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What Potential M&A Buyers Must Know About R&W Tax Risks

Michael Q. Cannon

Law360, New York (January 27, 2017, 11:00 AM EST) --Representation and warranty insurance is not a new product, but as any lawyer who regularly works on mergers and acquisitions transactions knows, in recent years the product's use has increased exponentially. Very generally, R&W insurance policies protect buyers by providing coverage for breaches of the representations and warranties in a purchase agreement.

More and more frequently in M&A deals, particularly in the context of competitive auctions, sellers will serve up drafts of purchase agreements that offer virtually no indemnity coverage, instead including a provision specifying that the buyer will purchase and pay for a R&W insurance policy. The allure, and increasing prevalence, of such policies is unsurprising.

From a seller's perspective, elimination of indemnity coverage offers certainty and finality. The proceeds from the deal received at closing will be the proceeds of the deal, with virtually no possibility of any clawback at a later date. Such finality is particularly appealing for certain sellers, including private equity funds, who generally desire to distribute sales proceeds to their investors as soon as possible rather than reserving cash against a future contingent liability (and in doing so negatively impacting the internal rates of return that they deliver to their investors).

And R&W insurance also offers benefits for buyers, even though many (but not all) purchase agreements impose a buyer cost by requiring the buyer to pay for the insurance coverage. In particular, because policies are generally underwritten by financially secure companies, securing such a policy can eliminate concerns about whether a seller (or guarantor) is sufficiently creditworthy to stand behind its representations and warranties. Similarly, because R&W insurers are repeat players in the market with reputations to protect, if an indemnification claim arises, a R&W insurance provider may be easier to deal with than a seller. Moreover, in a competitive auction context where a seller has not already suggested the purchase of a R&W insurance policy, a buyer's affirmative suggestion that the buyer is willing to acquire such a policy (and eliminate most or all of seller's indemnification obligations) can potentially give that buyer a leg up. Additionally, a R&W insurance policy can facilitate quicker deal signing, foreclosing the need for substantial negotiation of various indemnification matters (e.g., caps, thresholds, baskets, escrows, holdbacks, etc.) that are often among the most contentious deal issues.

With all of these (and other) advantages, it is not at all surprising that many parties to M&A deals (including their lawyers) are eager to agree early (often in term sheets or letters of intent) that a buyer's indemnification coverage will be limited (entirely or mostly) to a R&W insurance policy.[1] But all too

frequently, tax considerations are neglected as these commercial deals are struck, generally to the detriment of the buyer, who is left with inadequate tax coverage because of the limitations of R&W insurance policies.

To illustrate some of these inadequacies, it is useful to briefly consider the treatment of taxes in the context of a private deal for the acquisition of a corporate target that does not involve R&W insurance coverage. As most M&A lawyers know, taxes are often treated specially in purchase agreements. This special treatment is no accident, since taxes are unique in a number of respects. For example, unlike many types of liabilities, pre-closing tax liabilities are often not assessed until several years after closing, which generally results in longer survival period for tax representations.[2] Moreover, because potential tax liabilities are often much larger (and less contingent) than potential liabilities under other representations, frequently the limitations imposed on other seller indemnification obligations (e.g., caps, baskets, thresholds, etc.) are made inapplicable to tax claims and stand-alone pre-closing tax indemnity provisions are added to provide additional protection (including protection against known risks disclosed on the tax disclosure schedules that correspond to the tax representations in the purchase agreement). Additionally, because there are often tax payments that become due after the closing but that relate to taxable periods (or portions of those periods) prior to the closing (e.g., taxes reflected as due on final tax returns for pre-closing periods that are filed post-closing), purchase agreements frequently include special covenants requiring buyers to pay taxes shown as due on tax returns filed after the closing that relate to pre-closing taxes and blanket pre-closing tax indemnities that backstop these covenants. Furthermore, because buyers often take certain anticipated tax attributes into account in determining the amount they will pay for a target (e.g., net operating losses that will be available to shield future income), purchase agreements sometimes contain special, forward-looking representations and indemnities about the availability of those attributes.[3]

In sum, in private deals not involving R&W insurance coverage, tax lawyers utilize certain well-established techniques to address the unique aspects of tax risk to a purchaser. Yet all too often, parties (and their lawyers) forget that those exact same risks exist in deals involving R&W insurance and are often not adequately covered under the policy.

For example, some R&W insurance policies may have limited terms of only one or two years, and (as noted above) tax claims related to preclosing periods may arise much further in the future. Moreover, R&W insurance policies all have coverage limits, and depending on the tax risk profile of the target, these limits may prove inadequate if the target's tax risks materialize. Likewise, R&W insurance may prove inadequate in the face of known tax risks. Buyers will often discover some tax issues during the course of due diligence. In addition, sellers will also usually disclose some tax-related items on the disclosure schedules. R&W insurers, however, like most insurers, generally shy away from insuring against known, concrete risks, so many policies often contain exclusions for tax items discovered during diligence or disclosed on schedules to the purchase agreement. Similarly, nearly all policies exclude coverage for transfer taxes and taxes that have economically accrued preclosing that are not required to be paid until sometime after closing. Finally, most R&W insurers simply refuse to provide insurance for the risk that target tax attributes (e.g., net operating losses) are not at the anticipated level.

Thus, R&W policies potentially provide no or inadequate coverage against various tax risks. And while there is nothing wrong with a buyer agreeing to affirmatively accept certain tax risks in connection with an acquisition, buyers should do so knowingly, not inadvertently. Thus, buyers contemplating a R&W insurance deal (and the M&A lawyers who advise them) must (1) have a basic understanding that a number of tax risks exist and that some of these tax risks may not be adequately addressed under a R&W insurance policy and (2) consult with tax counsel sufficiently early on in the negotiating process (generally

at the term sheet or letter of intent stage) to ensure that the buyer is not blindsided by unanticipated tax risks as a result of a hasty willingness to agree to rely on R&W insurance coverage only, particularly since there are a number of approaches that tax counsel can suggest for risk-conscious buyers that want to address those risks.

Michael Q. Cannon is a tax associate with Gibson Dunn & Crutcher LLP.

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[1] Because most R&W insurance policies have a retention amount (i.e., deductible), often a seller will agree to provide a narrow indemnity strip equal to all or part (e.g., 50 percent) of the retention amount.

[2] For example, the U.S. federal income tax statute of limitations is generally three years (although there are exceptions where the statute is longer and the statute of limitations can also be extended by agreement between the Internal Revenue Service and a taxpayer), but that statute does not begin to run until a return is filed. See Code § 6501(a), (e)(1). Most federal corporate income tax returns are filed nearly nine months after the applicable tax year has ended. See Code § 6072; Treas. Reg. § 1.6081-3. Thus, even in the normal case, there is a substantial risk of a material tax assessment for almost four years after closing. And in jurisdictions where a target company does not file tax returns, the statute of limitations generally remains open indefinitely. See, e.g., Code § 6501(c)(3). All references to the “code” in this article refer to the Internal Revenue Code of 1986, as amended.

[3] For example, where the target has net operating losses, the purchase agreement will often contain a representation stating that those net operating losses are not currently limited under provisions such as Code Sections 269 and 382, which are aimed at preventing trafficking in net operating losses.

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