In a perfect world, an in-house legal team would be looped in on potential acquisitions early and often.

But in the real world, that is not always (often?) the case. As a result, in-house counsel is often asked to answer legal questions on potential deals on short notice and with great urgency. This can be especially challenging when the company wishes to use its stock as deal consideration.

Here are six questions to ask at the outset when your company wants to pay for an acquisition with stock:

1. Do we have sufficient authorized shares?

This is the easiest of the questions, but maybe the most fundamental. First things first, determine whether you have the authorized shares to complete the deal without a charter amendment — and accompanying shareholder

vote.

2. Do we need to register the issuance of shares in the acquisition?

Again, start with the basics. All securities issuances must either be registered or made pursuant to an exemption from registration. Consequently, the buyer must either confirm that it has a valid exemption to issue its stock to the sellers as consideration, or register the issuance of stock to the sellers (*i.e.*, file a Form S-4 with the SEC). With its lengthy disclosure requirements and review periods, preparing and filing a Form S-4 is not for the faint of heart. In some deals—such as the acquisition of a public target or a company with a large base of unaccredited shareholders—it may be unavoidable. But buyers prefer to find a valid exemption from registration where possible.

The most common exemptions for M&A transactions are:

- the private placement exemption under Section 4(a)(2)/Regulation D, and
- the offshore transaction exemption under Regulation S.

To determine if either (or both) of these exemptions are applicable, you will want to diligence whether the target's shareholders are "accredited investors," in order to use the private placement exemption, or non-U.S. persons, in order to use the offshore transaction exemption. [Aside #1: Regulation D allows up to 35 non-accredited investors to participate in an unregistered offering, but the accompanying disclosure requirements dramatically limit the utility of this allowance.]

In deals where some target shareholders are both (a) not accredited investors and (b) U.S. persons, buyers will often structure the deal so that those investors will receive cash instead of stock. But beware: this can impact a deal's tax treatment, as discussed in greater detail below.

3. How long will the target company shareholders need to hold the stock post-closing?

The target company will likely be keenly interested in how quickly its shareholders can sell the stock and have the liquidity they often desire. Here is where the use of Form S-4 can pay off, since shareholders of the target company who receive securities in a transaction registered on a Form S-4 can generally resell their securities immediately after the closing of the transaction. [Aside #2: Different rules apply to significant target company shareholders or executives who become affiliates of the acquiring company and will have to sell their acquiring company securities under Rule 144.]

If a Form S-4 is not used to register the issuance of shares by the acquiring company, then the target company shareholders will receive restricted securities that may only be resold in an offering registered with the SEC or under an exemption from registration. A buyer may issue restricted securities to target shareholders and then register those shares for resale by filing a resale registration statement. A target company may negotiate for registration rights for its shareholders to require the buyer to file, and maintain the effectiveness of, a resale registration statement. If restricted securities will not be registered for resale, then the target shareholders will need to comply with Rule 144 in order to sell their shares and receive liquidity. In most instances, this will mean that the target company shareholders will need to hold the shares they receive in the acquisition for six months before they may be sold. Target shareholders often are not happy with this but it happens.

A negotiating point for both parties to consider here is whether any registration rights are really worth the cost incurred by the acquiring company in filing and keeping a resale registration statement effective. Often, a shareholder's broker prefers sales made under Rule 144 rather than relying on a resale registration statement, due to internal compliance processes. When shareholders press for registration rights, it can be useful to take a moment to first consider whether they are really critical for, and likely to be used by, that shareholder.

4. Will shareholder approval be required under stock exchange listing requirements?

Both the New York Stock Exchange and Nasdaq Stock Market have a rule (known as the "20% Rule") that shareholders approve a listed company's new issuance of common stock or securities convertible into common stock that could equal or exceed 20% of the listed company's outstanding common stock or voting power before the new issuance. The 20% Rule applies to stock issuances made as consideration for acquisitions, and any contingent future issuances that are part of the consideration (such as stock potentially issuable in an earnout) are included in the calculation. Frequently, buyers will include a "cap" on the maximum number of shares that may be issued as consideration to ensure that the 20% Rule is not implicated.

5. What consents or waivers may be required under our contracts?

Among the places to check:

- Convertible securities (*e.g.*, warrants and convertible notes) to identify any potential anti-dilution adjustments that may result from issuing the acquisition shares.
- Shareholder agreements for restrictions and participation rights.
- Registration rights agreements to see if filing a resale registration statement may trigger any notices or consent requirements.
- Credit agreements and indentures.

6. Will the target shareholders be subject to U.S. federal income taxation on receipt of our shares?

It depends. There are provisions under U.S. federal income tax law applicable to "reorganizations" that, if certain conditions are satisfied, generally require the recognition of gain only to the extent of any non-stock (or certain debt-like preferred stock) consideration received in exchange for target company stock. Any unrecognized gain generally is deferred until the acquirer stock received in the exchange is sold in a taxable disposition.

The relative mix of stock and non-stock consideration required for gain non-recognition varies depending on the means used to effect the acquisition. Due to certain strict statutory limitations applicable to stock and asset purchases, as a practical matter, acquisitions by public companies that are intended to provide target shareholders with gain non-recognition (whether in whole or in part) generally will be effected by means of a statutory merger. A key factor in determining the necessary amount of stock consideration is the "direction" of the merger (i.e., which of the companies survives).

For example, in an acquisition by means of a reverse triangular merger (where the target company survives the merger and becomes a subsidiary of the acquiring company), at least 80% of the value of the merger consideration generally must consist of voting stock of the acquiring company. Reverse triangular mergers are commonly favored for non-tax commercial reasons, such as minimizing the need to secure contract assignment consents.

By contrast, in an acquisition by means of a forward or forward triangular merger (where the target company merges into the acquiring company or its subsidiary and does not survive), only 40% of the value of the merger consideration must consist of stock of the acquiring company.

Other structures exist for best achieving gain non-recognition in more unique or complex situations, such as in situations where satisfying the requisite percentage of the value of the merger consideration represented by stock is in doubt, and where the transaction involves a merger of equals. The statutory and judicial requirements for these and the more common merger acquisition formats can be complex, and an in-house legal team can expect to benefit by looping in its tax team early in the process.

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