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Contract Assignment in M&A Transactions

By Ryan M. Murphy

Given the pace of M&A transactions and the abundance of issues to be negotiated, there is a danger that transferability of third-party contracts (*i.e.*, the need for consent and obtaining the same) can be lost in the shuffle. The deal complications associated with assignment of contracts—including delays in closing and a third party extracting concessions as a quid pro quo for consent—can erode transaction value. As such, it is incumbent upon deal counsel to identify potential hurdles to assignment and develop a strategy to avoid these potential impediments to closing. This article focuses on the intersection of Delaware law with contract assignment, namely the default rules for transferability as well as guidance on interpreting non-assignment clauses commonly confronted in the M&A context. In addition, practical considerations are offered to develop a strategy to manage the contract assignment process.

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I. Default Rules Governing Contracts Silent as to Transferability

The inquiry underpinning assignment is, absent the counterparty's consent, whether assignment is permissible and if the assigning party is relieved of liability post-transfer.[1] As with all contract questions, the relevant contractual language, if any, would govern these questions in the first instance. In the absence of applicable language, the default rule under Delaware law, which mirrors other U.S. jurisdictions, is that a contract that is silent as to assignment is transferable without consent.[2] This default rule is subject to the following well-recognized exceptions: (1) statutory prohibition,[3] (2) contrary public policy,[4] or (3) transfers that materially alter the parties' rights.[5]

[1] An often neglected distinction exists between the ''assignment'' of rights and ''delegation'' of duties. *See Reserves Dev. LLC v. Crystal Properties, LLC*, 986 A.2d 362, 370, n.22 (Del. 2009) (explaining that ''one can assign rights and delegate duties; however, one cannot *assign* duties'') (emphasis in original). For ease of reference, the term ''assignment'' herein includes both assignment and delegation.

[2] *See Grynberg v. Burke*, 1981 WL 15118, at *1 (Del. Ch. May 20, 1981); *see generally* Restatement (Second) of Contracts, § 317(2) (1981).

[3] The Bankruptcy Code is an example of a statute restricting assignment. *See* 11 U.S.C. § 365.

[4] Personal services agreements and intellectual property licenses are instances where public policy outweighs the interest in alienability of contracts. *See generally Industrial Trust Co. v. Stidham*, 33 A.2d 159, 161 (Del. 1942); Elaine D. Ziff & John G. Deming, IP Licenses: Restrictions on Assignment and Change of Control (2012).

[5] *See, e.g., Grynberg*, 1981 WL 15118, at *1.

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Moving to the corollary question of the continuation of the assignor's liability post-transfer, Delaware law provides that the assignor remains responsible for continued performance notwithstanding a valid assignment.[6] This default rule applies even though the counterparty assents to the assignment and accepts performance from the assignee post-transfer. As such, a novation is necessary to extinguish any liability arising under the contract after the assignment.[7] Delaware courts have recognized an ''implied novation'' based on the parties' conduct in limited circumstances. However, the counterparty's acceptance of continued performance by the assignee is inadequate to demonstrate that an implied novation was intended.[8]

II. Non-Assignment Clauses: 'Operation of Law' and 'Substantially All' Assets

Notwithstanding the default rules governing assignment, most contracts contain a form of non-assignment clause. Nevertheless, the omnipresence of ''contractual ambiguity'' can often require interpretation of such non-assignment provisions. Unsurprisingly, Delaware courts rely on well-developed doctrines of contract interpretation to construe non-assignment clauses.[9] Frequently, a non-assignment provision includes either or both of a (1) prohibition on assignment by ''operation of law'' or (2) an exception to the requirement of obtaining prior consent if the assigning entity transfers ''all or substantially all'' its assets.[10] Whether a transaction fits these contractually-prescribed parameters ultimately rests on the parties' intent as expressed through the specific non-assignment language. Delaware law, however, provides guidance on these issues that can inform an M&A strategy.[11]

A. Assignment by Operation of Law

Whether an assignment by ''operation of law'' has been triggered in the M&A context is dictated by the transactional structure, and whether there is a ''new'' entity acceding to the contractual rights post-closing.[12] Delaware courts have provided guidance on this principle of assignment by operation of law in examining the contrasts between stock purchases, forward triangular mergers and reverse triangular mergers.[13]

Generally, the acquisition of the equity of a contract party does not, in and of itself, constitute an assignment by operation of law. As explained by the Delaware Court of Chancery in *Baxter Pharmaceutical Products v. ESI Lederle, Inc.*, a purchase or change in ownership of securities, standing alone, does not qualify as an ''assignment'' since the target company remains intact as the same entity comprised of the same assets as existed prior to the transaction closing.[14] As such, the underlying contract rights are not being transferred to a new (or ''stranger'') entity.

The Delaware Court of Chancery in *Meso Scale Diagnostics, LLC v. Meso Scale Technologies, LLC*[15] analyzed forward triangular mergers and reverse triangular mergers under Delaware law—and reached divergent conclusions as to whether each is an assignment by operation of law. The Chancery Court dissected the language of the General Corporation Law of the State of Delaware to conclude that the rights and liabilities of the constituent corporation pass by operation of law to the surviving corporation as a result of the merger.[16] Therefore, with respect to forward triangular mergers, as the target company does not survive and its assets vest in the surviving corporation, an assignment by operation of law would result.[17] In contrast, since the target in a reverse triangular merger retains the relevant asset as the surviving entity post-merger, there is no assignment by operation of law.[18] Although *Meso Scale* focused on ascertaining the parties' intent in interpreting the relevant non-assignment provision, rather than promulgating ''blackletter law,'' the decision affirms the prevailing view that a reverse triangular merger does not result in an assignment of the target's contractual rights by operation of law.

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[6] *See Reserves Dev.*, 986 A.2d at 370; *Schwartz v. Centennial Ins. Co.*, 1980 WL 77940, at *2 (Del. Ch. Jan. 16, 1980); *see also* Restatement (Second) of Contracts § 318(1).

[7] *See Schwarz*, 1980 WL 77940, at *3 (citation omitted); *see also Fontana v. Julian*, 1979 WL 4633, at *3 (Del. Ch. Oct. 29, 1979). An effective novation requires the same elements required for formation of the underlying contract, namely a meeting of the minds and exchange of consideration.

[8] *See e.g., Schwarz*, 1980 WL 77940, at *2-3 (citation omitted); *The Reserves Dev. Corp. v. Esham*, 2009 WL 3765497, at *9 (Del. Super. Nov. 10, 2009).

[9] *See Tenneco Auto., Inc. v. El Paso Corp.*, 2002 WL 453930, at *1 (Del. Ch. Mar. 20, 2002).

[10] Non-assignment clauses often include additional exceptions to the requirement of obtaining prior consent. A typical carve-out is for a transfer to an affiliated entity.

[11] These concepts also arise in the context of ''change of control'' clauses. Although change of control clauses protect similar interests as non-assignment clauses, they are not interchangeable and must be analyzed separately.

[12] *See generally First Am. Fin. Mgmt. Co v. Royal Sovereign GP., L.L.C.*, 2010 WL 273422, at *1 n.1 (Del. Ch. July 9, 2010) (''A 'transfer of interest' in the corporate context takes place when one corporation becomes the successor, typically by merger, to the interest the original corporate party had in the proceeding.'') (citation omitted).

[13] A stock sale typically transfers the equity interests of the target entity without affecting its other assets. A forward triangular merger results in a target merging into a wholly-owned subsidiary of the acquirer, with the wholly-owned subsidiary surviving the merger. In contrast, in a reverse triangular merger, the target merges with the wholly-owned subsidiary but the target is the surviving entity.

[14] 1999 WL 160148, at *5 (Del. Ch. Mar. 11, 1999) (citation omitted).

[15] 62 A.2d 62 (Del. Ch. 2013).

[16] 62 A.2d at 82; *see also DeAscanis v. Brosius-Eliason Co.*, 533 A.2d 1254, 1987 WL 4628, at *2 (Del. 1987).

[17] *Meso Scale* distinguished two Delaware decisions which indirectly supported the proposition that both forward and reverse triangular mergers qualify as an assignment by operation of law. *See Tenneco*, 2002 WL 453930, at *3-4 (evaluating a forward triangular merger and observing that as ''a general matter in the corporate context, the phrase 'assignment by operation of law' would be commonly understood to include a merger,'' but finding that the parties did not intend to prohibit the merger in the applicable non-assignment clause because no adverse consequences to the counterparty could be identified); *Star Cellular Tel. Co. v. Baton Rouge CGSA, Inc.*, 1993 WL 294847, at *2-3, 8, 11 (Del. Ch. Aug. 2, 1993) (finding that since no unreasonable risks were created for the counterparty as a result of the forward triangular merger, the non-assignment provision would not be interpreted to prohibit the transaction).

[18] *Meso Scale*, 62 A.2d at 82.

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B. Disposition of All or Substantially All Assets

The author is not aware of any Delaware precedent that addresses squarely a non-assignment provision in the context of whether a contemplated transaction constitutes a sale of ''substantially all'' of the assignor's assets. This analysis instead arises under Delaware law in determining whether stockholder approval is required under Section 271 of the General Corporation Law of Delaware.[19] Nevertheless, guidance may be gleaned from Delaware law on this issue for purposes of developing a strategy on contract assignment in M&A transactions.

Delaware law provides a two-pronged ''qualitative'' and ''quantitative'' test as to whether a disposition constitutes ''substantially all'' of an entity's assets, which has been distilled to whether (1) the assets were quantitatively vital to operations, (2) the disposition is not in the ordinary course of business, and (3) the entity's existence and purpose is substantially affected.[20] This standard is highly subjective and contextual. Various economic metrics, such as asset value and income production, have been utilized to ascertain whether a transaction meets the ''substantially all'' standard. Although Delaware courts eschew any threshold percentage,[21] asset dispositions ranging from 50 percent to 80 percent have been found to trigger the ''substantially all'' designation in certain circumstances.[22]

III. Practical Considerations in Transaction Planning

As with other aspects of M&A transactions, identifying obstacles to assignment early on mitigates risks to a successful closing. Developing robust protocols in due diligence for reviewing and cataloging third-party agreements, including governing law provisions,[23] can assure that contracts impacting business continuity are accounted for appropriately in advance of closing.

Once the universe of potential assignment issues have been identified, a strategy can be developed to curtail potential pitfalls. This may include deploying a multi-step transaction structure designed to circumvent the limitations of a non-assignment clause. Although such a strategy needs to be considered in tandem with other deal considerations (*e.g.*, tax planning), employing a reverse triangular merger or similar multi-step arrangement may nullify a counterparty's consent right.[24]

If counterparty consents do need to be solicited, it is critical to negotiate the parties' respective obligations with precision to preserve deal value.[25] A gating issue to be resolved is the identification of any consents that are material to the business and the receipt of which will be a condition to closing. Unsurprisingly, this often is a source of friction both because of the impact on deal certainty and because of confidentiality concerns about disclosing the transaction to third parties, particularly those which may be competitors. As such, M&A transactions typically close prior to all required consents being obtained, and therefore the actions required to obtain consents post-closing, as well as the interim arrangement between the parties, must be defined with specificity. This includes delineating the ''efforts'' to be undertaken to seek consent (*i.e.*, ''commercially reasonable efforts'' versus ''best efforts'') as well as the interim ''pass-through'' of the benefits and liabilities of the underlying contract while consent is being obtained.

Despite a well-planned approach, the risk of a counterparty holdout cannot be removed entirely and therefore necessitates negotiation of potential remedies in the event a consent ultimately cannot be obtained. Such remedies include monetary recourse in the form of a purchase price reduction or indemnity for a breach claim by the non-consenting counterparty. In addition, a transition services agreement (or a sublicense with respect to intellectual property) may be a viable workaround to assure business continuity on a short-term basis. This requires careful scrutiny of the underlying contract to avoid inadvertently triggering a termination right by implementing this ''pass-through'' approach. It is common, however, for enterprise agreements to include a ''divested business clause'' authorizing transitional ''pass-through'' of contract rights for a designated period post-closing. At a minimum, this alternative may inject leverage into negotiations with the non-consenting counterparty to help secure consent to assignment.

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[19] Section 271 requires that the board's authorization of a ''[sale], lease or exchange'' by the corporation of ''all or substantially all of its property and assets'' be accompanied by the approval of the ''holders of a majority of the outstanding stock of the corporation entitled to vote thereon.'' 8 *Del. C.* § 271(a).

[20] *See Hollinger Inc. v. Hollinger Int'l, Inc.*, 858 A.2d 342, 378 (Del. Ch. 2004) (citation omitted).

[21] *See In re GM Class H S'holders Litig.*, 734 A.2d 611, 623 (Del. Ch. 1999) (observing that no bright-line rule has been issued).

[22] *See, e.g.*, *Winston v. Mandor*, 710 A.2d at 835, 843 n.32 (Del. Ch. 1997); *Thorpe v. Cerbco Inc.*, 1995 WL 478954, at *9 (Del. Ch. Aug. 9, 1995), *rev'd on other grounds*, 676 A.2d 436 (1996); *BSF Co. v. Philadelphia Nat'l Bank*, 204 A.2d 746 (Del. 1964); *Katz v. Bregman*, 431 A.2d 1274, 1276 (Del. Ch. 1981); *Gimbel v. Signal Cos.*, 316 A.2d 599, 606 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. 1974). *See generally Hollinger*, 858 A.2d at 349 (observing that the transfer of a ''major asset or trophy'' is not ''substantially all'' a company's assets where considerable income-generating assets are retained).

[23] Choice of law may be particularly relevant where different laws govern the relevant merger agreement and the third-party contract.

[24] *See generally Fletcher Int'l, Ltd. v. ION Geophysical Corp.*, 2011 WL 1167088, at *4-5, n. 39 (Del. Ch. Mar. 29, 2011) (relying on the doctrine of independent legal significance in respecting transaction structure that negated counterparty's consent right). This approach, however, is not wholly without risk as Delaware courts have applied the step-transaction doctrine (*i.e.*, collapsing a series of formally separate but related transactions) to equitably ''unwind'' certain transactions in other contexts. *See, e.g., Noddings Inv. Grp., Inc. v. Capstar Commc'ns, Inc.*, 1999 WL 182568, at *6-7 (Del. Ch. Mar. 24, 1999), *aff'd* 741 A.2d 16 (Del. 1999).

[25] Typically, the assigning entity with the existing relationship will seek consent via execution of a letter. Such letters must be crafted with precision to assure that the counterparty consents both to the assignment as well as the extinguishment of post-closing liability of the assignor.