/02/markets/deal\\_activity/index.htm](http://money.cnn.com/2007/04/02/markets/deal_activity/index.htm). In the United States, M&A deal value totaled \$886.2 billion in 2004, \$1.1 trillion in 2005, and \$1.6 trillion in 2006. Roy Harris, *The Year of Living Strategically*, CFO MAGAZINE, Jan. 10, 2007, at 55; Walter Updegrave, *Make Money in 2008: The Outlook*, CNN.MONEY.COM, Nov. 6, 2007, [http://money.cnn.com/2007/11/01/pf/2008\\_outlook\\_economy/index.htm](http://money.cnn.com/2007/11/01/pf/2008_outlook_economy/index.htm).

<sup>3</sup> See Tim Reason, *A High-Water Mark?*, CFO MAGAZINE, Jan. 1, 2006, at 23. In the third quarter of 2007, ninety venture-backed companies announced more than \$10.5 billion in M&A transactions, a 31% increase over last year's third-quarter figure and the highest quarterly amount since 2000. Furthermore, in 2007, the domestic M&A market achieved market capitalization rates of over 15%, thereby eclipsing the robust M&A market capitalization activity seen during 2006. As a result, 2007 was a banner year for M&A deals and was the largest year for venture-backed liquidity—in terms of both initial public offerings and M&As—in the United States since the dot-com boom. See *U.S. M&A Activity Jumps to \$10.5B in Q3*, SACRAMENTO BUS. J., Oct. 1, 2007, available at <http://www.bizjournals.com/sacramento/stories/2007/10/01/daily7.html>.

<sup>4</sup> See Ellen Rosen, *How Deal-Making Lawyers Keep Score*, N.Y. TIMES, Oct. 19, 2007, at C3; Press Release, PricewaterhouseCoopers LLP, U.S. M&A Insights—Entertainment & Media: Analysis and Trends in U.S. M&A Activity (2008), available at [http://www.pwc.com/extweb/pwcpublishations.nsf/docid/35F7F2E22E680573852573F600671E94/\\$File/pwc\\_em\\_ma.pdf](http://www.pwc.com/extweb/pwcpublishations.nsf/docid/35F7F2E22E680573852573F600671E94/$File/pwc_em_ma.pdf); Press Release, PricewaterhouseCoopers LLP, PwC's M&A Update (July 19, 2007), available at <http://cfodirect.pwc.com/CFODirectWeb/Controller.jpf.jsessionid=J1VDrRrXJVKG4Rvy4fg9KWp7rvlfnB0yJhLJpvfQ1hLPyZv6Z8d6!2119814881?ContentCode=FSAE-74RL5L&ContentType=Content> (concluding that United States M&A activity level will accelerate through 2007 and will be fueled by public-to-private deals and cross-border deals across the United States, European and Asian markets). See generally Matt Krantz, *Let's Make a Deal: M&A Activity on Track to Hit Record this Year*, USA TODAY, Dec. 5, 2006, at D2 (citing the telecommunications, finance, and technology industries as the top industries for M&A deal activity). The top five industries by M&A dollar volume are the telecommunications industry (\$193.5 billion), real estate and property industry (\$156.3 billion), finance industry (\$150.7 billion), health care industry (\$128.4 billion), and technology industry (\$109.8 billion). With the technology and telecommunication industries "roar[ing] back into the forefront of large investors' attention," these industries have become "prime targets" for M&A deals. *Id.*

<sup>5</sup> Heidi Moore, *M&A Boom May Last Until 2010*, MIDMARKETPLACE.COM, Oct. 30, 2007, <http://www.midmarketplace.com/about/news/MA%20Boom>. See generally Sarah Johnson, *M&A Surge to Continue in 2007*, CFO.COM, Jan. 10, 2007, <http://www.cfo.com/article.cfm/8514186?f=search> (although nearly half of the M&A dealmakers surveyed by ACG and Thomson Financial predict that the pace of M&A activity will increase in 2007, dealmakers are also wary that interest rates and transaction costs may impede M&A growth in 2007.). For purposes of this Comment, the scope of discussion is

The fundamental difficulty<sup>6</sup> that all M&A deals face, particularly at the due diligence stage, arises from general principles of contract law, which favors free assignability of contractual rights and obligations.<sup>7</sup> In essence, parties are typically permitted to freely transfer contractual rights without obtaining permission from other contracted parties.<sup>8</sup> However, many business contracts contain a clause (an “anti-assignment clause”) prohibiting free transfer of contractual rights and property without consent from all contracting parties; these clauses are often used in the context of merger or acquisition agreements.<sup>9</sup> The anti-assignment clause serves two primary purposes: (1) it enables contracting parties to protect their contractual interests;<sup>10</sup> and (2) it provides the contract’s nonmerging party with a way to prevent a future acquiring entity from becoming a party to the contract.<sup>11</sup> As a general proposition, anti-assignment clauses are enforceable and effectively prevent the assignment of contractual rights without obtaining the party’s consent. Nevertheless, in the context of a merger, the anti-assignment clause does not always prevent the transfer of contractual rights.<sup>12</sup> Ambiguity in the transfer or consent requirements of an anti-assignment clause creates controversial questions about whether a corporate merger would violate the contract’s anti-assignment provision.<sup>13</sup> Such con-

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generally limited to events that occurred prior to the credit market and mortgage-related crises of late 2007 and 2008.

<sup>6</sup> Business combination transactions generate many diverse and complex issues ranging from corporate, antitrust, tax, securities, and accounting considerations to successor liabilities, appraisal rights, and management and employee retention issues. For purposes of this Comment’s narrow focus on anti-assignment clauses, the details of the aforementioned factors are not explored in this Comment.

<sup>7</sup> See Jessica L. Braeger, *Antiassignment Clauses, Mergers, and the Myth about Federal Preemption of Application of State Contract Law to Patent License Agreements*, 50 DRAKE L. REV. 639, 641 (2002).

<sup>8</sup> See Sung Yang, *Considerations for the Patent Holder: The Transfer of Patent Licenses in the Context of a Merger*, 42 IDEA 515, 521 (2002) (public policy and courts disfavor restraints on alienation of property); see generally David W. Larue, *A Case for Neutrality in the Design and Implementation of the Merger and Acquisitions Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations*, 43 TAX L. REV. 85, 88–91 (1987) (one of the many benefits a purchasing company may derive from an M&A transaction is the ability to acquire another company’s preexisting contracts, rights (e.g., licenses, patents, permits), and assets by operation of law, which further supports the doctrine of free alienability).

<sup>9</sup> Contracting parties can carve out an exception to the applicability to the free assignability default rule by expressly prohibiting assignment by operation of law, change of control, or merger—for example: Party A shall not assign, sell, mortgage, pledge, or in any manner transfer the contract or any interest herein whether voluntary or involuntary or by operation of law without the prior written consent of Party B. See Peter Macaulay, Note, *The Effects of Mergers on Anti-Assignment Provision in Contracts: A Case Note on TXO Production Co. v. M.D. Mark*, 53 BAYLOR L. REV. 489, 489–90 (2001).

<sup>10</sup> Jon Perry & Victoria Lee, *The Hidden Traps in Buying Targets with Technology Licenses*, 36 MERGERS & ACQUISITIONS 29, 30–31 (2001).

<sup>11</sup> *Id.* at 30.

<sup>12</sup> See Macaulay, *supra* note 9, at 490.

<sup>13</sup> See *id.*

tractual complications may lead to irreconcilable differences that can frustrate or completely destroy an M&A deal.<sup>14</sup>

The reverse triangular merger structure has emerged as a popular M&A vehicle<sup>15</sup> best used to circumvent the aforementioned contractual liabilities.<sup>16</sup> In a reverse triangular merger, an acquiring entity forms a subsidiary corporation, and the newly created subsidiary merges with the target corporation.<sup>17</sup> The target company survives the merger and continues to own its assets, but the acquiring entity holds all of the target company's stock and serves as the target company's sole shareholder.<sup>18</sup> Because the target company survives the merger and is still the same "original party" to its preexisting contracts,<sup>19</sup> the reverse triangular merger process "purport-

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<sup>14</sup> Stephen E. Gillette & Daniel R. Mitz, *How to Secure Licenses You Pay For*, DEALMAKER'S J., June 2005, at 1. "In acquisitions where agreements with anti-assignment clauses are key assets, this lack of clarity can be an unpleasant due diligence surprise for both the acquirer and the target." David Shine, *Applicability of Anti-Assignment Clauses in Reverse Triangular Mergers*, 11 M&A LAW. 8, 8-9 (2007).

<sup>15</sup> See JOSEPH B. DARBY III, PRACTICAL GUIDE TO MERGERS, ACQUISITIONS AND BUSINESS SALES 192 (2006); Theodore F. di Stefano, *Reverse Mergers: They're Back!*, E-COMMERCE TIMES, Jan. 1, 2007, <http://www.ectnews.com/story/54999.html>. Reverse triangular mergers are on the rise in the United States. Approximately 222 U.S. companies listed as public companies in 2007 did so through reverse triangular merger transactions rather than through the traditional IPO process. See Ralph Amato, *Reverse Shell Mergers Then and Now: Breaking Records, Gaining Steam*, E-COMMERCE TIMES, Feb. 20, 2008, <http://www.ecommercetimes.com/story/61871.html>. Reverse triangular mergers were expected to increase in 2008, especially since the Securities and Exchange Commission announced that they accept reverse triangular mergers as a viable way for companies to go public. *Id.*

<sup>16</sup> The reverse triangular merger structure has "long been used for public company acquisitions . . . [and] has also become the preferred structure for private company acquisitions since, unlike a stock purchase, it does not require the participation of all individual stockholders. And in the private company context, the applicability of anti-assignment clauses is particularly relevant since an acquirer of a private company may have the ability to require that the closing be conditioned on the receipt of necessary third-party consents." Shine, *supra* note 14, at 8; see also Art Beroff & Dwayne Moyers, *Put It in Reverse—Benefits of Reverse Mergers*, ENTREPRENEUR, June 1999, at 8; Avital Louria Hahn, *Reverse Mergers on the Rise*, INV. DEALERS DIG., May 29, 2006 (explaining that the recent economic environment has forced many enterprises to look to reverse triangular mergers for methods of "going public" other than through an IPO). The reverse triangular merger process can be accomplished in as few as two weeks for as little as \$50,000-\$150,000. See Beroff & Moyers, *supra*, at 8. Reverse triangular mergers are quick to market because the structure (1) circumvents the need for contractual consent from third parties; (2) fulfills public company requirements from state and federal regulators; and (3) does not engage an underwriter or investors on a roadshow to go public. See generally JAMES C. FREUND, ANATOMY OF A MERGER 79 (1975); *The Rise of "Reverse Mergers,"* M&A ADVISOR, Sept. 2003, at 1-2, available at [http://www.nixonpeabody.com/linked\\_media/publications/MAAdvisor\\_09002003.pdf](http://www.nixonpeabody.com/linked_media/publications/MAAdvisor_09002003.pdf).

<sup>17</sup> See Elaine D. Ziff, *The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 BUS. LAW. 767, 787-89 (2002); see also *supra* note 9 and accompanying text.

<sup>18</sup> See Michael Amm, *Canada's Booming M&A Market: Trends and Strategic Considerations for Cross-Border Transactions*, METROPOLITAN CORP. COUNS., Dec. 2006, at 11; Securities Law Institute, *Mergers & Acquisitions*, <http://www.securitieslawinstitute.com/m&a.html#reverse%20triangular%20merger> (last visited Apr. 14, 2009).

<sup>19</sup> Ziff, *supra* note 17, at 787. For most practical purposes, the reverse triangular merger is similar to the sale of the target company's stock. In a stock acquisition, the "corporate structure of the seller [or target company] continues intact and the conduct of the [target company's] business is not affected by the transfer of stock ownership." See CHARLES A. SCHARF ET AL., ACQUISITIONS, MERGERS, SALES,

edly obviates the issue of whether the merger constitutes a transfer of the target company's assets in violation of existing contracts."<sup>20</sup> In other words, reverse triangular mergers are believed to successfully avoid anti-assignment clause issues.

However, the contractual benefits ascribed to the reverse triangular merger process<sup>21</sup> are ephemeral at best and are still fraught with difficulties.<sup>22</sup> Caselaw indicates that reverse triangular mergers are not a clear-cut solution to overcoming anti-assignment clause issues.<sup>23</sup> Despite the complex issues that anti-assignability clauses present in reverse triangular mergers, neither legislatures nor courts have adequately addressed the issue.<sup>24</sup> Coupling the dramatic dollar impact of cancelled M&A deals with the inherent risks associated with assignability issues, it is important to definitively establish the applicability of anti-assignment clauses in reverse triangular mergers.

This Comment argues that a reverse triangular merger should trigger a contract's anti-assignment clause and result in an impermissible assignment of contractual rights unless the contract involves an intellectual property license or the contract explicitly prohibits assignment by reverse triangular merger. Part I of this Comment provides an introductory discussion of anti-assignment clauses in the context of reverse triangular mergers. It also synthesizes the history of triangular mergers and examines when a reverse triangular merger may violate contractual anti-assignment clauses. By focusing on the reverse triangular merger's fundamental defects with respect to assignability issues, this Part also emphasizes the importance of anticipating assignment limitations in evaluating alternative approaches to

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BUYOUTS, AND TAKEOVERS: A HANDBOOK WITH FORMS 9–10 (1985). Since contracts, leases, and franchises are not affected, "no problems arise with respect to their assignability of lease or other contracts requiring the consents of third parties to their assignment." *Id.*

<sup>20</sup> *Id.* at 787; see also PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1094 (6th Cir. 1979).

<sup>21</sup> See *supra* note 16 and accompanying text.

<sup>22</sup> Even though reverse triangular mergers are gaining credibility in the mainstream markets, the process still has its share of critics as well as potential pitfalls. There are many who maintain that the process is too lax, allowing the formation of companies that would have never passed muster with an underwriter or investors. Also, because the transaction is structured as a merger, the acquiring company runs the risk of succeeding to unknown contractual liabilities based on prior activities of the target company. Some protection is often obtained through appropriate representations, warranties, and due diligence, but the risks inherent in reverse triangular mergers cannot be completely eliminated. See *supra* note 18 and accompanying text.

<sup>23</sup> See *infra* Part III.

<sup>24</sup> See Joshua G. Graubart, Comment, *Unintended Consequences: State Merger Statutes and Nonassignable Licenses*, 2003 DUKE L. & TECH. REV. 25 (arguing that state corporate merger statutes, legislatures, and courts view the treatment of anti-assignment clauses in mergers as "particularly confusing," "inconsistent[,] and "disturbing"); see generally James Molloy & Michael Fung, *Full Speed Reverse! The Reverse Merger: Backing into Wall Street's Worst Idea*, RWS MIRUS TECH. GROUP RES. (2007) (explaining that the reverse triangular merger process is commonly misunderstood and produces few benefits for shareholders).

structuring M&A transactions. Part II analyzes judicially developed limitations and reactions to reverse merger transactions. This Part also provides a technical analysis of the leading reverse triangular merger case, *SQL Solutions v. Oracle*.<sup>25</sup> That case may prove to be a seminal one, shaping the future interpretation of reverse triangular mergers. In *SQL Solutions*, the parties to a reverse triangular merger failed to obtain written consent from the nonmerging party and transferred a licensing agreement to the nonmerging party's competitor upon merger.<sup>26</sup> The District Court found that the merger resulted in nonpermissible transfer of the licensing agreement despite the fact that the surviving entity was the original owner of the license.<sup>27</sup> Part III argues for the application of anti-assignment clauses and thus for requiring consent when assigning contractual rights in reverse triangular mergers. This Comment concludes by suggesting due diligence processes by which the current system could be made more congruent with generally accepted tenets of contract law and the economic realities attending corporate M&A transactions.

## I. BACKGROUND

The assignment of contractual rights in the context of M&A transactions ranks as one of the most complex areas of contemporary corporate law. The necessity of assigning contracts from a target company to an acquiring entity is a critical factor in every M&A deal because it impacts timing, costs, and the parties' ability to consummate a successful transaction.<sup>28</sup> Since 1971, reverse triangular mergers have been a hotly contested area of regulation<sup>29</sup> and were recently touted as the best M&A structure for avoiding third-party contractual assignment limitations.<sup>30</sup> Section A discusses the role of anti-assignment clauses and legal complications that result from violating their provisions. Section B explains the mechanics of triangular mergers based on whether the transaction takes the form of a forward or reverse triangular merger. The section also analyzes the sometimes asymmetric treatment of anti-assignment clauses by triangular mergers and suggests that reverse triangular mergers are not the ideal solution to anti-assignment clause problems.

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<sup>25</sup> C-91-1079 MHP, 1991 U.S. Dist. LEXIS 21097, at \*2-5 (N.D. Cal. Dec. 18, 1991).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at \*12, \*15.

<sup>28</sup> See Graubart, *supra* note 24, at 27-43.

<sup>29</sup> *Id.*

<sup>30</sup> See *supra* note 16 and accompanying text.

### A. The Role of Anti-Assignment Clauses

The common law generally favors free assignability of contractual rights,<sup>31</sup> thereby affording contractual parties the freedom to contract and the ability to structure their relationships as they see fit.<sup>32</sup> The assignment of contract rights is permitted in the absence of a contractual restriction to the contrary.<sup>33</sup> However, exceptions to the default rule of free assignability exist when parties to a contract use an anti-assignment clause to expressly prohibit assignment, transfer, or use of contractual rights and property.<sup>34</sup> Many contracts that corporations enter into contain anti-assignment clauses such as the following: this contract shall not be assigned or transferred by party X without first obtaining the consent of party B.<sup>35</sup> In the context of a merger or acquisition, the anti-assignment clause requires parties to make a full inventory of all contracts and information licenses,<sup>36</sup> review license terms to ascertain transfer and use restrictions, make contractual right inquiries, and obtain third-party consents as necessary before closing the M&A deal.<sup>37</sup>

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<sup>31</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981) (“A contractual right can be assigned.”).

<sup>32</sup> JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 1.3 (4th ed. 1998).

<sup>33</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 322 (1981); see also *Riley v. Hewlett-Packard Co.*, 36 Fed. App’x 194, 195 (6th Cir. 2002); E. ALLAN FARNSWORTH, *FARNSWORTH ON CONTRACTS* § 12, at 61 (2d ed. 1998) (“[T]oday most contract rights are freely transferable.”); JOHN EDWARD MURRAY, JR., *MURRAY ON CONTRACTS* § 138, at 799 (3d ed. 1990) (“[T]he modern view is that contract rights should be freely assignable.”). “The principle of free alienability of property, which has been traditionally associated with real property, has carried over to intangible property as well. It is thought to be important to commerce that rights to payment be freely assignable; the modern credit economy would have a difficult time functioning if rights to payment could not be assigned. A seller of goods would be reluctant to sell goods on credit if the seller could not discount the right to be paid to a financing institution.” Bryan D. Hull, *Harmonization of Rules Governing Assignments of Right to Payment*, 54 SMU L. REV. 473, 479 (2001).

<sup>34</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 317 (1981) (“A contractual right can be assigned unless . . . assignment is validly precluded by contract.”); FARNSWORTH, *supra* note 33, at 82 (most courts have upheld terms prohibiting assignments as precluding effective assignments).

<sup>35</sup> Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law*, 73 B.U. L. REV. 389, 391–93 (1993). Contract law represents the freedom to interact with others, free from government coercion. The freedom is limited by the power of others to withhold their consent to interact, and by the power of parties to limit their own freedom through agreements with others. The values underlying property law support the right to control the use of one’s property independently of the consent of others. As compared to contract rights, property rights are also supported by stronger remedies. *Id.*

<sup>36</sup> See Catherine H. Stockwell, *A Primer on Due Diligence Reviews of Intellectual Property Assets*, in *HANDLING MERGERS & ACQUISITIONS IN A HIGH-TECH AND EMERGING GROWTH ENVIRONMENT*, PLI CORP. L. & PRAC. COURSE HANDBOOK SERIES 303 (1997).

<sup>37</sup> See Corinne Ball & John K. Kane, *A Practical Guide to Distress M&A*, 6 M&A LAW. 1, 4–6, 10 (Jan.–Feb. 2003).

The costs and risks associated with due diligence processes are not trivial.<sup>38</sup> The ultimate risk in this process is that, despite good faith and substantial effort, an anti-assignment clause requiring consent is not obtained during due diligence proceedings.<sup>39</sup> Completion of the M&A transaction followed by the use of an overlooked contractual right can: (1) make the acquiring entity liable in damages,<sup>40</sup> (2) make the contract's continued use subject to injunction,<sup>41</sup> and (3) make the entire M&A enterprise hostage to terms offered for quick settlement of the third party's claim.<sup>42</sup> The ability to acquire a contract and the frequent need to obtain third-party consent arises in customer contracts, key technology licensing agreements, and other revenue-producing agreements.<sup>43</sup> As a result, both the ability to acquire a contract—whether expressly or by operation of law—and the unavoidable need to obtain consent from contractual third parties are important factors to consider both prior to and during an acquisition by all practitioners.<sup>44</sup>

### B. *Triangular Mergers and Anti-Assignment Clauses*

A target company's existing contract with an anti-assignment clause can be transferred to the surviving entity without consent upon merger depending on the examination of several factors: (1) the structure and nature of the M&A transaction; (2) the state merger statute and caselaw; (3) the exact phrasing of the anti-assignment clause; (4) the types of contract rights involved; (5) any equitable considerations that may impose adverse conse-

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<sup>38</sup> Due diligence is the process of identifying and confirming or disconfirming the business reasons for the proposed capital transaction. Due diligence findings are summarized in due diligence schedules that list all relevant contracts, assets, liabilities, equity, representations, and warranties of the target company. Generally, the management of the acquiring entity and target entity heavily depend on the due diligence schedule to determine the value of the merger and any contentious issues. See generally Martin B. Robins, *Intellectual Property and Information Technology Due Diligence in Mergers and Acquisitions: A More Substantive Approach Needed*, U. ILL. J.L. TECH. & POL'Y 321, 321–22, 328 (Fall 2008).

<sup>39</sup> See, e.g., Henry Less, *Some Practical Suggestions for the M&A Due Diligence Process*, in ADVANCED DOING DEALS: A STRATEGIC APPROACH TO COMPLETING THE TRANSACTIONS, PLI CORP. L. AND PRAC. COURSE HANDBOOK SERIES 403 (1998).

<sup>40</sup> David A. Rice, *License with Contract and Precedent: Publisher-Licensors Protection Consequences and the Rationale Offered for the Nontransferability of Licenses Under Article 2B*, 13 BERKELEY TECH. L.J. 1239, 1242–53 (1998). Serious liability exposure is created by Article 2B of the U.C.C. when a transfer of contractual rights is contractually prohibited pursuant to an anti-assignment clause. Subsequent to a merger, contractual assignment violations constitute infringement of the third party's contractual rights. Any further use of the contractual right may be enjoined and the third party may elect to recover statutory damages and reasonable attorney's fees. *Id.* at 1262–64.

<sup>41</sup> See Ziff, *supra* note 17, at 776. In the case of intellectual property rights, continued use without consent would constitute infringement. Infringement may be enjoined under 17 U.S.C. § 501 (2000). See Ziff, *supra* note 17, at 776.

<sup>42</sup> See *supra* note 39 and accompanying text.

<sup>43</sup> See Carole A. Quinn & R. Scott Weide, Comment, *Violation of the Erie Doctrine: Application of a Rule of Federal Common Law to Issues of Patent License Transferability*, 32 CREIGHTON L. REV. 1121, 1122–27, 1145 (1999).

<sup>44</sup> See *infra* Part IV.

quences to the nonmerging party.<sup>45</sup> The form of merger employed influences the merger outcome in terms of whether certain contractual rights are assignable.<sup>46</sup> There are two common types of mergers: a standard “forward triangular merger,” also called a “direct triangular” or “forward subsidiary” merger, and a “reverse triangular merger,” also called a “reverse subsidiary” merger.<sup>47</sup>

In a forward triangular merger,<sup>48</sup> the target company ceases to exist and is subsumed by the acquiring company or its subsidiary, which survives the merger. The acquiring entity takes over the target company’s contracts, assets and liabilities by operation of law. Essentially, the forward merger consolidates the two companies into one surviving entity. This structure may result in substantial legal problems. First, the acquiring entity automatically becomes liable for all the assets, debts, and obligations of the target company.<sup>49</sup> Second, because the acquiring entity assumes all of the target company’s contracts, the acquiring entity must obtain third-party consent when a contract it assumes from the target company contains an anti-assignment provision between the target company and the third party. The acquiring entity needs consent from the third party to overcome the

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<sup>45</sup> Frederic C. Woodward, *Assignability of Contract*, 18 HARV. L. REV. 23–35 (1904).

<sup>46</sup> See generally Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003).

<sup>47</sup> In two early Supreme Court cases, the Court held that triangular acquisitions failed to qualify as corporate reorganizations because shareholders of the target corporation did not have a continuity of interest in the target company’s assets due to the fact that they held stock of the acquiring entity rather than that of the target company. See *Helvering v. Bashford*, 302 U.S. 454 (1938); *Groman v. Comm’r*, 302 U.S. 82 (1937). These two cases established the *Groman-Bashford* doctrine, barring triangular acquisitions from qualifying as legitimate forms of corporate reorganization. See BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 12-76 to 12-77 (6th ed. 1994). In 1969, Internal Revenue Code § 368(a)(2)(D) was enacted to permit forward triangular mergers. In 1971, § 368(a)(2)(E) was enacted to permit reverse triangular mergers. *Id.* at 12-77; New York State Bar Association Tax Section, Committee on Reorganizations, Comment, *Report on Reverse Triangular Mergers and Basis-Nonrecognition Rules in Triangular Reorganizations*, 36 TAX L. REV. 395, 397–98 (1981).

<sup>48</sup> In a forward triangular merger, an acquiring entity forms a subsidiary corporation (the “subsidiary”) and the target corporation (the “target company”) merges directly with and into the newly created subsidiary. See Graubart, *supra* note 24, at 25–27. The subsidiary survives the merger and succeeds, by operation of law, to all the target company’s assets and liabilities. Tax Mgmt. (BNA) Portfolios, Structuring Corporate Acquisitions—Tax Aspects, No. 770 at A-144, A-147 (1993). The former shareholders of the target company receive the acquiring entity’s stock, or other consideration, in exchange for their target company stock. See Graubart, *supra* note 24, at 25–27.

<sup>49</sup> In a forward triangular merger, all the target company’s assets and liabilities are automatically transferred to the surviving corporation by operation of law after the merger certificate is filed with the Secretary of State of the surviving corporation’s state of incorporation. See SCHARF ET AL., *supra* note 19, at 6 (1985). Liabilities may include disclosed and latent debts and contractual liabilities such as nonassignable franchises, antitrust claims, long-term debt covenants, and other valuable contract rights that cannot be transferred without third-party approval. See *id.* at 6–7; see generally PPG Indus., Inc. v. Guardian Indus. Corp., 597 F.2d 1090, 1094 (6th Cir. 1979) (the court explicitly concluded that a merger resulted in an impermissible assignment of a nonexclusive patent license agreement).

anti-assignment provision and to effectively assign contractual rights to the acquiring entity. Consent from third parties may be particularly difficult to secure when third parties resist consenting and demand additional consideration.<sup>50</sup> Finally, the acquiring entity must obtain every shareholder's approval to effectuate the M&A transaction.<sup>51</sup>

In an effort to avoid contractual complications related to assignability issues, the reverse triangular merger has become a popular form of merger among corporate practitioners.<sup>52</sup> In a reverse triangular merger, the acquiring entity creates a subsidiary that merges with and into the target company; the target company survives and the subsidiary disappears.<sup>53</sup> The former target company's shareholders receive acquiring entity voting stock in exchange for their target company stock, and the acquiring entity becomes the sole shareholder of the target company.<sup>54</sup> Thus, in a reverse triangular merger, only the ownership of the target company changes. The target company continues to exist and continues to own its own properties and assets following the merger, and no assets are transferred or contracts assigned to the acquiring entity.<sup>55</sup> Many commentators believe that this

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<sup>50</sup> From the acquiring entity's point of view, it is very important to obtain third-party consent to assignment because the acquiring entity is liable for upholding the terms and conditions of the contract and because the acquiring entity wants to avoid the possibility that the third party would have a cause of action for a breach or infringing use of the contract by the acquiring entity. See FREUND, *supra* note 16, at 7-440; Rev. Rul. 77-428, 1977-2 C.B. Generally, the acquiring entity hopes to be able to conclude that consent is not needed so that the acquiring entity will not be forced to renegotiate aspects of the agreement or license as a quid pro quo for the other party's granting consent to the assignment. See Richardson v. La Rancherita La Jolla, Inc., 159 Cal. Rptr. 285, 287 (Cal. Ct. App. 1979).

<sup>51</sup> See 1 MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND LEVERAGED BUYOUTS* 1002-04 (1993). Generally, approval from both the acquiring company and the target company's stockholders are required to approve a forward triangular merger transaction. See SCHARF ET AL., *supra* note 19, at 7. Stockholders of both companies have the right to dissent from the transaction and be paid off in cash. *Id.* A large number of dissents may result in a substantial cash drain on the combined entity. *Id.*

<sup>52</sup> See Glen A. Kohl & Lea Anne Storum, *M&A Double Take: Why Two Mergers are Better than One*, 5 M&A LAW. 1, 2-3 (2002) (acknowledging that acquirors may use the reverse triangular merger structure to "avoid the extra consents and resulting delays" that other business combinations might entail). See generally DALE A. OESTERLE, *MERGERS AND ACQUISITIONS* 25 (2006) (triangular mergers in general have become a very popular form of merger); Robert Willens, *Flexibility of Reverse Mergers Increased by Regulations and Rulings*, 70 J. TAX'N 52 (1989). For example, in the first quarter of 2006, there were 46 reverse triangular mergers, up from 43 in the first quarter of 2005. Reverse mergers totaled \$1.31 billion in market capitalization in the first quarter of 2006. See Andrew Dolbeck, *Alternative Offerings: Going Public with Reverse Mergers & SPACs*, DEAL.COM, May 22, 2006, [http://findarticles.com/p/articles/mi\\_qa3755/is\\_200605/ai\\_n17174211](http://findarticles.com/p/articles/mi_qa3755/is_200605/ai_n17174211).

<sup>53</sup> Aden R. Pavkov, *Ghouls and Godsenders? A Critique of "Reverse Merger" Policy*, 3 BERKELEY BUS. L.J. 475, 478 (2006).

<sup>54</sup> See PETER A. HUNT, *STRUCTURING MERGERS & ACQUISITIONS: A GUIDE TO CREATING SHAREHOLDER VALUE* 227-28 (2004).

<sup>55</sup> See Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act Release No. 33-8587, Exchange Release No. 34-52038, 70 Fed. Reg. 42,234 (July 15, 2005); Use of Form S-8 and Form 8-K by Shell Companies, Securities Act Release No. 33-8407, Exchange Act Release No. 34-49566, 69 Fed. Reg. 21,650, 21,652 (Apr. 21, 2004). Upon completion of the merger, the business op-

structure legitimately avoids constraints inherent in anti-assignment clauses by eliminating the need for third-party consent to close the transaction.<sup>56</sup> As a result of these considerations, the reverse triangular merger is commonly used in acquisitions involving banks, insurance companies, public utilities, and other highly regulated industries.<sup>57</sup>

The mechanics of whether a forward triangular merger or reverse triangular merger constitutes an assignment are governed by the state of incorporation's corporate merger statutes.<sup>58</sup> Although states have taken various approaches to the problem of assignment via merger, a majority of states have either adopted or mirrored their merger statutes after the ABA Model Business Corporation Act.<sup>59</sup> Under section 11.07 of the ABA Model Business Corporation Act, "all property owned by, and every contract right possessed by, each corporation or eligible entity that merges into the survivor is vested in the survivor without reversion or impairment."<sup>60</sup> Similarly,

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erations of the target company are carried out through the public corporation with the target company changing its name and trading symbol to reflect the merger. *See supra* note 22 and accompanying text.

<sup>56</sup> *See supra* note 49, at 4–5, 359–360; *see* Howard Stock, *New IRS Regs Could Mean Smoother M&A*, MERGERS & ACQUISITIONS REP. (Oct. 22, 2001) (under Revenue Ruling 73-257, an acquiring entity that does not assume the target company's liabilities will not result in an impermissible assignment). The reverse triangular structure also protects the acquiring entity from any preexisting target liabilities, and in some cases dispenses with the need for shareholder approval first. *Id.* In fact, the reverse triangular merger plan avoids the need for approval from the acquiring company's shareholders and only needs approval from the shell subsidiary's shareholders (most likely the acquiring company's board) and the target company's shareholders and board. After the reverse triangular merger, the target company survives as a direct wholly owned subsidiary of the acquiring company, and the shell subsidiary is subsumed. The acquiring company can then allow its wholly owned subsidiary (i.e., the target company) to continue operating as before, which helps eliminate the need for corporate restructuring and avoid disruptions to its own business practices. *Id.*

<sup>57</sup> Herbert N. Beller, *Final Regulations Ease Planning for Tax-Free Reverse Subsidiary Mergers*, 64 J. TAX'N 80, 80 (1986). In addition, the existence of target corporation foreign branches or subsidiaries may warrant the use of a reverse triangular merger. *Id.*

<sup>58</sup> Graubart, *supra* note 24, at 25; *see supra* notes 54–56 and accompanying text.

<sup>59</sup> Developed and adopted by the Committee on Corporate Law of the American Bar Association, the ABA Model Business Corporation Act is a model statute that suggests a corporate law regime for state governments to adopt and use. *See* M. Thomas Arnold, *Administrative Aspects of State Corporation Law*, 28 U. RICH L. REV. 1, 3–4 (1994); Robert W. Hamilton, *The Revised Model Business Corporation Act: Comment and Observation: Reflections of a Reporter*, 63 TEX. L. REV. 1455, 1455–57 (1985). The merger provisions of many jurisdictions are patterned after the Model Business Corporation Act. *See generally* MODEL BUS. CORP. ACT § 11.07 (Supp. 1998/1999) (authorizing mergers between different corporations). Thirty-five states (e.g., Arizona, Florida, Georgia, Illinois, North Carolina, Washington, Wisconsin) have corporate laws based on the ABA Model Business Corporation Act. Other states such as New York, California, Texas, and Illinois, have corporate statutes that combine the Model Business Corporation Act with local rules. *See* Jennifer L. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315 (1987). References in this Comment to the Model Business Corporation Act are to the 1984 version of the Model Business Corporation Act as amended through 1999.

<sup>60</sup> MODEL BUS. CORP. ACT § 11.07(a)(3) (1984) (includes modifications through 1999). The official comment to the act includes the following note: "A merger is not a conveyance, transfer, or assignment . . . . It does not give rise to a claim that a contract with a party to the merger is no longer in effect

state merger statutes provide that the target company's rights and obligations under its contracts are automatically assumed by the surviving entity at closing.<sup>61</sup>

However, in contracts with anti-assignment clauses, nonmerging third parties are not obligated to uphold their contractual duties if the original party to the contract changes. For example, in a forward triangular merger, the acquiring entity replaces the original party to the contract—the target company, which ceases to exist—and becomes a new party to the target company's preexisting contracts.<sup>62</sup> This structure would violate a contractual anti-assignment clause, thereby preventing transfer of a contract without consent from the nonmerging party.<sup>63</sup> If the nonmerging party unilaterally rejects transferring its contractual rights to the acquiring entity, the success of the M&A transaction could be jeopardized.<sup>64</sup> On the other hand, because the target company survives in a reverse triangular merger, such a merger does not fall prey to the uncertainty forward triangular mergers face with respect to anti-assignment clauses.<sup>65</sup> Unfortunately, inconsistent interpretations among the states have fostered continued confusion regarding the efficacy of anti-assignment clauses when parties to a reverse triangular merger attempt to address the issue.<sup>66</sup> Even within only one jurisdiction, sparse and ambiguous rulings often result in uncertainty that is conducive to neither sound business decisions nor the ability to secure licensing of rights.<sup>67</sup> Thus, the controversial treatment of anti-assignment

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on the ground of nonassignability, unless the contract specifically provides that it does not survive a merger." MODEL BUS. CORP. ACT ANN. § 11.07 cmt. (Supp. 2002).

<sup>61</sup> See generally ARIZ. REV. STAT. ANN. § 29-373 (2008); CAL. CORP. CODE § 1107(a) (West 2007); DEL. CODE ANN. tit. 8, § 259 (2008); FLA. STAT. ANN. §§ 620.2109, 620.8919 (West 2007); 805 ILL. COMP. STAT. 180/37-30, 215/1109 (2007); MD. CORPS. & ASS'NS CODE ANN. §§ 3-115, 9A-909 (West 2007); MASS. GEN. LAWS ANN. ch. 156, § 46A (West 2007); NEV. REV. STAT. ANN. § 92A.250 (West 2007); N.Y. BUS. CORP. LAW § 906 (McKinney 2008); TEX. BUS. CORP. ACT ANN. art. 5.06 (Vernon 2007).

<sup>62</sup> See W.W. Allen, *Validity of Anti-Assignment Clause in Contract*, 37 A.L.R.2d 1251, 1253 (1954).

<sup>63</sup> The acquiring entity must obtain copies of all agreements and ensure that the target company had the right to transfer the agreements, and that the agreements allow for sublicense, sale, or transfer of contractual rights to the acquiring entity. See generally Less, *supra* note 39 (providing practical suggestions that focus on the need to identify, review, and determine the transferability of agreements in the context of mergers).

<sup>64</sup> See FREUND, *supra* note 16, at 77–138 (analyzing a wide range of considerations that may affect the success and economics of a merger transaction); GEORGE D. MCCARTHY, *ACQUISITIONS AND MERGERS* 12–14 (1963) (discussing motivation for mergers).

<sup>65</sup> Virginia Henschel, "Backdoor" Access to Patented Technology, 17 AM. BANKR. INST. J. 40, 40 (1998).

<sup>66</sup> See *infra* Part III. This acquisition structure increases the need for contract-by-contract due diligence because the anti-assignment clause creates a necessity for the transferring party to request consent from the nonmerging party, such as a vendor, landlord, technology partner, or customer. See *id.*

<sup>67</sup> Macaulay, *supra* note 9, at 496; see also Burns v. McGraw, 171 P.2d 148, 151 (Cal. 1946) (despite anti-assignment clause prohibiting assignments by operation of law, devolution of lease to the executrix did not breach the covenant against assignment); *In re Estate of David*, 714 N.Y.S.2d 175, 176

clauses in reverse triangular mergers has resulted in very contradictory guidance from courts on this basic transfer issue.

## II. CRITIQUE OF THE INCONSISTENT LEGAL TREATMENT OF ASSIGNABILITY ISSUES IN REVERSE TRIANGULAR MERGERS

The level of uncertainty surrounding the legal efficacy of anti-assignment clauses in reverse triangular agreements is further accentuated by the asymmetrical treatment of assignability issues across jurisdictions. The legal effect of a business consolidation on the contractual rights of a constituent corporation can be unclear, so different jurisdictions applying the same principle can reach surprisingly conflicting results. A review of the relevant caselaw and secondary authority reveals two lines of analyses regarding anti-assignment clauses in the reverse triangular merger context.

Section A discusses the first line of analysis: a functionalist approach that assumes that reverse triangular mergers do not violate anti-assignment clauses. Section B reviews the second line of analysis: a formalist approach, which holds that reverse triangular mergers violate anti-assignment clauses when contracts expressly demand third-party consent. Due to the paucity of reverse triangular merger cases, sections A and B instead analyze forward triangular merger cases.<sup>68</sup> Section C discusses the ambiguous application of both lines of analyses in Delaware.<sup>69</sup> Finally, section D examines the critical decision reached in *SQL Solutions v. Oracle*.<sup>70</sup> Because there is little caselaw dealing with reverse triangular mergers, *SQL Solutions* serves as the most recent and best-known case addressing the question of whether a reverse triangular merger affects an assignment of the target corporation's assets by operation of law.<sup>71</sup>

### A. *The Functionalist Approach: Preserving the Myth of Reverse Triangular Mergers*

The functionalist approach is essentially an outcome-oriented, policy-based analysis that takes into consideration the transaction and the agreement as a whole. Generally, a court utilizing the functional approach will

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(N.Y. 2000) (general anti-assignment clause did not bar transfer of a leasehold to decedent's administrator).

<sup>68</sup> For purposes of this Comment, it is presumed that courts will use existing forward triangular merger cases as guidance when analyzing reverse triangular merger cases due to the paucity of caselaw involving reverse triangular mergers.

<sup>69</sup> Delaware was selected because Delaware is well known as a corporate haven with over fifty percent of publicly traded U.S. corporations and over half of the Fortune 500 companies incorporated there due to its well-developed body of caselaw and favorable corporate formation processes. See LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 1 (2007), available at [http://corp.delaware.gov/whydelaware/whycorporations\\_web.pdf](http://corp.delaware.gov/whydelaware/whycorporations_web.pdf).

<sup>70</sup> C-91-1079 MHP, 1991 U.S. Dist. LEXIS 21097, at \*1 (N.D. Cal. Dec. 18, 1991).

<sup>71</sup> See *id.* at \*3.

assume that reverse triangular mergers do not necessarily trigger anti-assignment clauses because the target company survives and is the same legal entity as the original party to the contract.<sup>72</sup> Whether a contractual right may be assigned depends upon whether the transfer affects the interests of the party protected by the nonassignability of the contract.<sup>73</sup> As a result, a reverse triangular merger does not result in an impermissible assignment of contractual rights unless the merger imposes materially adverse consequences on the nonmerging party.<sup>74</sup>

This view is supported by the California Supreme Court's decision in *Trubowitch v. Riverbank Canning Co.*<sup>75</sup> In this case, Trubowitch entered into a contractual agreement with Pan American Food Corporation to manufacture and supply 3900 cases of retail product.<sup>76</sup> Within five months of entering the contract, Pan American Food Corporation merged with Riverbank Canning and transferred all of its assets and contracts to Riverbank Canning.<sup>77</sup> Pursuant to its contractual anti-assignment clause, Trubowitch sued Riverbank Canning for violating its licensing agreements by acquiring Pan American Food Corporation's contracts without first obtaining Trubowitch's consent.<sup>78</sup> The court applied the functionalist approach and held that the merger did not breach the anti-assignment clause because the merger did not adversely affect the parties to the contract.<sup>79</sup>

Citing strong public policy considerations weighing against restraining the alienability and assignability of contractual rights, the court explained that mergers do not necessarily result in an invalid assignment of contrac-

<sup>72</sup> See *Trubowitch v. Riverbank Canning Co.*, 182 P.2d 182, 188–89 (Cal. 1947). Under the formalistic approach, an assignment does not necessarily trigger nonassignment clauses or laws where such assignment results “merely from a change in legal form.” *Id.* at 188. Instead, whether a right may be assigned is dependent upon whether the transfer would affect the interests of the party protected by the nonassignability of the contract. *Id.*

<sup>73</sup> Courts may also examine the language of the contract and the state merger statute to determine whether an assignment by operation of law is an assignment within the meaning of the contract. *See id.*

<sup>74</sup> The default rule under the functionalist approach holds that reverse triangular mergers do not trigger anti-assignment clauses. However, if the assignment materially changes the duties of the nonmerging party, increases the nonmerging party's risk or burden, or impairs the nonmerging party's chance of obtaining return performance, then the assignment will result in materially adverse change and will be held ineffective. *See* Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. L. REV. 329, 375 (1991). A violation of the anti-assignment clause is found only if the risks of performance increase upon transfer to the surviving corporation in a statutory merger. *See* Steven E. Ballew, *The Assignment of Rights, Franchises, and Obligations of the Disappearing Corporation in a Merger*, 38 BUS. LAW. 45, 50–53 (1982).

<sup>75</sup> *Trubowitch*, 182 P.2d at 182.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 192.

<sup>79</sup> *Id.* at 188–89. In dicta, the Court explained that the prohibition against assignments “does not necessarily apply to all claims under the contract.” *Id.* at 188. Furthermore, the Court reasoned that in the absence of language to the contrary in the contract, “a provision against assignment in a contract or lease does not preclude a transfer of the rights thereunder by operation of law.” *Id.*

tual rights.<sup>80</sup> Thus, under the prevailing view of the functionalist approach, a change in corporate ownership (1) does not constitute a change in the target company's contractual responsibilities, and (2) does not harm the non-merging party because it can still obtain the same services on the same terms it bargained for from the same entity with which it bargained. Consequently, when an acquiring entity—in this case, Riverbank Canning—succeeds in the ownership of a target company's—Pan American Food Corporation—assets, the succession of ownership does not constitute a technical transfer, and therefore no breach of contract occurs.<sup>81</sup>

Moreover, Justice Traynor's opinion for the *Trubowitch* court held that the validity of assigning contract rights resulting from a change in the legal form of ownership of a business is not an impermissible assignment unless the transfer adversely affects the interests of the parties protected by the anti-assignability clause.<sup>82</sup> The court stated, "[I]f an assignment results merely from a change in the legal form of ownership of a business, its validity depends upon whether it [adversely] affects the interests of the parties protected by the nonassignability of the contract."<sup>83</sup> This result is similar to the finding in *Syenergy Methods v. Kelly Energy Systems, Inc.*<sup>84</sup> The *Syenergy Methods* case addressed whether a covenant not to sue prevents a claim of infringement by a patentee when a new corporation is formed that acquires the covenant not to sue.<sup>85</sup> As a result, the functionalist approach requires a "case-by-case" approach in which the court analyzes and interprets the specific facts of each case. Here, the court could discern "no change in the protected interests of the parties" as a result of the merger.<sup>86</sup> This "adverse effects" test finds its counterpart in the Uniform Commercial Code,<sup>87</sup> which prohibits the transfer of contracts for the sale of goods that would materially increase the risks to the nontransferring party.<sup>88</sup> In this case, the court found no substantial basis for dispute because the parties to the contract could still perform and receive their contracted services.<sup>89</sup> Thus, the court held that the transfer of contractual rights did not require

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<sup>80</sup> *Id.*

<sup>81</sup> *See generally id.*

<sup>82</sup> *Id.*

<sup>83</sup> *Id.*

<sup>84</sup> 695 F.Supp. 1362, 1366 (D.R.I. 1988) (holding that when the assignment results from a transformation of the legal form of the assignee, then the anti-assignment clause does not control). The court commented that the general rule—licenses are personal to the licensee—does not apply in cases where the assignment results from a transformation of the legal form of the licensee or assignee. *Id.*

<sup>85</sup> *Id.* at 1363–64.

<sup>86</sup> *Id.* at 1366.

<sup>87</sup> U.C.C. § 2-210 (2001).

<sup>88</sup> *See Syenergy Methods*, 695 F. Supp. at 1365.

<sup>89</sup> *Trubowitch*, 182 P.2d at 183–84.

consent from Trubowitch and that the merger did not violate the contract's anti-assignment clause.<sup>90</sup>

Courts utilizing the functionalist approach often hold that mergers, by default, do not result in an impermissible transfer of contractual rights.<sup>91</sup> Furthermore, the court in *Syenergy Methods* applied the functionalist approach and found that a covenant not to sue could be assigned by merger.<sup>92</sup> Another court applied the functionalist approach in a case where the primary result of the mergers was a change of name and domicile for the parent of a wholly owned subsidiary.<sup>93</sup> Thus, under the functionalist approach outlined above, a court determining whether a reverse triangular merger violates an anti-assignment provision would presumably hold the provision ineffective unless it placed material burden on the contracted parties. This lack of an adverse, bright-line rule has enabled companies to complete reverse triangular mergers without encountering anti-assignment clause issues.<sup>94</sup>

*B. The Formalist Approach: Deconstructing the Myth of Reverse Triangular Mergers*

By contrast, the formalist approach holds that whether a license may be assigned depends entirely upon the court's interpretation of the words "transfer" or "assignment." Under this definitional view, contractual rights may be nonassignable in the context of a reverse triangular merger. Courts examine the language of the contract and the state merger statute to determine whether an assignment by operation of law is an assignment within the meaning of the contract.

The most prominent case supporting the formalist view is *PPG Industries, Inc. v. Guardian Industries Corp.*<sup>95</sup> This case involved a grant of patent license rights by PPG Industries, Inc. to Permaglass, Inc.<sup>96</sup> Using an anti-assignment clause, the parties agreed that neither party would have the right to assign the patent contract without obtaining consent from the other party.<sup>97</sup> Five years after the patent license rights were signed, Permaglass merged with and into Guardian Industries Corp. and assigned all of its contracts and patent licenses to Guardian.<sup>98</sup> In response, PPG sued for breach of contract on the theory that its patent contract was not legally assignable

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<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 189–90.

<sup>92</sup> *Syenergy Methods*, 695 F. Supp. at 1366.

<sup>93</sup> *Sun World Corp. v. Pennysaver, Inc.*, 637 P.2d 1088, 1091–92 (Ariz. Ct. App. 1981).

<sup>94</sup> *See supra* note 74 and accompanying text.

<sup>95</sup> 597 F.2d 1090, 1093–95 (6th Cir. 1979).

<sup>96</sup> *Id.* at 1093.

<sup>97</sup> *Id.* at 1092.

<sup>98</sup> *Id.*

to Guardian.<sup>99</sup> The Sixth Circuit held that there was an impermissible transfer of assets and that a transfer by operation of law constituted an assignment that violated the anti-assignment restraining provision.<sup>100</sup> The court stated that a “transfer is no less a transfer because it takes place by operation of law rather than by particular act of the parties.”<sup>101</sup> In such a case, the court reasoned, the nonmerging party to the contract must consent to assignment of contract rights to the acquiring entity.<sup>102</sup> Under a reverse triangular merger, only the ownership of the target company changes because the acquiring entity’s subsidiary disappears into the target company.<sup>103</sup>

### C. Ambiguous Application of Both Approaches in Delaware

Delaware courts have not addressed the applicability of anti-assignment clauses in the context of reverse triangular mergers.<sup>104</sup> Title 8, Section 259 of the Delaware Code provides: “[A]ll rights, privileges, powers, franchises, property, debts, stock subscriptions, and all things in action or belonging to the merging corporation vest in the surviving corporation when the merger becomes effective.”<sup>105</sup> When a corporation merges with and into another corporation under the Delaware merger statute, no assignment of rights or obligations under the agreement takes place, and the surviving corporation assumes contractual rights and obligations automatically by operation of law. It follows that in a forward triangular merger, no assignment or transfer falls within the prohibition of an anti-assignment clause.

Even though the Delaware merger statute allows the acquiring entity to assume automatically the rights and obligations of the target company, Delaware courts have not addressed the applicability of the functionalist approach and formalist approach to reverse triangular mergers. In *Star Cellular Telephone Co., Inc. v. Baton Rouge CGSA, Inc.*, the Delaware Court of Chancery addressed the issue in the context of a forward triangular merger.<sup>106</sup> In that case, limited partners claimed that an anti-assignment clause in their limited partnership agreement was triggered when a general

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<sup>99</sup> *Id.* at 1093.

<sup>100</sup> *Id.* at 1093–94.

<sup>101</sup> *Id.* at 1096.

<sup>102</sup> *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> See DAVID N. FELDMAN, REVERSE MERGERS: TAKING A COMPANY PUBLIC WITHOUT AN IPO 200 (2006). The lack of litigation in Delaware is primarily due to the paucity of reverse triangular merger cases. When a company faces anti-assignment clause issues, the M&A deal generally is either internally resolved through additional consideration or the M&A deal fails completely. See *supra* note 52 and accompanying text. Although there are few reverse triangular merger cases in Delaware, the fact that every merger and acquisition practitioner runs into the issue of whether third-party consents should be obtained makes it imperative that a bright-line rule be developed.

<sup>105</sup> DEL CODE ANN. tit. 8, § 259 (1991).

<sup>106</sup> No. 12507, 1993 Del. Ch. LEXIS 158 (Del. Ch. July 30, 1993).

partner's partnership interest was transferred to another general partner upon merger.<sup>107</sup> Despite the existence of an anti-assignment clause, the merger effectively forced the nonmerging parties—the limited partners—to accept a new partner without their consent.<sup>108</sup> The Delaware Court of Chancery held that it would not enforce the anti-assignment clause because the merger was not an “assignment” under the Model Business Corporation Act or the Delaware Limited Partnership Act.<sup>109</sup> Using the functionalist approach, the court reasoned that the merger “did not materially affect the plaintiffs’ position in the partnership or their rights under the agreement.”<sup>110</sup> The court further reasoned that Delaware favored free assignability of contractual rights upon merger in the absence of materially adverse consequences to the nonmerging parties.<sup>111</sup> The court therefore concluded that the merger of the general partner was not a violation of the anti-assignment clause.<sup>112</sup>

Despite the holding in *Star Cellular*, Delaware caselaw is not clear in its treatment of anti-assignment clauses in the context of mergers. For example, in applying Delaware caselaw, a court in the Southern District of New York used the formalist approach and held that the amalgamation of two corporations violated the contract’s anti-assignment clause. In *National Bank of Canada v. Interbank Card Ass’n*,<sup>113</sup> the federal court considered whether an amalgamation of two Canadian corporations violated the anti-assignment clause of a license agreement governed by Delaware law.<sup>114</sup> Under that agreement, a Canadian bank had obtained the right to be part of the Canadian Mastercharge system.<sup>115</sup> The agreement provided that the bank “may not sublicense or assign its rights hereunder.”<sup>116</sup> The bank later merged with another Canadian bank in an amalgamation transaction<sup>117</sup> that resulted in a single new entity.<sup>118</sup> In deciding the case, the federal court applied the formalist approach and stated that the parties intended the anti-assignment clause to apply to an amalgamation.<sup>119</sup> Therefore, the amalga-

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<sup>107</sup> *Id.* at \*4. Corporate entities and limited partners can be included in forward triangular merger and reverse triangular merger transactions.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at \*7.

<sup>110</sup> *Id.* at \*24–25.

<sup>111</sup> *Id.* at \*26.

<sup>112</sup> *Id.* at \*27–28.

<sup>113</sup> 507 F. Supp. 1113 (S.D.N.Y. 1980).

<sup>114</sup> *Id.* at 1115.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 1116.

<sup>117</sup> An amalgamation is the merging of two or more companies to form a single new entity. See ELIZABETH J. JOHNSON ET AL., UNDERSTANDING THE TAXATION OF PARTNERSHIPS 180 (5th ed. 2006).

<sup>118</sup> *Nat’l Bank*, 507 F. Supp. at 1116.

<sup>119</sup> *Id.* at 1122.

mation was found to have violated the anti-assignment clause of the parties' contract.<sup>120</sup>

#### D. The Significance of *SQL Solutions v. Oracle*

The leading case applying an anti-assignment clause in a reverse triangular merger transaction is the depublished<sup>121</sup> opinion in *SQL Solutions, Inc. v. Oracle Corp.*<sup>122</sup> The *SQL Solutions* decision is widely known because of its potentially significant impact on the structuring—and even the economics—of corporate reverse triangular mergers and acquisitions.

In 1987, D & N Systems, Inc. entered into a software license agreement with Oracle Corporation.<sup>123</sup> D & N received a nonexclusive intellectual property license to use Oracle software in its internal operations.<sup>124</sup> The license agreement included a provision that expressly prohibited assignment or transfer without the written consent of Oracle.<sup>125</sup> In 1990, D & N merged with and into a subsidiary of Sybase, Inc.<sup>126</sup> D & N survived the reverse triangular merger, changed its name to SQL Solutions, Inc., and became a wholly owned subsidiary of Sybase through an exchange of stock ownership.<sup>127</sup> Oracle then claimed that D & N breached their agreement by transferring the license to SQL Solutions without obtaining consent from Oracle.<sup>128</sup>

The U.S. District Court for the Northern District of California applied federal copyright law and held that the reverse triangular merger resulted in

<sup>120</sup> *Id.*

<sup>121</sup> Depublished opinions in California form a small and select subgroup of unpublished opinions, representing about one percent of the total and possessing special importance and visibility. See Stephen R. Barnett, *Depublication Deflating: The California Supreme Court's Wonderful Law-Making Machine Begins to Self-Destruct*, 45 HASTINGS L.J. 519, 522–26, 566 (1994). While depublished cases are non-binding, analysts suggest that depublished cases are a “major way in which the California Supreme Court shapes . . . the law.” *Id.* at 520. Unlike unpublished opinions, depublished opinions in California are influential and exhibit the following traits: (1) they are important, as attested to by the California Court of Appeal in certifying them for publication in the Official Reports under the standards of Rule 976; (2) they were published originally in the Official Reports and in the unofficial California Reporter and are permanently available in Lexis and Westlaw; and (3) they have been the subject of a public judicial action by the California Supreme Court. See *id.* at 548; see also CAL. CT. R. 8.1105. Although *SQL Solutions* is a depublished case, such opinions are “designed to illuminate, distinguish and clarify the law.” Paige Merrill Baker, Comment, *Depublication: The New Starchamber*, 18 W. ST. U. L. REV. 313, 317 (1990). “The law, as we know it, does not exist in isolation nor can it be set apart from civilization as a whole.” *Id.* at 318. As a result, depublished cases like *SQL Solutions v. Oracle* “play a role in our [legal] culture such that its influence can be measured by its effect on people.” *Id.*

<sup>122</sup> C-91-1079 MHP, 1991 U.S. Dist. LEXIS 21097, at \*5 (N.D. Cal. Dec. 18, 1991).

<sup>123</sup> See *id.* at \*1.

<sup>124</sup> *Id.* at \*2.

<sup>125</sup> *Id.* at \*1–3.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* at \*2.

<sup>128</sup> *Id.* at \*4.

an impermissible transfer of Oracle's contractual rights.<sup>129</sup> The court rejected the argument that no transfer had occurred in the reverse triangular merger process.<sup>130</sup> Instead, the court concluded that a reverse triangular merger produced a fundamental change "in the legal form of ownership" of the target company because the target company became the subsidiary of the acquiring company (i.e., Sybase, Inc.) upon merger.<sup>131</sup> In essence, the court rejected the functionalist approach, which holds that mergers do not violate anti-assignment clauses unless the mergers produce an adverse effect on the interests of the parties. The Court noted that the reverse triangular merger constituted a transfer of rights which violated the anti-assignment clause. Having made this determination, the court found D & N in breach of the agreement for violating the anti-assignment provision and held that Oracle was entitled to terminate the license.<sup>132</sup>

The court in *SQL Solutions* made a critical decision. By determining that a reverse triangular merger results in an impermissible transfer of contractual rights to the acquiring entity, the opinion effectively casts doubt on the general proposition that contractual rights in reverse triangular mergers are freely assignable. The court reasoned that the change of stock ownership in the target company constituted a change of legal form, thereby resulting in an impermissible transfer of intellectual property rights.<sup>133</sup> Despite taking explicit note of the functionalist approach, the *SQL Solutions* court concluded that contractual rights are not assignable, and so the transfer, though it might otherwise survive an analysis under the functionalist approach, is forbidden under the *SQL Solutions* rule of nonassignability in reverse triangular mergers. In the decade since *SQL Solutions* there have been no other cases analyzing the assignment of a contractual right via a reverse triangular merger.<sup>134</sup> Although the case is depublished, courts across jurisdictions continue to refer favorably to the *SQL Solutions* decision, widening its impact.<sup>135</sup> Consequently, the decision in *SQL Solutions* established a new principle that the reverse triangular merger structure is subject to a

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<sup>129</sup> *Id.* at \*5–6.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> *Id.* at \*12–18.

<sup>133</sup> *See id.*

<sup>134</sup> *See id.* at \*1, \*3–10.

<sup>135</sup> *See Pro-Edge, L.P. v. Gue*, 419 F. Supp. 2d 1064, 1070–74, 1083–85 (N.D. Iowa 2006) (explicitly adopting the *SQL Solutions* approach and finding an employment agreement was not permitted to be transferred in a series of corporate transactions which revamped employer's corporate structure); *Cincom Sys., Inc. v. Novelis Corp.*, No. 1:05cv152, 2007 U.S. Dist. LEXIS 2721, at \*1, \*3–\*5 (S.D. Ohio Jan. 12, 2007) (expressly adopting *SQL Solutions* and holding that a nontransferable software license could not be passed to the corporate affiliates of a licensee through a series of mergers; stating that the court "cannot ignore federal law and policy supporting the non-assignability of intellectual property rights").

bright-line prohibition against transfer of contractual agreements and rights when a nonmerging party has an anti-assignment clause.<sup>136</sup>

### III. ENFORCING ANTI-ASSIGNMENT CLAUSES IN REVERSE TRIANGULAR MERGERS

To ensure that their transactions are legitimate, contracting parties must make an accurate assessment of who may ultimately come into possession of their contractual rights. An M&A deal should not exempt the parties from obtaining third-party consents simply because it uses the reverse triangular merger structure. To understand the justifications that support the argument that reverse triangular mergers are not immune from anti-assignment clauses, a number of issues and policies concerning the assignability of contractual rights must be analyzed.

Section A argues that a reverse triangular merger technically results in a fundamental and material change in the target company. Section B argues that enforcing anti-assignment clauses in reverse triangular mergers promotes uniformity in commercial transactions and reduces the potential for litigation. Section C asserts that enforcing anti-assignment clauses effectively protects the nonmerging party's interests. Section D discusses the benefits of requiring consent in reverse triangular mergers in the intellectual property realm. Section E examines the implications of the *SQL Solutions* decision and its impact on assignability clauses, arguing that *SQL Solutions*' bright-line rule should be followed by all jurisdictions to bring consistency to reverse triangular mergers. Finally, section F stresses the necessity of enforcing a default rule that requires third-party consent in reverse triangular mergers. Parties who wish to contract around the default rule must expressly approve of free contractual assignment in the event of a reverse triangular merger.

#### *A. Reverse Triangular Mergers Fundamentally Change the Target Company*

Reverse triangular mergers can avoid assignability issues primarily because the target company continues to exist and serve as the "original party" to its contracts. This view leads to the belief that the target company's business, customers, suppliers, and officers remain intact and unaffected after undergoing a reverse triangular merger.<sup>137</sup> However, a reverse triangular merger does result in a fundamental change in the target company's legal form of ownership.

First, a reverse triangular merger signifies the absorption of the target company's original corporate officers and directors by the acquiring en-

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<sup>136</sup> *SQL Solutions*, 1991 U.S. Dist. LEXIS 21097, at \*5; see also *Cincom Sys.*, 2007 U.S. Dist. LEXIS 2721, at \*2.

<sup>137</sup> See Ziff, *supra* note 17, at 786.

tity.<sup>138</sup> This transaction produces a permanent change in the nature and structure of the target company's management and business.<sup>139</sup> Corporate statutes recognize this fact by giving management the right to negotiate and approve the terms of a proposed reverse triangular merger.<sup>140</sup> A completed reverse triangular merger necessitates the disappearance of the target company as an autonomous entity with the concomitant loss of control and job security for target company managers.

Second, the acquiring entity automatically assumes the target company's rights, privileges, franchises, and properties.<sup>141</sup> For example, if the target company were to default on a loan or breach a contract, the acquiring entity would be held accountable for the target company's assets, liabilities, and legal claims. Pursuant to a reverse triangular merger, the acquiring entity takes over and ultimately dictates the target company's business model, marketing plans, and operating strategies. The consolidation of the rights, privileges, franchises, and properties of the two parties transforms the target company into a new, shell-like legal entity. This produces a "fundamental change in the nature of the target company" because the target company loses its original corporate existence.<sup>142</sup>

Third, in a reverse triangular merger, the target company can undergo a complete corporate personality change, resulting in a legal entity with a new structure, nature, and corporate culture. Consider the following example: Nike, Apple, and Reebok are in an industry where Nike and Apple share a mutually beneficial working relationship.<sup>143</sup> The relationship between Nike and Apple is founded on personal trust, deep business familiarity, and a strong track record of satisfactory performance. Nike and Reebok have an antagonistic relationship as competitors. Nike and Apple enter into a contract in which Apple agrees to share its patented technology with Nike in return for royalties and fees. The contract also includes an anti-assignment clause that prohibits transfer of contractual rights without Apple's consent.

Later, Apple learns that Nike engaged in a reverse triangular merger with Reebok. Although Nike continues to exist and remains a party to Apple's contract, Reebok takes over management for Nike and takes ownership of Nike's assets. Under Reebok's management and direction, Nike

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<sup>138</sup> William K. Sjostrom, Jr., *The Truth about Reverse Mergers*, 2 ENTERPRENEURIAL BUS. L.J. 231, 743, 743, 746 (2008); see generally HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 204 (3d ed. 1983).

<sup>139</sup> *Statutory Merger and Consolidation of Corporations*, 45 YALE L.J. 105, 105-34 (1935).

<sup>140</sup> See generally Steven H. Schulman & Alan Schenk, *Shareholders Voting and Appraisal Rights in Corporate Acquisition Transactions*, 38 BUS. LAW. 1529 (1983) (examining shareholder and management rights in a wide variety of transactions in which one corporation acquires another).

<sup>141</sup> See *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462, 467 (1933).

<sup>142</sup> Johnson & Siegel, *supra* note 59, at 318.

<sup>143</sup> Although the assignment issue in this example is a hypothetical situation, Nike and Apple pursued business partnerships with Nike producing iPod-compatible footwear that tracks runner's training routines in 2006. Apple, Nike + iPod, <http://www.apple.com/ipod/nike/run.html>.

retains its corporate name but changes its corporate culture, hires new employees, and restructures its business operations. As a result, Apple will feel as though it is contracting with an entirely new corporate entity or a stranger. Apple may not want to engage in a business relationship with Nike because of Nike's change in corporate personality. Under the theory that reverse triangular mergers are not exempt from anti-assignment clauses, Apple has the right to invoke the anti-assignment clause and refuse to continue its contract with Nike. As this example shows, enforcement of anti-assignment clauses can be essential to achieving sound results in such a situation.

A reverse triangular merger produces severe discontinuity in the target company's business enterprise, corporate personality, and corporate ownership. Target companies are affected by reverse triangular mergers and do not remain "intact." Consequently, a reverse triangular merger results in an impermissible assignment of contractual rights absent consent from the nonmerging party.

### *B. Enforcing Anti-Assignment Clauses*

The theory of contractual freedom suggests that corporate entities are free to structure and modify their contractual relationships in order to maximize their joint wealth and utility.<sup>144</sup> As a result, anti-assignment clauses are used to fulfill parties' explicit desire to require consent prior to assigning contractual rights upon merger.<sup>145</sup> If contracting parties carve out the applicability of free assignability by expressly prohibiting assignment, courts will generally uphold such provisions.<sup>146</sup> Shielding reverse triangular mergers from the efficacy of anti-assignment clauses improperly imposes exceptions, limitations, and conditions of free assignability on reverse triangular mergers when no such privileges were intended by the contracting parties. If parties to a contract agree that an anti-assignment clause best protects their contractual interests,<sup>147</sup> then a reverse triangular merger cannot avoid the necessity of obtaining consent.

Moreover, enforcing anti-assignment clauses does more than simply require parties to obtain consent in the case of a merger. Enforcing anti-assignment clauses in reverse triangular mergers also reduces uncertainty in

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<sup>144</sup> In the context of a merger, an anti-assignment clause is an unequivocal expression of the parties' desire to prohibit contractual assignment absent consent from the nonmerging party. Note, *Effect of Corporate Reorganization on Nonassignable Contracts*, 74 HARV. L. REV. 393, 394-96 (1960).

<sup>145</sup> Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1549 (1989) (explaining that anti-assignment clauses are supported by reciprocal expectations and judicially cognizable duties and obligations).

<sup>146</sup> Aaron Xavier Fellmeth, *Control Without Interest: State Law of Assignment, Federal Preemption, and the Intellectual Property License*, 6 VA. J.L. & TECH. 8, 8-10 (2001) (explaining that courts have consistently enforced anti-assignment clauses and held that a target company has "no right to assign or sublicense" a third party's rights absent contractual permission).

<sup>147</sup> See *id.* at 15, 23-43.

commercial business transactions and promotes uniformity. Under the Model Business Corporation Act, states should consistently interpret mergers to achieve the Model Business Corporation Act's "purposes and policies" of providing uniformity in commercial transactions.<sup>148</sup> Requiring parties to obtain third-party consents in reverse triangular mergers creates an unambiguous procedural checklist that enables practitioners to easily analyze the validity of anti-assignment clauses and to achieve finality, certainty, and efficiency in commercial transactions.<sup>149</sup> Furthermore, it also supports the public policy "need for quick and inexpensive resolutions of commercial disputes."<sup>150</sup>

Additionally, exempting reverse triangular mergers from anti-assignment clauses unless they result in materially adverse effects to the nonmerging party—the functionalist approach—is inconsistent with the Model Business Corporation Act's purposes and policies promoting predictability and uniformity in commercial transactions across jurisdictions.<sup>151</sup> The functionalist approach frustrates the Model Business Corporation Act by injecting uncertainty into an area of law in which uniformity and certainty are highly valued. For example, in *AES Technology Systems, Inc. v. Coherent Radiation*,<sup>152</sup> the Seventh Circuit improperly enforced a nonexistent contractual disclaimer against a buyer by examining the parties' factual background using the functionalist approach.<sup>153</sup> The court engaged in a factual inquiry to determine the precise nature and intent of the contract and any materially adverse changes that would result from the actions of the parties.<sup>154</sup> Like the case-by-case functionalist approach that enforced an invalid contract limitation against the buyer in *AES Technology*, exempting reverse triangular mergers from anti-assignment clauses would subject cases to complicated, fact-driven inquiries. This, in turn, would lead to an increase in factual disputes, time-consuming hearings, and inconsistent decisions—in short, litigation costs will greatly increase. Therefore, it is important to consistently enforce anti-assignment clauses in reverse triangular mergers to achieve predictability and efficiency in M&A transactions.

### C. *Protecting the Nonmerging Party*

The obvious purposes of an anti-assignment clause are to prevent the introduction of a stranger into the contractual relationship between the parties and to guarantee that the original parties will remain responsible for the performance of the contract. In general, upon a reverse triangular merger,

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<sup>148</sup> See generally MODEL BUS. CORP. ACT §§ 3.02–3.08 (1984).

<sup>149</sup> See *id.*

<sup>150</sup> See *Fulton State Bank v. Deutz-Allis Credit Corp.*, 701 F. Supp. 151, 154–57 (N.D. Ill. 1988).

<sup>151</sup> See MODEL BUS. CORP. ACT § 3.02 (1984).

<sup>152</sup> *AES Technology Systems, Inc. v. Coherent Radiation*, 583 F.2d 933 (7th Cir. 1978).

<sup>153</sup> *Id.* at 942–43.

<sup>154</sup> *Id.* at 947–49.

the acquiring entity automatically becomes the owner of property belonging to the target corporation.<sup>155</sup> Thus, a nonmerging party may be primarily concerned that it does not end up in an undesirable or unintended relationship with a direct competitor through the acquisition.<sup>156</sup>

Imagine that a market is comprised of two dominant companies—like Microsoft and Google—and one small technology company—like Doubleclick. Google specializes in creating patented technology that gives it a competitive advantage over Microsoft. Doubleclick also has specialized technologies and tools that Google hopes to use to further its own technological development. Thus, Google partners with Doubleclick by entering into a contract that allows Doubleclick to access Google's patented technology in return for payment of revenue. In an effort to prevent Microsoft from becoming a party to the contract, Google includes an anti-assignment clause in its licensing agreement. The anti-assignment clause prohibits assignment of the patent license without Google's explicit consent. This arrangement provides Google and Doubleclick with a mutually beneficial agreement where they leverage each other's competitive advantage and further their technological potential. Several months after entering into the contract agreement with Google, Doubleclick engages in a reverse triangular merger with Microsoft.

Under the theory that reverse triangular mergers do not constitute an impermissible assignment of contractual rights, Microsoft has now acquired access to Google's patented technology and contractual rights. In response, Google would fight to terminate the contract by arguing that the reverse triangular merger was a violation of the consent-first anti-assignment clause.

Unfortunately, Google's argument would not be accepted by a court taking a functionalist approach. The question about whether reverse triangular mergers violate contractual anti-assignment clauses prevents Google from defending its contractual rights. It is crucial to give the nonmerging third party the ability to "opt out" of the contract when a reverse triangular merger occurs. Protecting the nonmerging party remains a serious concern in contractual anti-assignment clauses. Enforcing anti-assignment clauses in reverse triangular mergers effectively protects the third party from inadvertently contracting with undesired parties.

#### *D. Intellectual Property Through the SQL Solutions Lens and Exceptions to Enforcing Anti-Assignment Clauses*

In the context of patent licenses, failed enforcement of anti-assignment clauses in reverse triangular mergers would create a secondary market for licenses. Consider this example from *SQL Solutions*: suppose the market consists of Company A, Company B, and Company C. Company A cannot

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<sup>155</sup> James J. Fuld, *Some Practical Aspects of a Merger*, 60 HARV. L. REV. 1092, 1101–03 (1947).

<sup>156</sup> See Perry & Lee, *supra* note 10, at 30–33.

purchase Company B's patent rights independently of a merger, acquisition, or bankruptcy proceeding. Company C, however, has a contract with Company B to use and develop Company B's patent rights. Under the theory that reverse triangular mergers permit free assignability of contractual rights, Company A can manipulate the merger system and acquire Company C through a reverse triangular merger. Company A would then automatically assume Company C's contractual patent rights with Company B. This transaction would effectively create a secondary market for licenses. The existence of an unregulated secondary market would diminish the nonmerging party's ability to profit from its creation, thereby lessening the incentive to create.<sup>157</sup>

In order to stimulate creativity, the rights of patent owners, authors, and composers must be preserved.<sup>158</sup> Authorizing unconditional assignment in reverse triangular mergers could impair a nonmerging party's intellectual property monopoly in two instances: (1) sublicensing of rights under a license, and (2) the assignment of a license to a direct competitor.<sup>159</sup> For example, if a reverse triangular merger involved the transfer of patent licenses, then the patent owner might legitimately worry that his patent could be transferred to a "stranger" or "competitor" without his permission. The Ninth Circuit summarized this point in *Everex Systems, Inc. v. Cadtrak Corp.*, regarding the assignment of a patent license in an M&A deal:

Allowing free assignability . . . [of patent licenses] would undermine the reward that encourages invention because a party seeking to use the patented invention could either seek a license from the patent holder or seek an assignment of an existing patent license directly from a licensee [i.e., the target company]. In essence, every licensee would become a potential competitor with the patent-owner in the market for licenses under the patents.<sup>160</sup>

Enforcing anti-assignment clauses in reverse triangular mergers is a pragmatic deterrent to combating the unwanted transfer of rights by a target company to the acquiring entity.<sup>161</sup> Requiring contractual consent presumably would prevent reverse triangular mergers based solely on the desire to acquire rights through the backdoor.<sup>162</sup> A default rule enforcing anti-assignment clauses in reverse triangular mergers would not permit unau-

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<sup>157</sup> See *Everex Sys., Inc., v. Cadtrak Corp.*, 89 F.3d 673, 679 (9th Cir. 1996).

<sup>158</sup> *Harris v. Emus Records Corp.*, 734 F.2d 1329, 1334 (9th Cir. 1984). Protecting intellectual property rights in the context of a merger allows innovators to benefit from their work and creativity. Protecting innovation benefits society as a whole by precluding anticompetitive activities that restrict creative freedom and users' rights.

<sup>159</sup> Daniel R. Mitz, et al., *How to Secure Licenses You Pay For*, MERGERS & ACQUISITIONS J., June 1, 2005, at 1.

<sup>160</sup> *Everex Sys.*, 89 F.3d at 682.

<sup>161</sup> See Mitz, *supra* note 159, at 2.

<sup>162</sup> See *id.*

thorized sublicensing by preventing the existence of a secondary market for licenses.

*SQL Solutions* held that an anti-assignment clause in a contract precludes assignment in a reverse triangular merger.<sup>163</sup> The court in *SQL Solutions* reasoned that a reverse triangular merger involving the transfer of rights under a nonexclusive copyright license was an invalid assignment or transfer for the purposes of the anti-assignment clause.<sup>164</sup> In doing so, the court further reasoned that the legal system “consistently recognize[s] that an assignment or transfer of rights does occur through a change in the legal form of ownership of a business.”<sup>165</sup> Thus, the court concluded that consent must be obtained where a transfer has occurred in the context of a reverse triangular merger.<sup>166</sup>

As recently as November 6, 2007, the United States District Court for the District of Nebraska cited *SQL Solutions* in *Board of Regents of the University of Nebraska v. BASF Corp.*<sup>167</sup> In that case, a university agreed to purchase a business run by a research institute that specialized in the manufacture of active ingredients that support the development of herbicide-tolerant agriculture.<sup>168</sup> Citing *SQL Solutions*, the court found that in the context of an asset purchase acquisition,<sup>169</sup> patent licenses were not assignable without express permission from the nonmerging party.<sup>170</sup>

The *SQL Solutions* decision casts doubt on the widely held belief that a reverse triangular merger does not result in a “transfer” or “assignment” of contractual rights. Following *SQL Solutions*, it is likely that courts will require consent in reverse triangular mergers involving transfers of patent, copyright and trademark rights—rights that are “personal” to a nonmerging party and therefore nontransferable without its consent. Departing from the freedom-to-transfer norm of modern commercial law preserves the limited monopoly rights created by federal patent and copyright statutes.<sup>171</sup> Thus, the decision in *SQL Solutions* effectively establishes a precedent at odds

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<sup>163</sup> *SQL Solutions, Inc. v. Oracle Corp.*, C-91-1079 MHP, 1991 U.S. Dist. LEXIS 21097, \*1, \*2–\*5 (N.D. Cal. Dec. 18, 1991).

<sup>164</sup> *Id.*

<sup>165</sup> *Id.* at \*4.

<sup>166</sup> *Id.*

<sup>167</sup> 4:04CV3356, 2007 U.S. Dist. LEXIS 82497, at \*48 (D. Neb. Nov. 6, 2007) (holding that the acquiring entity had “no right, title, or interest” in the target company’s license because the target company had “no right to assign or transfer the license” without the nonmerging party’s consent).

<sup>168</sup> *Id.* at \*12.

<sup>169</sup> An asset purchase involves the purchase of a selling company’s assets—e.g., facilities, equipment, stock, inventory, patent, business line, or business enterprise—by a corporate buyer. In the context of an asset purchase acquisition, the corporate buyer assumes responsibility for all the liabilities related to the purchased assets. See Press Release, DLA Piper, M&A Acquirors Beware: When You Succeed to the Liabilities of a Transferor, Don’t Assume That the Existing Insurance Transfers Too (Aug. 8, 2003), available at <http://www.dlapiper.com/global/publications/detail.aspx?pub=61>.

<sup>170</sup> *Bd. of Regents*, 2007 U.S. Dist. LEXIS 82497, at \*37.

<sup>171</sup> See *id.*

with the general view that reverse triangular mergers obviate the need for contractual consent in M&A deals. For pragmatic purposes, following *SQL Solutions* will achieve uniformity in the way anti-assignment clauses are treated in reverse triangular mergers.

The presumption in most jurisdictions is that agreements and the rights and duties created by contracts are assignable unless contracted parties explicitly carve out exceptions to the default rule. Anti-assignment clauses that contain specific language prohibiting assignment in the context of a reverse triangular merger should be sufficient to protect the nonmerging party.<sup>172</sup> A licensor may have significant concerns when a licensee assigns the right to exploit the licensed intellectual property to a competitor of the licensor, thereby damaging the licensors' overall business position in the market. Furthermore, contracted parties could carve out exceptions to the default rule by expressly stating that an anti-assignment clause is enforceable in the context of a change of control, change of ownership, or merger. However, in the absence of such express wording, courts should be extremely reluctant to decrease and minimize the scope of the anti-assignment clause. Interpreting reverse triangular mergers as exempt from anti-assignment clauses requires courts to improperly impose exceptions, limitations, and conditions of exemption on reverse triangular mergers when no such wording exists in the anti-assignment clause. The inclusion of specific language, as described above, can be used to ensure that any acquisition or transfer of the contractual agreement by the target company will require the consent of the third party.

Furthermore, the courts believe that a patent license involves such a degree of personal trust and confidence between the contracting parties that the contract can only be satisfactorily performed by these parties themselves.<sup>173</sup> Patent licenses generally cause increased complications in reverse triangular merger situations because patent agreements are analogous to personal services contracts. Generally, patent licenses cannot be transferred without consent even in the absence of an anti-assignment clause because such rights arguably involve a personal performance which could vary in character if rendered by anyone but the specific contracting party.<sup>174</sup> Based on this distinction, courts interpreting patent licenses are less likely to permit the assignment of patent licenses by operation of the jurisdiction's merger vesting statute.

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<sup>172</sup> For example, the following two hypothetical provisions would be sufficient: (1) Prohibit assignments: *Assignment of this contract shall be prohibited without the written consent of the contractor.* (2) Define the assignment: *Any transfer of this contract by Party A by merger, consolidation, or dissolution, or any change in ownership or power to vote a controlling share of the voting stock in Party A, shall constitute an assignment for the purposes of this contract.* See Macaulay, *supra* note 9, at 507–18.

<sup>173</sup> See *PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090, 1093 (6th Cir. 1979).

<sup>174</sup> *In re D.H. McBride & Co.*, 132 F. 285, 288 (S.D.N.Y. 1904).

## RECOMMENDATIONS AND CONCLUSION

Prior to consummating any M&A deal, the parties to the transaction must provide each other with a due diligence schedule that lists all active contracts.<sup>175</sup> The due diligence schedule helps each party determine the effect of the merger on each of the listed documents and the effect of the documents upon the merger. Some contracts may, in express terms, be terminable in case of merger. Under some bank loan agreements, payment of the principal indebtedness will be expressly accelerated. Indentures for convertible preferred stock provisions usually have varying, but elaborate, provisions in case of merger.<sup>176</sup>

Generally, courts disfavor any restraints on alienation and will narrowly construe anti-assignment clauses.<sup>177</sup> However, when parties to a contractual agreement stipulate that transfers by operation of law or changes of control pursuant to a merger (e.g., reverse triangular merger) constitute an assignment in violation of the contract's anti-assignment provision, then a reverse triangular merger should clearly fall within the restrictions imposed by the anti-assignment clause. Under the theory that an anti-assignment clause is triggered upon a reverse triangular merger, a contract containing an anti-assignment clause will not be transferable to the surviving target entity unless the parties obtain consent from the nonmerging party. For example, leases may occasionally contain a clause similar to the following: "Any transfer or assignment of this lease by operation of law shall ipso facto, at the election of the lessor, render this lease null and void." In this case, the lessor explicitly wants to protect himself from the risk of transferring contractual rights by merger. Despite hostility toward restrictions on alienation in the reverse triangular merger context, anti-assignment clauses should be honored as provisions that prohibit the transfer of property and rights by operation of law when the restraining clause specifies that an assignment includes a transfer that occurs by change of control or by operation of law in a merger. As a result, increased due diligence in reverse triangular merger transactions is required to ensure that the assignment of contractual rights does not violate the anti-assignment clause of a contract.

Requiring consent from third-party contracts does not render the reverse triangular merger structure ineffective. The reverse triangular merger structure still retains its advantages and is still one of the fastest ways to effectuate the consolidation and combining of two corporate entities. In-

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<sup>175</sup> Fuld, *supra* note 155, at 1104. The due diligence schedule requires a careful survey of all material contracts, banking arrangements, indentures, leases, insurance agreements, employment contracts with executives, union contracts, and pension plans. *Id.*

<sup>176</sup> *See id.* at 1113.

<sup>177</sup> *See* ROGER A. CUNNINGHAM ET AL., THE LAW OF PROPERTY § 6.71 (1993); *see also* Imperial Enters., Inc. v. Fireman's Fund Ins., 535 F.2d 287, 293 (5th Cir. 1976) (the court acknowledged that parties to an insurance contract may agree that the insured party shall have no rights to assign; however, the court narrowly construed the anti-assignment clause and held that it would not ritualistically and mechanically apply the restraining provision).

creased due diligence in obtaining the necessary third-party consents in a reverse triangular merger transaction will result in increased transaction costs for each party. Despite these increased costs, erring on the conservative side by requiring consent from all third parties reduces potential litigation and helps parties understand the viability of the proposed reverse triangular merger. Oftentimes, a proposed merger or acquisition “gets canned or valued down” following conflicts over intellectual property rights, personnel contracts, or contract incompatibilities in integrating the two companies.<sup>178</sup> Because of the benefits<sup>179</sup> of reverse triangular mergers, there is a tendency to underestimate the complexity of integrating two systems or changing over to a new system entirely. Requiring third-party consent in reverse triangular mergers is critical to curbing “potential risks and red flags.”<sup>180</sup> In an economy where the average life cycle of a product is only eighteen months from launch to death, arguing about a nonmerging party’s contractual anti-assignment clause rights in court for five years is not productive.<sup>181</sup>

Additionally, after the due diligence schedule is given to the acquiring entity and target company, it is ultimately the decision of management to determine which third-party consents they want to pursue. For example, a contractual right that is traditionally characterized as personal (i.e., patent rights) cannot be assigned with the nontransferring party’s consent. However, consent from a nonmerging third party who contracts to provide the target company with printer paper might be considered “insubstantial” and disregarded by company management. Due diligence is critical to the success of any reverse triangular merger. It must go beyond high-level overviews by effectively investigating any contract that might make or break transition efforts. Thus, upon the occurrence of a reverse triangular merger, entities do not need to obtain consent unless the contract in question involves the transfer of an intellectual property license or unless the contract prohibits assignment by reverse triangular merger or change of control.

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<sup>178</sup> Lee Copeland, *Due Diligence*, COMPUTERWORLD, Mar. 6, 2000, <http://www.computerworld.com/news/2000/story/0,11280,42836,00.html>. “Due diligence is going in and digging a hole in the ground and seeing if there’s oil, instead of taking someone’s word on it.” *Id.* Due diligence entails taking all the “reasonable steps” to ensure that both buyer and seller get what they expect “and not a lot of other things that you did not count on or expect.” *Id.* The process involves everything from reading the fine print in corporate legal and financial documents such as equity vesting plans and patents to interviewing corporate officers. *Id.*

<sup>179</sup> See *supra* note 16 and accompanying text.

<sup>180</sup> See Copeland, *supra* note 178.

<sup>181</sup> *Id.* “It’s the kiss of death to make an improper acquisition . . . not only are you buying a dog, but the dog can kill your company.” *Id.*