*Jenkins'* Practical M&A Treatise

# Restrictions on Transfer of Contract Rights

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## 7. Restrictions on Transfer of Contract Rights

Many contracts contain clauses prohibiting assignment or transfer of the rights and obligations of the parties to those contracts. There are many reasons that contracting parties will require these provisions. For example, there may be concerns about the ability of a transferee to live up to the obligations under the contract, or there may be concerns that a transferee's financial condition may require alteration in the economic terms of the arrangement.

Sometimes, who the counterparty is goes to the essence of the contract. For example, if you are hiring someone to do a job for you, that person's unique qualifications may be the whole reason you hired her or him in the first place (and vice versa). It works the same way in a number of business settings. For example, if I'm franchising a business, I want to be very comfortable with the qualifications of my franchisee, because I'm going to be wholly dependent on them to generate the royalties that make up the bulk of my income for those franchises. Licenses of intellectual property are subject to similar considerations — my income is dependent on the licensee's efforts.

On other occasions, you may not care about whether the performance is rendered by the party you originally contracted with, but there may be some people that you *don't* want to deal with. For example, there may be real concern about preventing some specific party (*e.g.,* a competitor) from obtaining rights under a particular contract.

## I. Is a "Change in Control" an Assignment?

The law generally treats patent licenses and contracts that are in the nature of personal service contracts as being non-assignable, absent an express contractual right to assign them. Why are personal service contracts not assignable? Well, among other reasons, the 13th Amendment to the U.S. Constitution prohibits slavery and involuntary servitude.

But as to most other contracts, the assumption is the opposite — unless an assignment is prohibited, the contracting party will be free to assign its rights and obligations under the contract to somebody else. A contract right is property, and our laws generally have a policy of encouraging the ability to alienate property freely. Courts tend to look at restrictions on alienation with a jaundiced eye. To generalize, non-assignability clauses are usually enforceable, but are strictly construed.

We're not usually too concerned about the effect of a rule like this on the other contracting party, because if that party is concerned about assignments, it can simply contract to prohibit them without consent.

Issues about whether a particular transaction involves an assignment of a contract almost never arise in asset deals. In those cases, it is pretty clear that if someone is buying the rights to a contract, an assignment is being made. It gets more interesting in stock deals (whether structured as mergers or not), because there may often be no change in the identity of the party with whom you're contracting, even though the people behind it may have changed completely.

## Changes in Control as Assignments of Contract Rights

The ability to transfer contract rights without the other party's consent can add significant value to a seller's business by reducing the post-closing risks of the business to a potential buyer. On the other hand, the counterparty to a contract may have a strong desire to prevent a corporate seller's rights from being transferred without its consent.

Despite the importance of this issue, there is much more uncertainty about whether a particular M&A transaction will result in an assignment — and the degree of protection that a contractual non-assignment clause will provide — than is sometimes appreciated.

### Contract Rights Typically Assignable

The law has a fairly strong bias in favor of a business or individual's right to alienate their property — and only a narrow subset of contracts and licenses are presumptively non-assignable. Aside from patent licenses, franchise agreements and other personal service-type contracts, most contract rights can be freely transferred, unless the parties have agreed to prohibit assignment.

That sounds simple enough, but because of the presumption in favor of assignability, courts tend to view non-assignability clauses very narrowly — so if a party wants to protect itself against a change in control, it needs to do so with precision.

### Corporations Are Independent Entities

A corporation is an independent legal entity, separate from any other entities with which it may be affiliated — and that needs

to be kept in mind when negotiating a contract. As the Seventh Circuit put it in *U.S. Can v. NLRB*, a corporation's separate existence means that, generally, "a sale of stock, like a merger, does not affect the contractual obligations of the corporation."[610]

Some state legislatures have reinforced this point by including language in their statutes that expressly provides that a merger does not involve an assignment. See, *e.g., Colo. Rev. Stat.* § 7-90-204(1)(a) ("A merger does not constitute a conveyance, transfer, or assignment.")

**Case Law on Changes in Control & Non-Assignment Clauses**

Two cases illustrate courts' reluctance to construe changes in corporate ownership as violations of contractual prohibitions on assignment. In *INEOS Polymers Inc. v. BASF Catalysts*, the Seventh Circuit held that a change in the ownership of a corporate entity did not breach a supply agreement's non-assignment clause. The court noted that "the general rule is that a change in corporate ownership does not effectuate an assignment of rights."[611]

The Delaware Chancery Court reached a similar conclusion in *BASF Corp. v. POSM II*.[612] In that case, BASF contended that a contractual non-assignability clause allowing it to withdraw

[610] *U.S. Can Co. v. NLRB*, 984 F.2d 864, 868 (7th Cir. 1993).

[611] *INEOS Polymers Inc. v. BASF Catalysts,* 553 F.3d 491, 499 (7th Cir. 2009).

[612] *BASF Corp. v. POSM II*, C.A. No. 3608-VCS (Del Ch. March 3, 2009).

from a partnership if the business was no longer operated by its original partner was triggered by a sale of that company. The court held that although the entity's ownership may have changed, it was still operating the business and the withdrawal right had not been triggered by the change-in-control.

**Caveat Emptor: Not Every Court Sees Things This Way**

The cases discussed above indicate that the burden is generally going to be on the parties to the contract to protect themselves. No one should count on mergers and other change in control transactions involving corporate parties being regarded as assignments of contracts to which those entities are parties.

Despite this authority, buyers need to avoid complacency when it comes to the effect of change in control transactions on contract rights. Surprisingly, there simply is not a lot of case law from leading jurisdictions addressing whether mergers or stock purchases involve assignments.

For example, while there are a few Chancery Court decisions, there's been no ruling from the Delaware Supreme Court on the issue. Moreover, there are some cases that have concluded that change-in-control transactions do involve assignments of contract rights. For instance, in *National Bank of Canada v. Interbank Card Association*, a federal court held that a statutory amalgamation of two Canadian corporations involved an assignment under New York law.[613]

Similarly, three Delaware cases have held that forward mergers involved an assignment "by operation of law" for purposes of

[613] *National Bank of Canada v. Interbank Card Association*, 507 F. Supp. 1113 (S.D.N.Y. 1980).

triggering an anti-assignment clause (*Tenneco Automotive v. El Paso Corp.,*[614] *Star Cellular v. Baton Rouge CGSA, Inc.*),[615] and *MTA Canada Royalty Corp. v. Compania Minera Pangea.*[616]

Along similar lines, the Sixth Circuit in *PPG Industries v. Guardian Industries* held that the language then contained in Ohio's merger statute meant that licenses were transferred to the surviving corporation as a result of a forward merger in violation of a contractual non-assignment clause.[617]

There is also case law suggesting that a reverse subsidiary merger (*i.e.*, one in which the target is the surviving corporation) may also involve an assignment. In *SQL Solutions v. Oracle*, a California federal court held that a nonexclusive copyright license was "transferred" to the surviving entity in a reverse triangular merger and that the "transfer" resulted in a breach of the anti-assignment provision in the license agreement.[618]

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[614] *Tenneco Automotive v. El Paso Corp.*, C.A. No. 18810-NC (Del. Ch. March 20, 2002).

[615] *Star Cellular v. Baton Rouge CGSA, Inc* ,19 Del J Corp. L. 875 (Del. Ch. 1993).

[616] *MTA Canada Royalty Corp. v. Compania Minera Pangea,* C.A. No.: N19C-11-228 AML CCLD, (Del. Super., Sept. 16, 2020).

[617] *PPG Industries, Inc. v. Guardian Industries Corp*., 597 F. 2d 1090 (6th Cir. 1979).

[618] *SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458 at 4 (N.D. Cal. Dec. 18, 1991).

The Delaware Chancery Court more recently reached the opposite conclusion concerning reverse subsidiary mergers in *Meso Scale Diagnostics v. Roche Diagnostics*.[619]

**The Bottom Line**

Parties should craft clauses tailored to address the types of change in control transactions that they need protection against. In thinking about these clauses, parties should consider the transactions covered, the entities to be bound by them, the interests that need to be protected and the potential limitations to which corporate counterparties may be subject.

## II. Change in Control Clauses

In order to address the uncertainties associated with whether changes in corporate ownership or control represent an assignment of a business entity's contractual obligations, so-called "change in control" clauses are now routinely included in leases (and in other contracts for that matter) that are triggered by any type of change in corporate control.

These provisions help eliminate the uncertainty over whether a particular transaction will be deemed to be an "assignment" of a particular contract. But there are usually gaps in these, even today. The most notable is the number of contracts that do not expressly cover reverse subsidiary mergers within the scope of the change in control clause.

[619] *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, 62 A.3d 62 (Del. Ch. 2013).

**Practice Pointers: Change in Control Clauses**

The general unwillingness of courts to give a broad reading to a non-assignability clause demonstrates that parties need something beyond a standard prohibition on assignment to protect against changes in the ownership of a corporate counterparty.

Key points to keep in mind when drafting these "change in control" clauses include:

**Identify the Right Entities** — An effective change in control clause needs to keep in mind that the entity that you have contracted with may not be the only relevant one. If your counterparty is controlled by another entity, you will need to consider the extent to which changes in control of the parent entity should be covered by the change in control clause.

**Identify the Right Triggering Events** — A wide variety of transactions may have a significant impact on a contractual relationship. These include not only mergers or sales of a controlling stake in the entity or its affiliates, but also changes in the management of the company through proxy contests or other transactions that do not necessarily involve acquisitions.

Also, note that language that limits the definition of a change in control to mergers in which the corporation or its affiliates are not the surviving or resulting entities may not protect the other party if a transaction is structured as reverse subsidiary merger.

**Address Non-Volitional Events** — Consider the impact of events beyond an entity's control. For example, tender offers or acquisitions of significant ownership stakes may occur without

the consent of the board or other shareholders, but could have a profound effect on the business relationship.

Similarly, bankruptcy or similar financial related events may be beyond the control of the parties, but should not necessarily be beyond the scope of the change in control clause.

**Identify Key Interests at Stake** — The interests of the parties to a supply agreement or other arm's length commercial relationship may be quite different than those of a joint venture partner. In many commercial relationships, issues of the corporation's creditworthiness and financial stability may take precedence, but the non-financial aspects of the relationship may be of equal or greater importance in a joint venture.

**Appreciate Limitations** — In negotiating these provisions, keep in mind that there may be limits to the extent of the protections that corporations can agree to provide their counterparties. For example, unduly stringent "continuing director" provisions designed to protect creditors against a change in control of a debtor's board due to a proxy fight could involve a breach of fiduciary duty and be unenforceable.

When conducting due diligence on an M&A deal, these change of control provisions are one of the big things that the buyer's lawyers need to look for. What a change of control clause does, from a practical standpoint, is to allow a contractual counterparty the ability to reopen the economic arrangements between the two parties. Any buyer needs to know just how many of the contracts on which the business it is buying relies require a signoff if they're to continue in place after the deal closes.

In some instances, it may be possible to develop workarounds for the prohibitions on assignment contained in these clauses. In some cases, those workarounds may be structural in nature. As previously noted, many change in control clauses do not address reverse subsidiary mergers, in which the acquiring entity forms a merger sub that merges into the target, with the target surviving. Based on case law in Delaware and other jurisdictions, many buyers take the position that the prohibitions contained in these clauses can be avoided by structuring the deal as a reverse subsidiary merger.

In other instances, the parties may attempt to avoid assignment through contractual arrangements obligating the seller to provide the buyer with the economic benefit of that contract until such time as a formal assignment can be obtained. This Weil blog summarizes the technique:

> "But where the clause triggering a required consent is a standard anti-assignment provision and the transaction is structured as an asset purchase, there is a well-recognized and frequently used workaround: a specific provision provides that regardless of anything to the contrary in the agreement, no contract shall be assigned to the buyer if such an assignment, without the consent of the counterparty, would be ineffective or constitute a breach of the contract, and such consent is not obtained prior to the closing; however, the seller nonetheless agrees that the buyer will be entitled to the benefits of such contract and that the seller will hold in trust and act as buyer's agent in respect of any payments or other benefits of that contract until such consent is obtained (and the buyer

> agrees to correspondingly bear the economic burdens of the non-assigned contract)."[620]

In many instances, the parties may also simply conclude that the agreement is not important enough to address contractually, either by including it on a "required consents" list as a closing condition or by undertaking efforts to work around the restrictions on transfer contained in it.

[620] Glenn West and Maryam Naghavi, *How Anti-Assignment Workarounds Work (or Not*), Weil Global Private Equity Watch, (May 2, 2018), https://privateequity.weil.com/insights/anti-assignment-workarounds/.