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### MERGER AGREEMENTS

## Trends in M&A Provisions: After-Tax Indemnity Limitations



DANIEL AVERY, ELIZABETH NORMAN AND STEVEN SCHNEIDER

*Daniel Avery is a Director and Co-Chair of the Business Law Group at Goulston & Storrs, in Boston. Elizabeth Norman is an associate in the Tax Group at Goulston & Storrs, in Boston. Steven Schneider is a Director in the Tax Group at Goulston & Storrs, in Washington, D.C.*

*Mr. Avery is a member of the ABA's working group which published the 2013 ABA private company M&A deal points study. This is the 15th installment in a series of 25 articles being co-authored by Mr. Avery and looking at trends in private company M&A deal points. The previous articles can be found on Goulston & Storr's "What's Market" web page at <http://www.goulstonstorr.com/WhatsMarket>.*

*Mr. Schneider maintains a blog providing timely summaries and analyses of US tax law developments, which can be accessed at <http://www.taxlawroundup.com/>*

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### Introduction

In merger and acquisition ("M&A") transactions, the definitive purchase agreement (whether asset purchase agreement, stock purchase agreement, or merger agreement) typically contains representations, warranties, and covenants, along with related indemnification obligations, provided by the parties.<sup>1</sup> One related issue often negotiated between buyer and seller is whether the amounts recoverable as indemnified damages should be calculated on a "after - tax" basis; in other words taking into account any tax benefit that the indemnified party received as a result of the loss for which it claims indemnification.

In 2005, 2007, 2009, 2011, and 2013 the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Points Studies (the "ABA studies"). The ABA studies looked at the M&A agreements of publicly available transactions that occurred in the year prior to each study. In each year, the studies reviewed 128, 143, 106, 100 and 136 private company

<sup>1</sup> Note that within this article we use the terms "seller" and "company" in the context of a stock purchase transaction - - the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A purchase agreement, and the "company" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but for consistency we are using "seller" and "company" in a stock purchase setting.

transactions, respectively. These transactions ranged in size from \$17 million to \$4.7 billion, across a broad range of industry sectors.

This article examines trends in the prevalence of “after-tax indemnity limitations” in private company M&A transactions, as reflected in the ABA studies.<sup>2</sup>

## After-Tax Indemnity Provisions

### General

An after-tax indemnity limitation reduces the liability of the indemnifying party to the indemnified party by an amount intended to take into account any tax benefit received by the indemnified party on account of the underlying claim.

The typical M&A agreement includes indemnification from the seller to the buyer, and vice versa. However, since the seller’s representations, warranties, and covenants, and related indemnification obligations, would normally be broader in scope and substance than those of the buyer, it is usually the seller who seeks to include an after-tax indemnity limitation (since the seller is more likely to be the indemnifying party and therefore more interested in including provisions which reduce indemnification liability, even if applicable to the buyer as well). Accordingly, this article looks at after-tax indemnity limitations assuming that the seller is more inclined, and the buyer less inclined, to include such provision in the M&A agreement.

A typical seller indemnification provision in an M&A purchase agreement might read as follows:

The Seller agrees to and will defend and indemnify the Buyer Parties and save and hold each of them harmless against, and pay on behalf of or reimburse such Buyer Parties for, any Losses which any such Buyer Party may suffer, sustain or become subject to, as a result of, relating to or arising from: (i) any breach by the Seller of any representation or warranty made by the Seller in this Agreement; (ii) any breach of any covenant or agreement by the Seller under this Agreement, or. . . .

An after-tax indemnity limitation may read as follows:

Any calculation of Losses for purposes of this Article X shall be reduced to take account of any net Tax benefit actually realized by the Indemnified Party as a result of any such Losses.

### Seller’s View

In seeking to include an after – tax indemnity limitation, the seller would likely argue that to the extent that the indemnified party receives a financial benefit or credit resulting from the underlying loss for which indemnification is being sought, the “real” harm to the indemnified party is the amount of the losses **net of that benefit**. M&A purchase agreements often include provisions whereby indemnified losses are reduced to the extent that insurance policy proceeds cover those losses as well, or where another third party shares in the loss (such as through indemnity or contribution). The general purpose of these limitations is to ensure that the in-

demnified party only is able to recover with respect to its actual losses and not collect “twice,” in whole or in part, from the M&A purchase agreement indemnifying party and any other third-party, whether insurance company or otherwise.

To do otherwise, the seller would argue, would be to create an unfair “windfall” to the indemnified party. If that’s the case, why should tax benefits inuring to the benefit of the buyer not reduce the seller’s indemnification obligation?

The most common rationale for the seller’s position relates to situations where the buyer would be expected to get a tax deduction with respect to an indemnified loss. For example, if the seller provides a representation and warranty that the manufacturing facilities sold as part of the transaction are in good working order and meet all building codes, and the buyer following the closing learns that that is not the case and needs to do repairs to the building to bring it up to code, the buyer may bring an indemnity claim with respect to this breach by the seller of its representation and warranty. The seller may argue that in that case, if the buyer gets a tax deduction because it is spending money on the repairs as a business expense, that tax deduction should reduce the amount for which the seller is liable.

### Buyer’s View

A buyer will usually have several reasons why it believes an after-tax indemnity limitation is not appropriate, including the following:

- An indemnity claim is simply a contract claim for damages, and (particularly outside of the M&A context) breach of contract claims are not normally reduced by tax benefits resulting from the claim, even if the tax benefits exist.
- Determining the “tax benefit” attributable to a particular claim may be much more complicated than the language would suggest, particularly with larger companies where various tax credits, deductions and other related issues would be relevant. Timing issues, including precisely when any benefit is received, further complicate the situation.
- The buyer’s financial statements and tax records may be confidential and private, and not something that the buyer wants the seller having access to in the event of a dispute over the tax benefit received.

Often, if the buyer accepts in principle the argument that its indemnity claims should be reduced by corresponding tax benefits it may try to restrict the scope of this concept. The following is one example of this type of restrictive language:

Any payment hereunder shall initially be made without regard to this Section 8.08(b) and shall be reduced to reflect any such net Tax benefit only after the Indemnified Party has actually realized such benefit. For purposes of this Agreement, the Indemnified Party shall be deemed to have ‘actually realized’ a net Tax benefit to the extent that, and at such time as, the amount of Taxes required to be paid by the Indemnified Party is reduced below the amount of Taxes that it would have been required to pay but for deductibility of such Losses, in each case: (i) during the same Tax year as the year in which the relevant Losses occurred; (ii) calculated so that the items related to the Indemnifying Party’s indemnification obligations are the last to be recog-

<sup>2</sup> This article looks at the usage of after-tax indemnification provisions in private company M&A transactions as reflected in the ABA studies. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.

nized; and (iii) as reasonably determined by the Indemnified Party. The amount of any reduction hereunder shall be adjusted to reflect any final determination with respect to the Indemnified Party's liability for Taxes, consistent with the foregoing.

## Much Ado About Not Much?

While the seller's arguments and the buyer's responses, as set forth above, may seem logical and reasonable upon their face, as a practical and legal matter, all of this back and forth may be of very little actual impact, because it is unlikely that the buyer will in fact receive any federal tax benefit<sup>3</sup> with respect to a loss for which it is indemnified by the seller.<sup>4</sup>

Whether or not an indemnified loss could give rise to permanent tax benefits (the potential "windfall" to the buyer) depends on whether the buyer is treated as buying stock or assets for tax purposes.

### Stock Purchases

In a pure stock sale (one that is not treated as a deemed asset sale for tax purposes), certain indemnified losses may be deductible by the target corporation, because the target has actually made payments that give rise to the right to receive indemnification. Tax law, however, doesn't treat the indemnification payments as taxable income to the target corporation. Thus, the target corporation gets a deduction without offsetting income. The buying shareholders' tax basis in the acquired target corporation stock is reduced by the indemnification payment, and this amount is the "purchase price adjustment". In these cases, a non-tax-effected indemnity payment does more than just make the buyer whole, since the buyer has received a real economic benefit by virtue of deducting the indemnified loss. Thus, it makes economic sense for the seller to ask for an after-tax indemnity limitation in a stock purchase agreement – without this provision, the buyer could receive full indemnification for a loss, *plus* the (potentially substantial) economic benefit of the deduction of the loss. The true value of this additional, cost-free tax benefit, however, largely depends on whether the target corporation's tax benefit is through an immediate deduction or whether the target corporation was required to capitalize the payment (because, for example, it gave rise to a long-term benefit) and recover the cost through future depreciation or amortization or simply through a reduction of gain when the corporation disposes of the asset to which the indemnified cost was allocated.

### What's the real value of the deduction?

While the tax deduction will provide an economic benefit inside the target corporation, that's not the whole story. Remember that ***the indemnity payment itself is treated as a downward purchase price adjustment***. As a

result, the buyer will be deemed to pay less for the stock in the amount of the indemnity payment, and will have a correspondingly reduced basis in the stock of the acquired company. Generally tax benefit provisions only take into account the benefit of the deduction, but ignore the long-term cost of reduced basis. Whether or not the indemnification payment should be adjusted to take account of lower basis may be a point of contention between the buyer and the seller. However, it is worth noting that the reduced basis would not actually put the buyers in a worse position than they would have been in if they had known about the existence and cost of the indemnified item at the time of the closing and the purchase price was adjusted accordingly.

### What should the tax benefit offset provision look like?

While it may be difficult (or overly cumbersome) to draft a provision that perfectly captures the value of potential tax benefits related to an indemnified loss, the buyer should tailor after-tax indemnity limitations so that they are not inappropriately broad. For example, a buyer may not wish to agree to a provision that simply states that indemnity payments will be offset by tax benefits related to the indemnified loss. Instead, the buyer may want limits on the time frame (i.e., so that the offset only looks to deductions in the year of the applicable loss, or some other agreed-upon time period) and may also want to specify that the provision applies only to benefits that are *actually realized* (not just theoretically available). There are many different flavors of after-tax indemnity limitation provision, with varying limitations and methodologies, and buyers will want to be deliberate in drafting a provision that works for them.

### Asset Purchases

It's much more difficult to see how a tax benefit could arise in an asset sale.<sup>5</sup> Here there is no "outside" tax basis in target stock that needs to be addressed, because any adjustments to the price paid must be "pushed down" to the acquired assets. The problem of a cost-free tax benefit simply does not exist. For example, liabilities assumed by the acquired target company (presumably the source of any indemnified loss) must be capitalized into the cost of the assets acquired, and cannot be deducted by the acquired target company. As a result, in asset sales sellers will face an uphill battle in trying to identify situations in which the buyer could have a tax "windfall" by virtue of an indemnified loss. From a buyer's perspective, it makes sense to push back on the inclusion of any tax benefit offset provision in an asset purchase agreement, as including such a provision may invite long and costly debates down the road about whether there really was a net tax benefit intended or contemplated.

## Trends in After Tax Indemnity Limitation Provisions

According to the ABA studies, after tax indemnity limitations were included in 48% of the deals reported

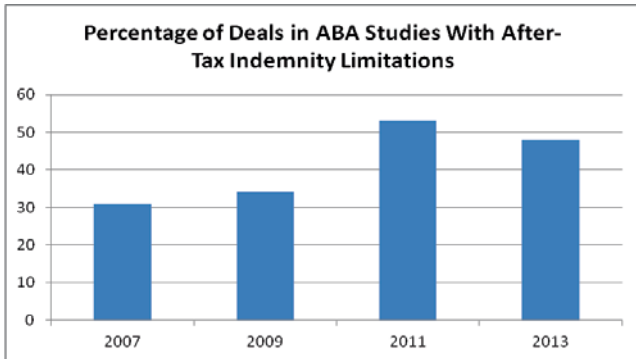
<sup>3</sup> The tax discussion and analysis herein is limited to US federal taxes. State, local or other taxes are beyond the scope of this article.

<sup>4</sup> See Corrigan and Lundsten, *Buyer Beware: Reduced Indemnity On Account Of Supposed (Mythical?) Tax Benefits*, Feb. 2013, reprinted on <http://www.jdsupra.com/legalnews/buyer-beware-reduced-indemnity-on-accou-59323/> December 14, 2014. ("Corrigan and Lundsten") (stating that "it may not be an overstatement (or at least it is a forgivable overstatement) to say that the tax benefit windfall is in most transactions elusive if not mythical.").

<sup>5</sup> See Corrigan and Lundsten ("in the case of a Stock Deal the seller's argument suffers significant weakness and limitation. In the case of an Asset Deal the argument has even less merit").

in the 2013 study. The previous three studies showed 53%, 34%, and 31% of reported deals, respectively, as including after-tax indemnity limitations (the 2005 ABA study did not cover this topic).

The following shows the information above in chart format:



So notwithstanding the potentially limited economic reality of an after-tax indemnity limitation, these provisions are still reasonably common in M&A transactions.

“I see this as a deal point between the parties on a regular basis” notes Mike Fondo, Senior VP, Tax of Audax Group, a private equity firm based in Boston, “and yet, the parties that insist upon it do not seem to really understand when, if, or how to possibly calculate what this tax benefit might be. Further, if the tax benefit is in the future, indemnifying for it is a nightmare from a practical perspective.”

## Conclusion

Whether or not indemnification claims should be reduced by purported tax benefits is a frequently negotiated term in an M&A agreement and, as reflected in the ABA studies, these reductions are often memorialized within the agreement. However, since in many cases, the buyer will be receiving limited if any tax benefit, at least as to federal taxes, with respect to a loss for which it receives indemnification from the seller, significant time and attention negotiating this issue may be at least partially misplaced.