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

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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.[2] One issue often negotiated is whether the amounts recoverable as indemnified damages should be calculated on an after-tax basis. In this instance, that means taking into account any tax benefit that the indemnified party received from the loss for which it claims indemnification. This article examines trends in the prevalence of after-tax indemnity limitations in private company M&A transactions.[3]

After-Tax Indemnity Provisions

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

M&A agreements typically include indemnification from the seller to the buyer, and vice versa. However, because the seller's representations, warranties, covenants, and related indemnification obligations are normally broader in scope and substance than those of the buyer, the seller is more likely to seek an after-tax indemnity limitation. This is because the seller is more likely to be the indemnifying party and, therefore, more interested in including provisions that reduce indemnification liability. Accordingly, this article examines after-tax indemnity limitations assuming that the seller is more inclined, and the buyer less inclined, to seek such a provision.

A typical seller indemnification provision in an M&A purchase agreement may read:

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 . . . .

Additionally, a related after-tax indemnity limitation may read:

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

Sellers' negotiating for an after-tax indemnity limitation often argue that if the indemnified party receives a financial benefit or credit resulting from the underlying loss for which indemnification is being sought, the “real” harm that the indemnified party suffers is the amount of its losses ***net of any financial benefit or credit***. M&A purchase agreements often include provisions that reduce indemnified losses (1) to the extent that insurance policy proceeds cover those losses, or (2) where another third party shares in the loss (e.g., through indemnity or contribution). Generally, these limitations ensure that the indemnified party only recovers for its actual losses and does not collect twice, in whole or in part, from both the indemnifying party and some other third-party (e.g., insurance company).

Not including an indemnity limitation, a seller may argue, would create an unfair windfall to the indemnified party. The most common rationale for the seller’s position relates to situations where the buyer would be expected to get a tax deduction related 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 the facilities require repairs to bring them up to code, the buyer may bring an indemnity claim for the seller’s breach. If the buyer makes a claim, the seller may argue that any business expense tax deduction that the buyer receives for spending money on the repairs should reduce the amount for which the seller is liable.[4]

Buyer’s View

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

- An indemnity claim is 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;
- Determining the tax benefit attributable to a particular claim may be more complicated than the language suggests, particularly with larger companies where various tax credits, deductions, and other related issues are relevant;
- Pinpointing when the tax benefit is received can be complicated; and
- The buyer’s financial statements and tax records may be confidential and private, and the buyer would not want to provide the seller access to these records if a dispute arose over the tax benefit received.

If the buyer accepts, in principle, the seller's argument that corresponding tax benefits should reduce its indemnity claims, it may try to restrict the scope of the reduction. The following is an example of a restricted limitation:

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 recognized; 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 may seem logical and reasonable, as a practical and legal matter, all of this back and forth may be of little actual impact. This is because it is unlikely that the buyer will receive any federal tax benefit[5] related to a loss for which the seller indemnifies it.[6] 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), the target corporation may be permitted to deduct certain indemnified losses because the target has actually made payments that give rise to the right to receive indemnification. Tax law, however, does not generally treat indemnity payments as taxable income to the target corporation, but instead as a tax-free recovery of capital.[7] Thus, the target corporation may get a deduction for the loss without offsetting income from the indemnity payment. Instead, the indemnity payment reduces the buying shareholders' tax basis in the acquired target corporation stock and this reduction in basis acts as a purchase price adjustment. In these cases, a non-tax-effected indemnity payment does more than just make the buyer whole, since deducting the indemnified loss provides the buyer with a real economic benefit. Thus, it makes economic sense for the seller to ask for an after-tax indemnity limitation in a stock purchase agreement because, without this provision, the buyer could receive full indemnification, *plus* the (potentially substantial) economic benefit of the deduction. The same dynamic could also apply to a purchase of a majority (but less than all) of the membership interests in an LLC. 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 (e.g., because 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 provides an economic benefit inside the target corporation, that's not the whole story. Remember that the indemnity payment 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 acquired company's stock. Generally tax benefit provisions only consider the benefit of the deduction, but ignore the long-term cost of reduced basis. Whether or not the indemnity payment should be adjusted to take account of lower basis may be a point of contention between the buyer and the seller. However, the reduced basis would not actually put the buyers in a worse position than they would have been 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 resist a provision that simply states that indemnity payments will be offset by tax benefits related to the indemnified loss. Instead, the buyer may negotiate for 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. There are many different flavors of after-tax indemnity limitation provision, with varying limitations and methodologies, and buyers should be deliberate in drafting a provision that works for them.

Asset Purchases

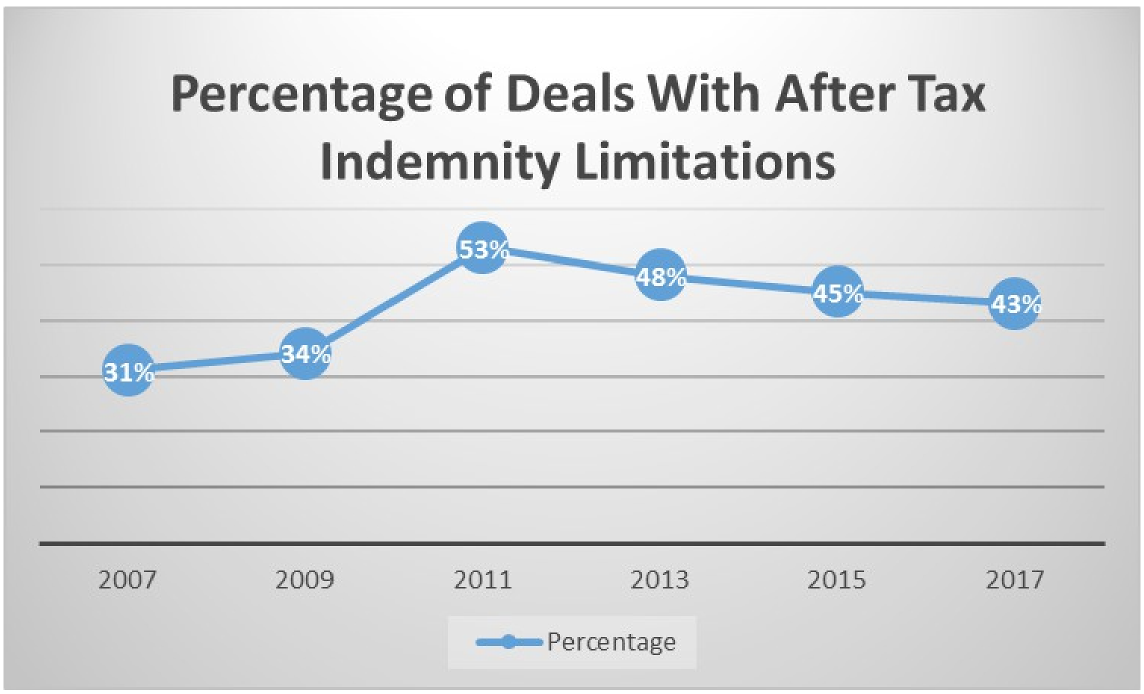
Compared to a stock sale, it is more difficult to see how a tax benefit could arise in an asset sale. [8] In an asset sale there is no "outside" tax basis in target stock to be addressed, because any adjustments to the price paid must be "pushed down" to the acquired assets. Thus, the problem of a cost-free tax benefit simply does not exist. For example, liabilities that the acquired target company assumes (presumably the source of any indemnified loss) must be capitalized into the cost of the assets acquired, and cannot be deducted. As a result, in asset sales sellers face an uphill battle in identifying situations in which the buyer could have a tax windfall resulting from 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 about whether there was a net tax benefit intended or contemplated.

This is also true for a stock sale or membership interest sale treated as an asset sale for tax purposes.

Trends in After Tax Indemnity Limitation Provisions

Every other year since 2005 the American Bar Association ("ABA") has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was $176.3 million.

According to the ABA studies, after tax indemnity limitations were included in 43% of the deals reported in the 2017 study. The previous five studies showed 45%, 48%, 53%, 34%, and 31% of reported deals, respectively, as including after-tax indemnity limitations (the 2005 ABA study did not cover this topic).



Tax indemnity limitations grew in prevalence across the first three ABA studies, to a peak of 53% for deals reported in 2010. In fact, 2010 was the first and only year that inclusion of such limitations represented the majority position. Since 2010, use of the limitations has steadily decreased, appearing in 43% of deals reviewed in 2017 study. Even though a minority position, and 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

Parties to M&A agreements frequently negotiate whether indemnification claims should be reduced by purported tax benefits. Further, as reflected in the ABA studies, these reductions are often memorialized within the M&A purchase agreement. However, because the buyer often receives limited or no tax benefit (at lease as to federal taxes) regarding a loss for which it receives indemnification from the seller, significant time and attention negotiating this issue may be at least partially misplaced.

[1] Daniel Avery is a Director in the Business Law Group, and Jon Stein is Counsel in the Tax Group, at Goulston & Storrs. Mr. Avery is a member of the ABA's working group which published the 2017 ABA private company M&A deal points study. Mr. Stein advises public and private companies, investment funds, and real estate investors on corporate, partnership, and international tax matters. This article is based on, and updates, the article of the same name co-authored by Mr. Avery, Steven Schneider, and Elizabeth Norman published in Bloomberg Mergers & Acquisitions Law Report, 18 MALR 307 2/23/15. This article is one of a series of over 20 articles co-authored by Mr. Avery looking at trends in private company M&A deal points. The series is currently being updated to reflect the 2017 ABA private company study and will be published throughout 2018. The articles can be found on Goulston & Storrs' "What's Market" web page at https://www.goulstonstorrs.com/Whats-Market/ and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[2] 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.

[3] This article examines the usage of after-tax indemnification provisions in private company M&A transactions. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.

[4] As a result of recently enacted tax legislation, amounts paid or incurred after December 22, 2017 for any settlement or payment related to sexual harassment or sexual abuse are not deductible if such settlement or payment is subject to a nondisclosure agreement.

[5] The tax discussion and analysis herein is limited to U.S. federal taxes. State, local, or other taxes are beyond the scope of this article.

[6] *See* Corrigan and Lundsten, *Buyer Beware: Reduced Indemnity On Account Of Supposed (Mythical?) Tax Benefits*, Feb. 5, 2013, reprinted on http://www.jdsupra.com/legalnews/buyer-

beware-reduced-indemnity-on-accou-59323. ("*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.").

[7] This non-taxable treatment may not apply to all indemnity payments. For example, the IRS generally considered tax indemnity payments taxable. *See, e.g.,* Private Letter Ruling 9833007 (May 13, 1998).

[8] *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").