Allegheny Tax Society

Doing Deals - M&A, Tax, and Other Fun Things

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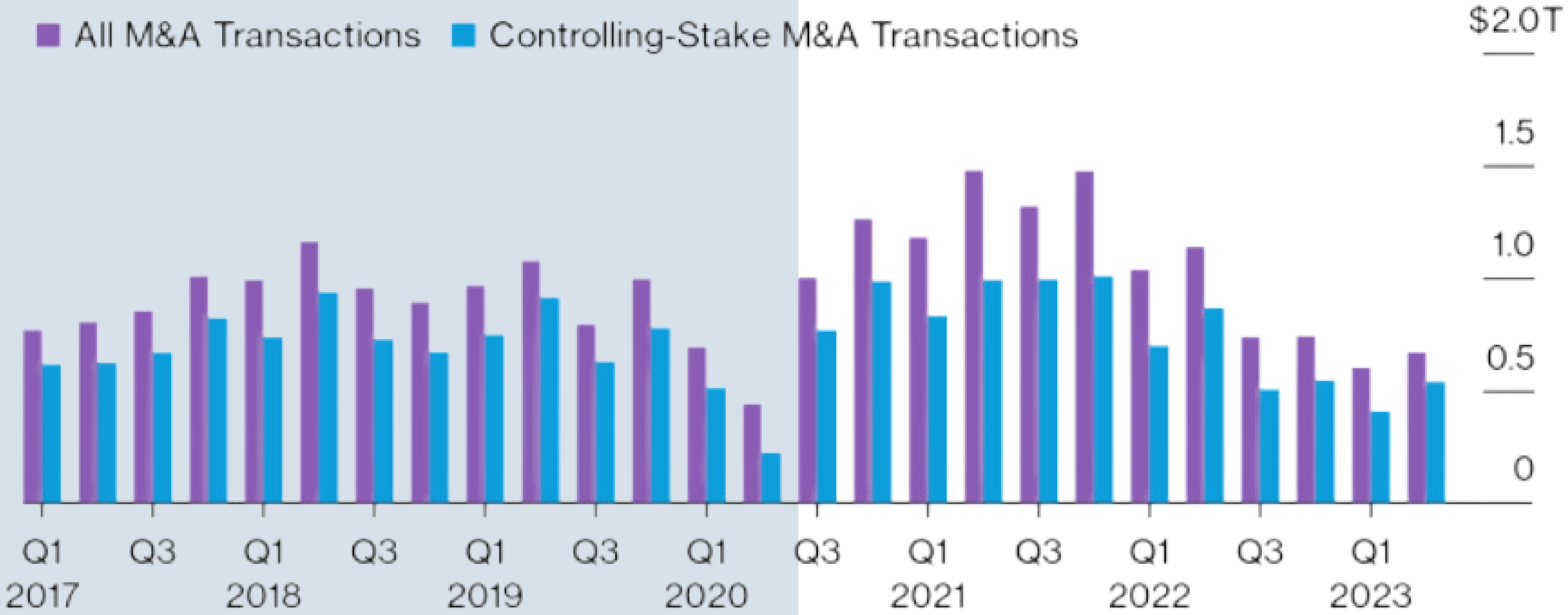
OVERVIEW

- Where We've Been?
- Perspectives on 2023
- M&A Lawyers + Tax Specialists?
- Structuring Transactions
- Developments in Tax Provisions
- Innovative Tax Insurance Products
- An Important Case
- A Real-World Application
- Where We're Going - 2024

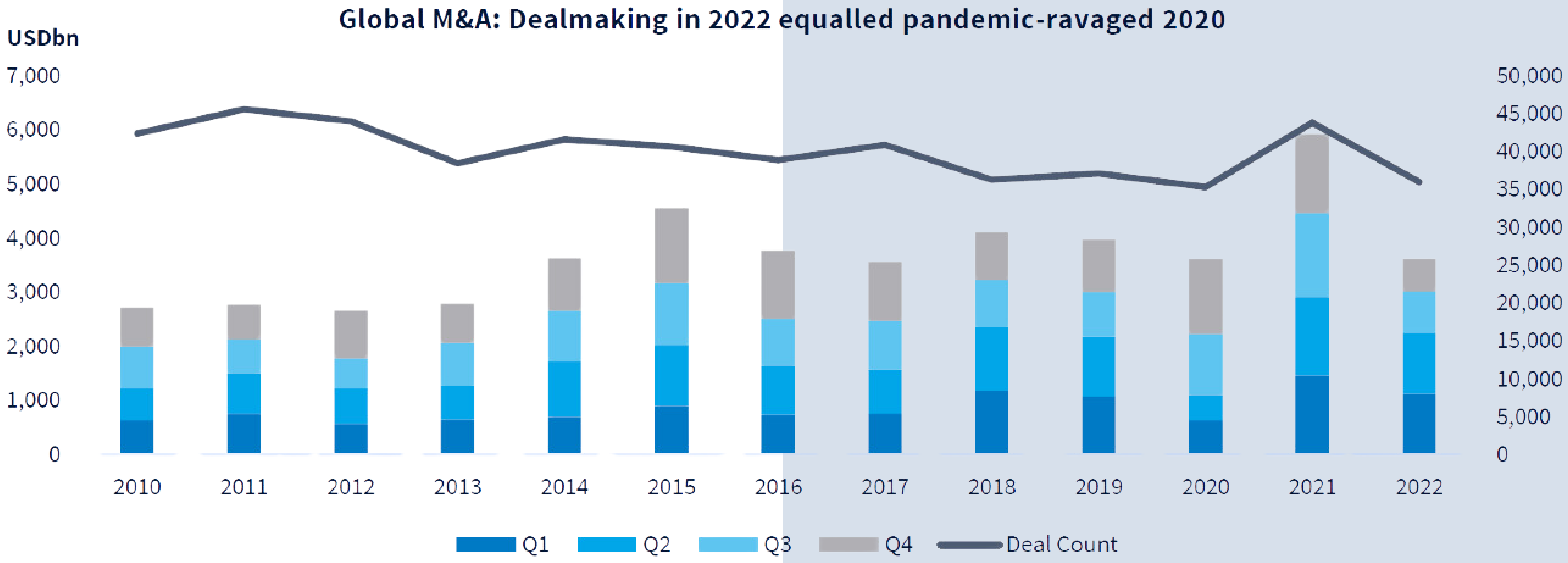
WHERE WE'VE BEEN



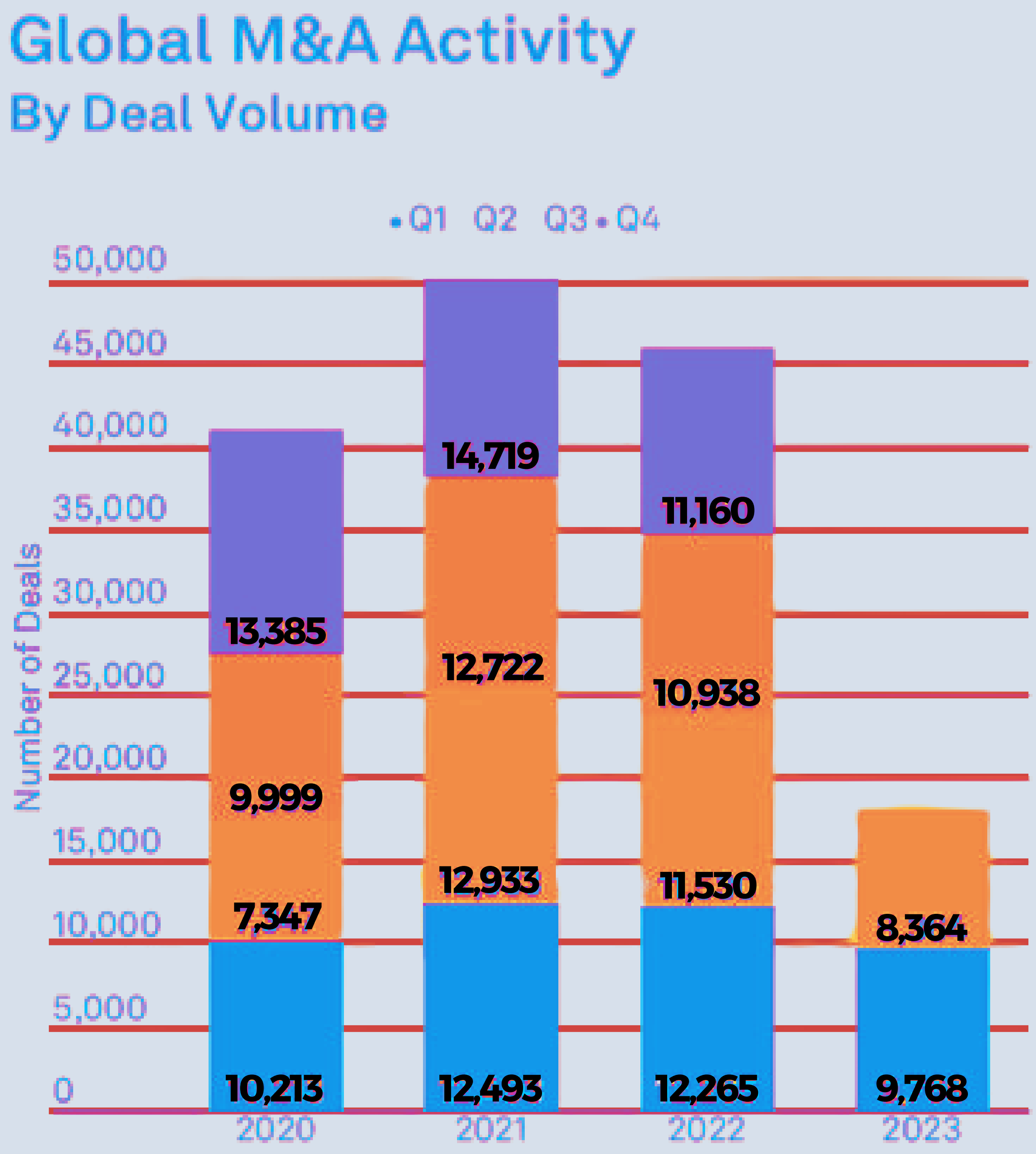
Source: Bloomberg as of July 4, 2023. The data include all pending and completed mergers and acquisitions announced between Jan. 1, 2017 and June 30, 2023.

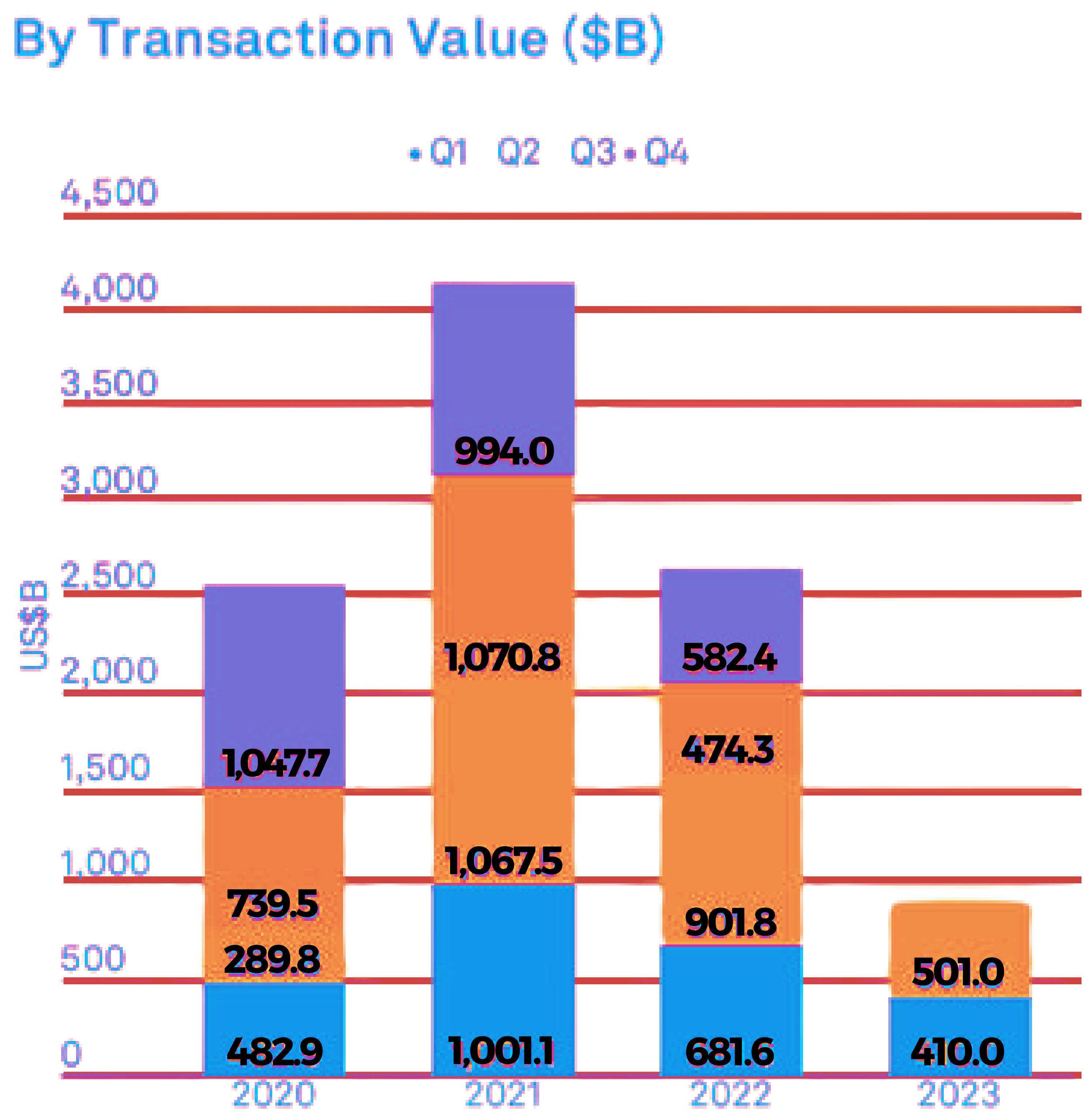
Bloomberg Law

WHERE WE'VE BEEN cont.



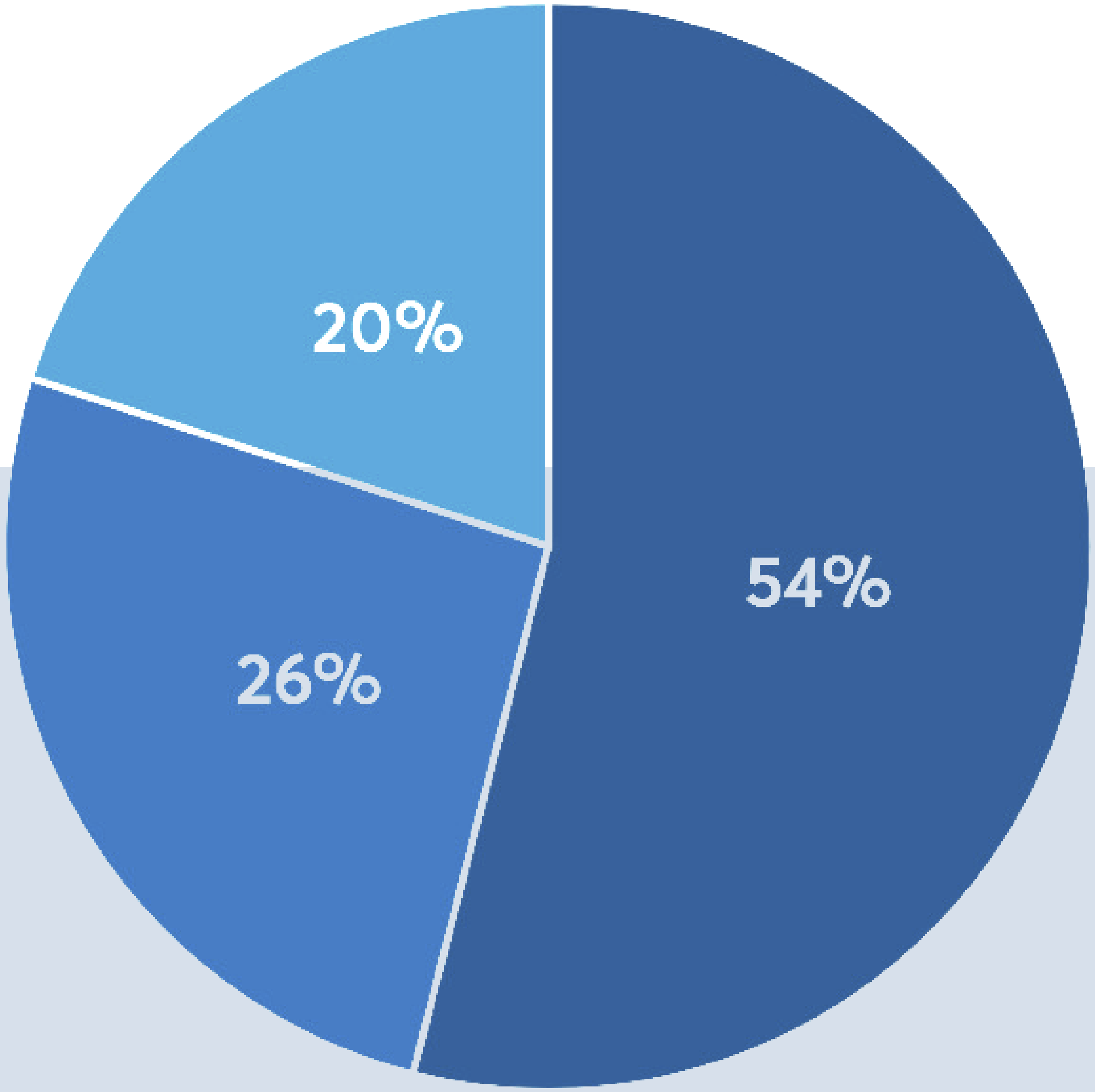
QUARTERLY GLOBAL ACTIVITY BY DEAL VOLUME





PERSPECTIVES ON 2023

- **Recent Trends in M&A**
  - Increase in the use of alternative transaction structures, earnouts, joint ventures and minority investments
  - Increased importance on due diligence
  - Increase in claims, litigation and disputes
  - Tax planning, structuring, and indemnities front-loaded
  - Offloading tax risks



Source: Bloomberg Tax

M&A tax advice

Tax departments are more involved in advising on M&A

- Highly involved, 54%
- Extremely involved, 26%
- Somewhat/slightly involved, 20%

M&A Lawyers + Tax Specialists

- Strong relationships between M&A lawyers and Tax Specialists lead to a better deal process

- But “Don’t Let the Tax Tail Wag the M&A Dog”
    - Tax Jargon - legal terms not matching deal terms
    - Focus on the “Big Picture”
    - Tax work silos
    - Keeping Perspective

FRONT-LOADING TAX

Tax advice is increasingly sought earlier in the transaction to find the structure that best suits the transaction.

How It Used to Be...

EARLY ADVICE: DEAL STRUCTURES

- Tax considerations involved in M&A deals vary depending on the form of the transaction and the entities involved.

- Example Deal Structures
  - Stock Purchase
  - Asset Purchase
  - Mergers

M&A Deal Structures 101

Generally, the structure of the transaction involves a balancing of often competing business, tax, corporate law, contract, securities law, and accounting considerations.

That's a lot to wrap your arms around!

General Considerations

- Public company or private company
- State of incorporation, and type of entity (e.g., LLC, LLP, S Corp, C Corp, etc.)
- What is Buyer buying? Everything? Carve-out?
- Is Seller business in a standalone entity or operated as a division of a larger entity?
- Are there assets/businesses the Buyer does not want?

Tax Considerations

- Tax treatment for Seller
- Tax treatment for Seller stockholders
- Availability and allocation of tax benefits like NOLs

Corporate Law

- Seller shareholder approval
- Buyer shareholder approval (stock consideration?)
- Appraisal rights

Additional Structuring Considerations cont.

- Leverage is an important but shifting thing
- Liability profile of the target business
- Indemnification? RWI Insurance?
- Third party/other consents, regulatory requirements
- State statutes (Delaware, Revlon-land, management favorable PA?)
- Stock purchase, asset deal, or merger?

Additional Structuring Considerations cont.

Tax Considerations

– Taxable or "Tax Free" Transaction

- – structure can change the result (form makes a difference in outcome)
- – the nature and amount of the consideration to be received in the transaction (with consideration being at least 50% stock), and
- – the nature of the entity that is the Seller (c-corp, s-corp, or a pass-through)

– For taxable deals, Seller is taxed on the gain recognized on the sale of the assets sold.

- – Cash Plus
- – Fair market value of property received plus
- – Liabilities assumed (in an asset sale) less
- – Tax basis in assets sold

Basic Deal Structures

Stock Purchase

Asset Purchase

Mergers....and lots of options in between.

Stock Purchase

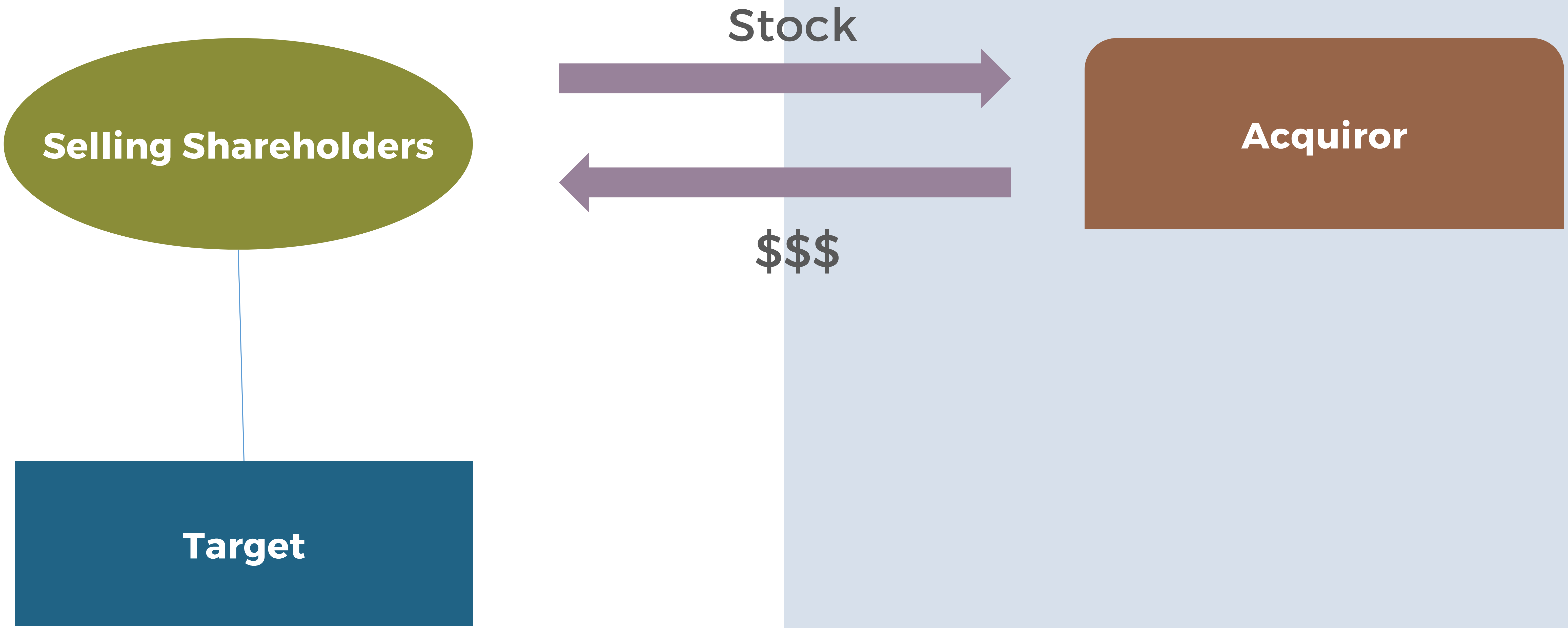
Overview

Buyer acquires Target's outstanding stock from the shareholders of Seller for stock of Buyer, cash or other consideration.

Completed through a stock purchase agreement

- Negotiate directly with Seller's shareholders (this can be a problem)
- Can pick up less than or 100% of outstanding shares (most strategic Buyers will want 100% ownership)
- Target continues to hold all of its assets and liabilities both before and after the transaction – now with different owners

Stock Purchase cont.



Stock Purchase cont.

Pros and Cons to Stock Purchase

Buyer

- May be able to avoid transfer taxes
- Cannot choose specific assets and liabilities (must assume both known and unknown)
- Does not receive "step-up" in tax basis

Seller

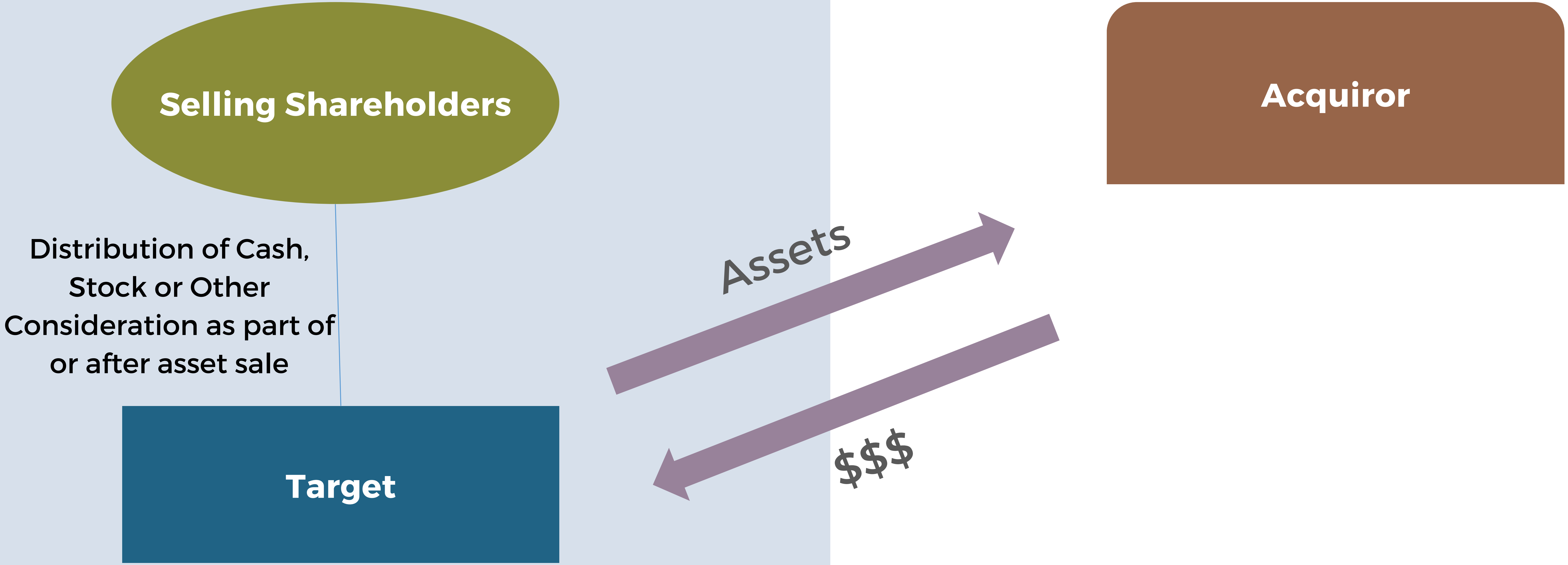
- Able to transfer any contingent liabilities
- Cash goes directly to shareholders

Asset Acquistion

Overview

- Buyer acquires specific assets of Seller for some type of consideration and the assumption of none, some or all of the related liabilities of Seller.
- Completed through asset purchase agreement
  - Negotiate directly with Seller's management
  - Able to specify assumed and excluded assets and liabilities (able to carve unwanted liabilities)
  - Seller survives acquisition holding with
    - Excluded assets
    - Excluded liabilities and
    - Unless distributed to Seller's creditors or stockholders, the cash, stock or other items paid as consideration

Asset Acquisition cont.



Asset Acquisition cont.

Pros and Cons to Asset Acquisition

Buyer

- You can pick and choose
- Be careful not to miss things you want
- Lower risk of assuming unknown or undisclosed liabilities
- Often better tax treatment than stock acquisitions
- Separating intermingled businesses (e.g., manual contract and employee transfers, dealing with shared services and IP)

Seller

- Left with liabilities not assumed
- If Seller is not a disregarded entity, often better tax treatment when selling stock
- More complicated (e.g., assigning specific assets, transferring employees, transitional services and shared IP)
- Takes longer than other structures...maybe!

Not always a free liability ride! **You can't assume that Buyer has no risk for liabilities that aren't expressly assumed (products claims, fraudulent transfer risk, tax and other successor liability claims)**

Mergers

– Three basic structures, all of which involve statutory mergers in which Target's outstanding stock is converted into the right to receive stock of Buyer, cash or other consideration:

Forward Merger	• Target merges into Buyer, with Buyer as surviving corporation • Note: requires approval of Buyer's stockholders (as well as Target's stockholders)
Reverse Triangular Merger:	• Subsidiary of Buyer merges into Target with Target as surviving corporation
Forward Triangular Merger:	• Target merges into Subsidiary of Buyer, with Subsidiary as surviving corporation

– Reverse Triangular Mergers tend to be the most common structure, as it allows the entity to be purchased and survive post-closing as a subsidiary of Buyer (fewer third party consents, no direct hiring of employees, etc., allowing more work to be done post-closing as opposed to prior to closing)

DEVELOPMENTS IN TAX PROVISIONS

- "No Undisclosed Liabilities"
- Compliance with Law
- Survival/Time to Assert Claims
- Baskets

“No Undisclosed Liabilities”

Representation Formulations

BUYER-FAVORABLE FORMULATION

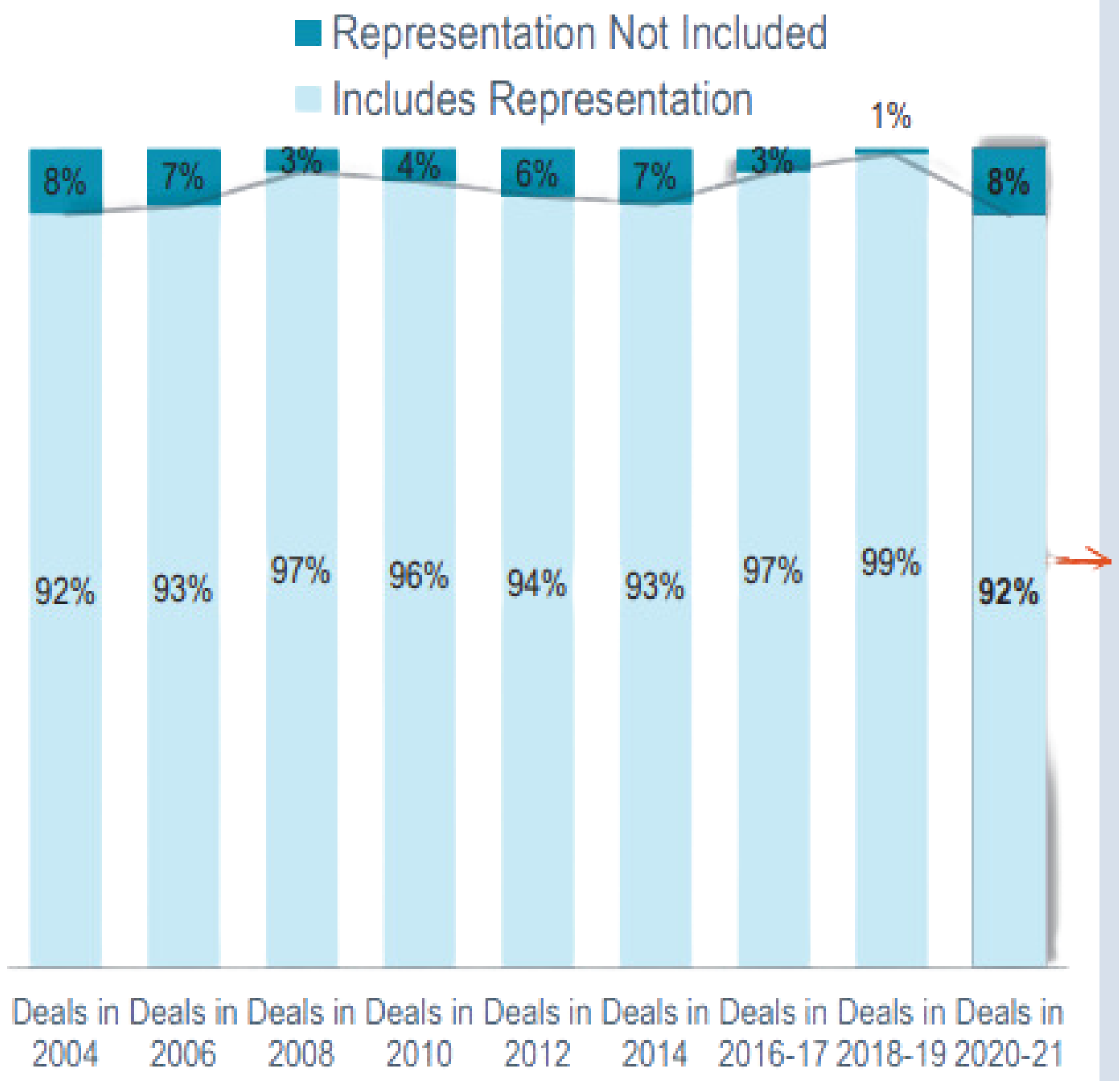
Target has no liability except for liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in Target’s ordinary course of business since the date of the Interim Balance Sheet.

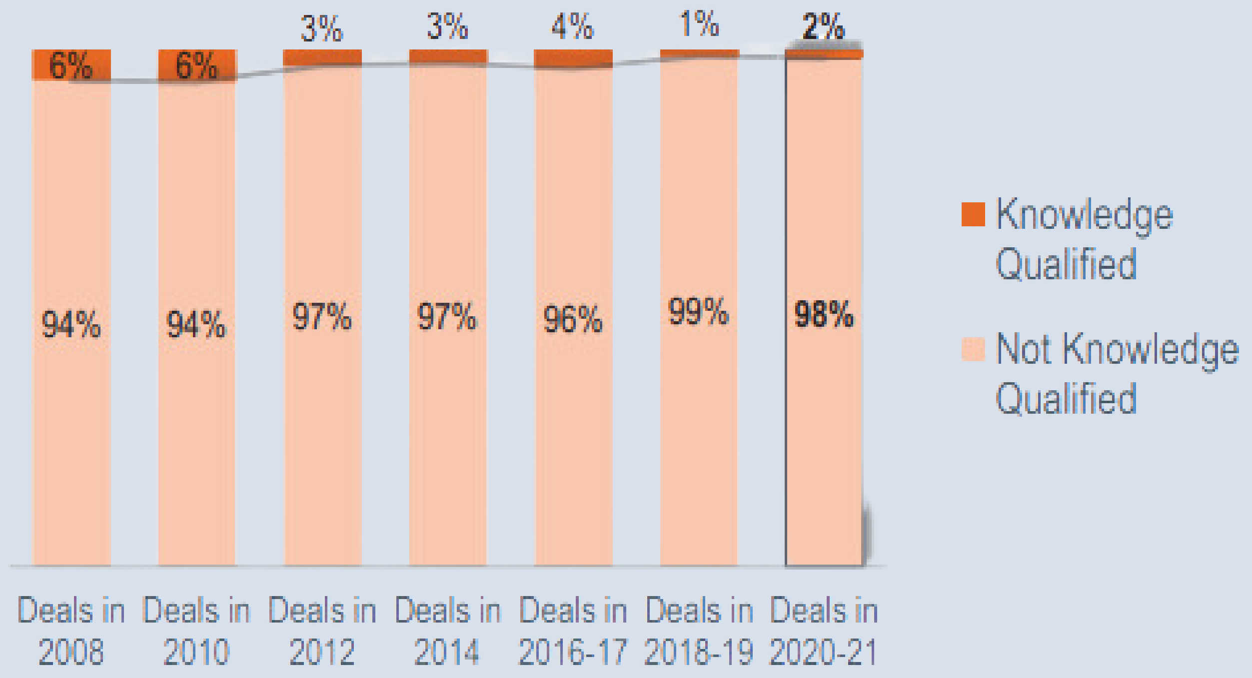
TARGET-FAVORABLE FORMULATION

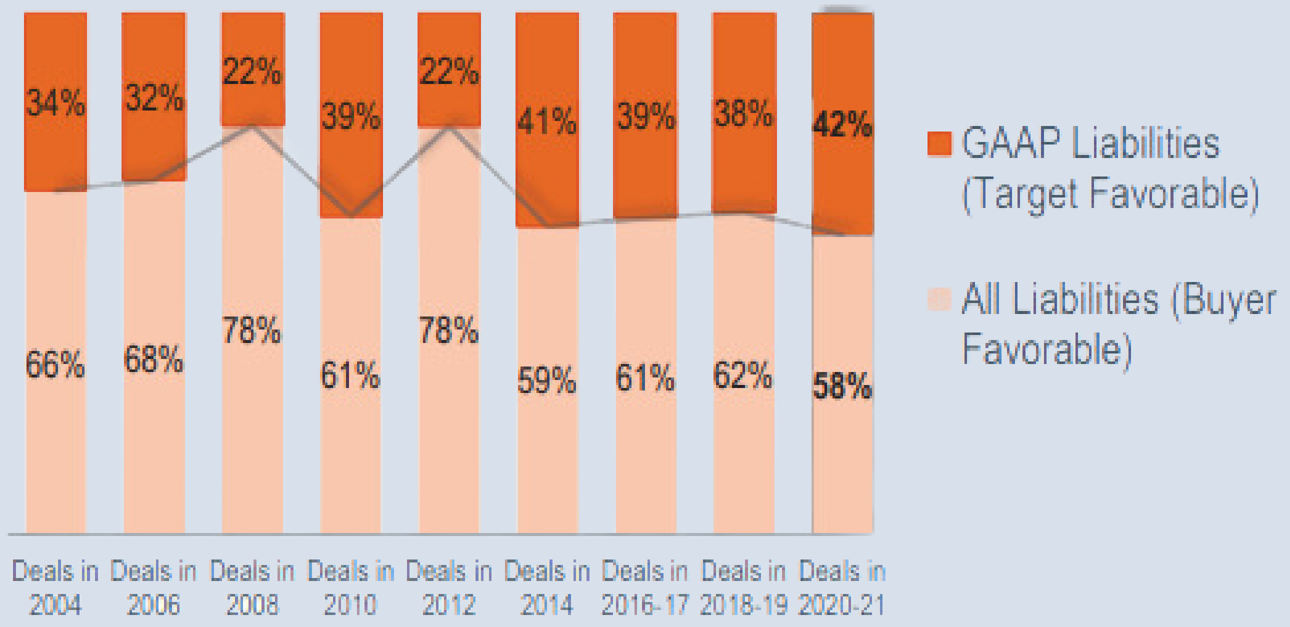
Target has no liability **of the nature required to be disclosed in a balance sheet prepared in accordance with GAAP** except for...

Source: ABA Private Target Study 2021

“No Undisclosed Liabilities” cont.

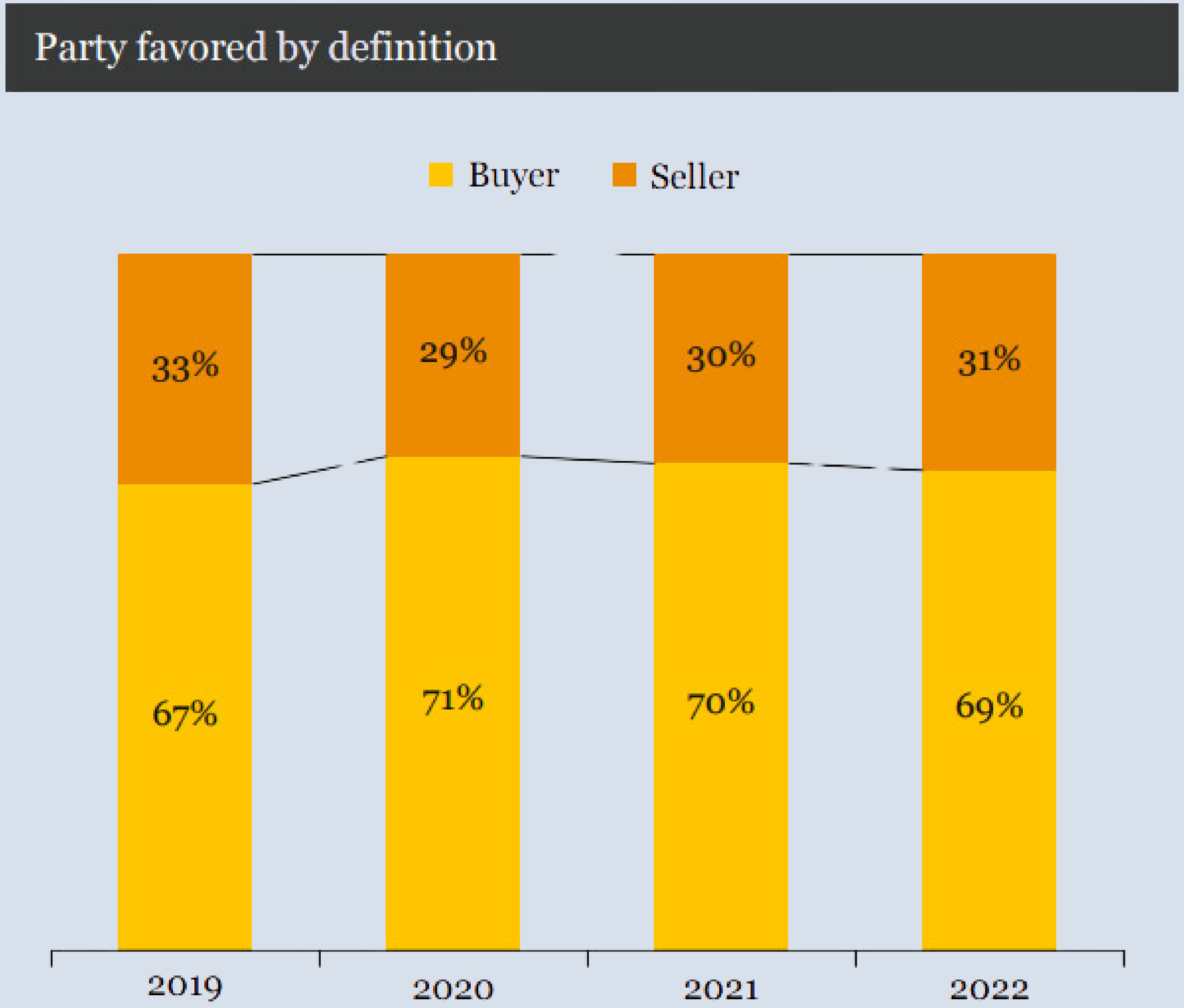


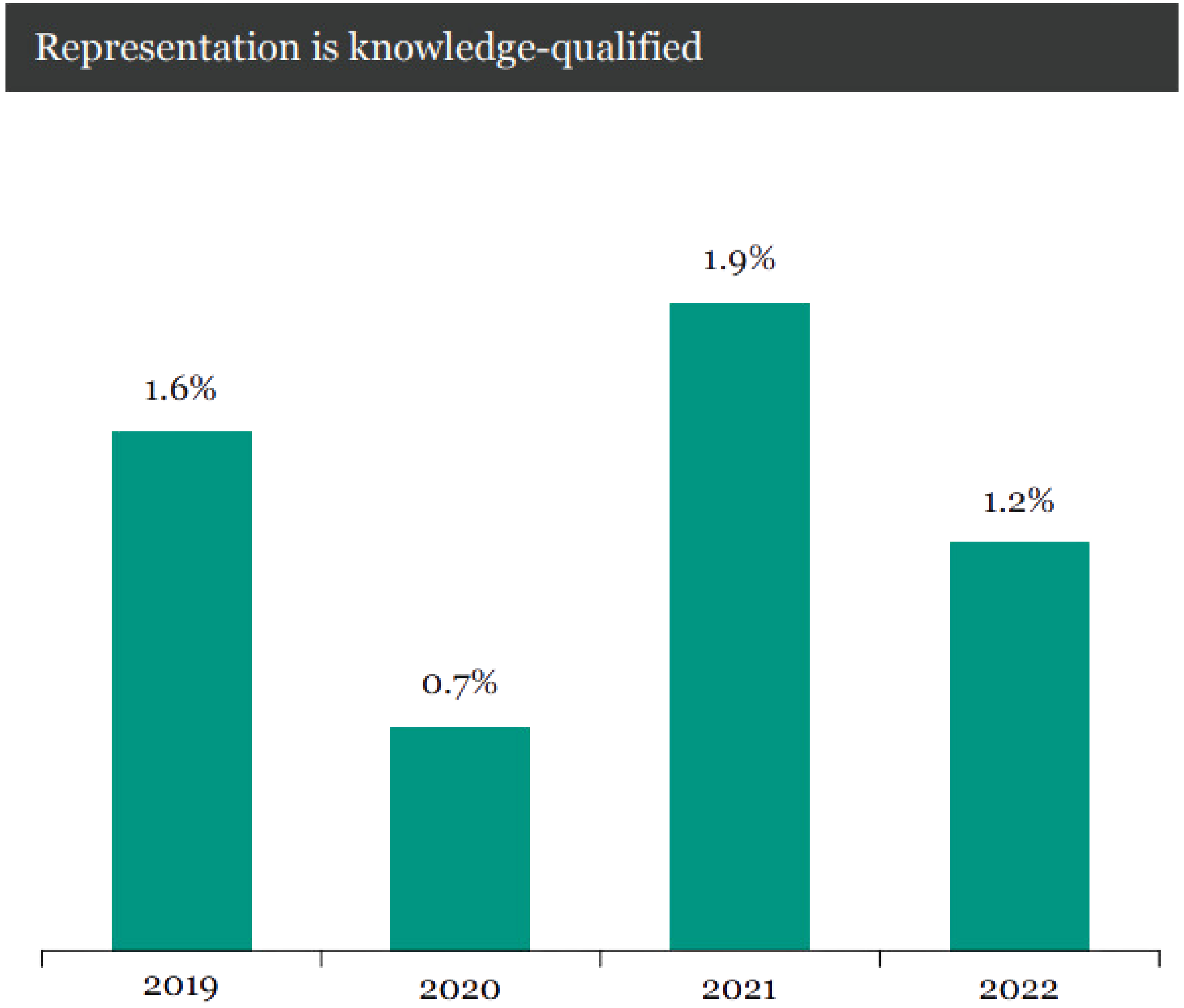




Source: ABA Private Target Study 2021

“No Undisclosed Liabilities” cont.





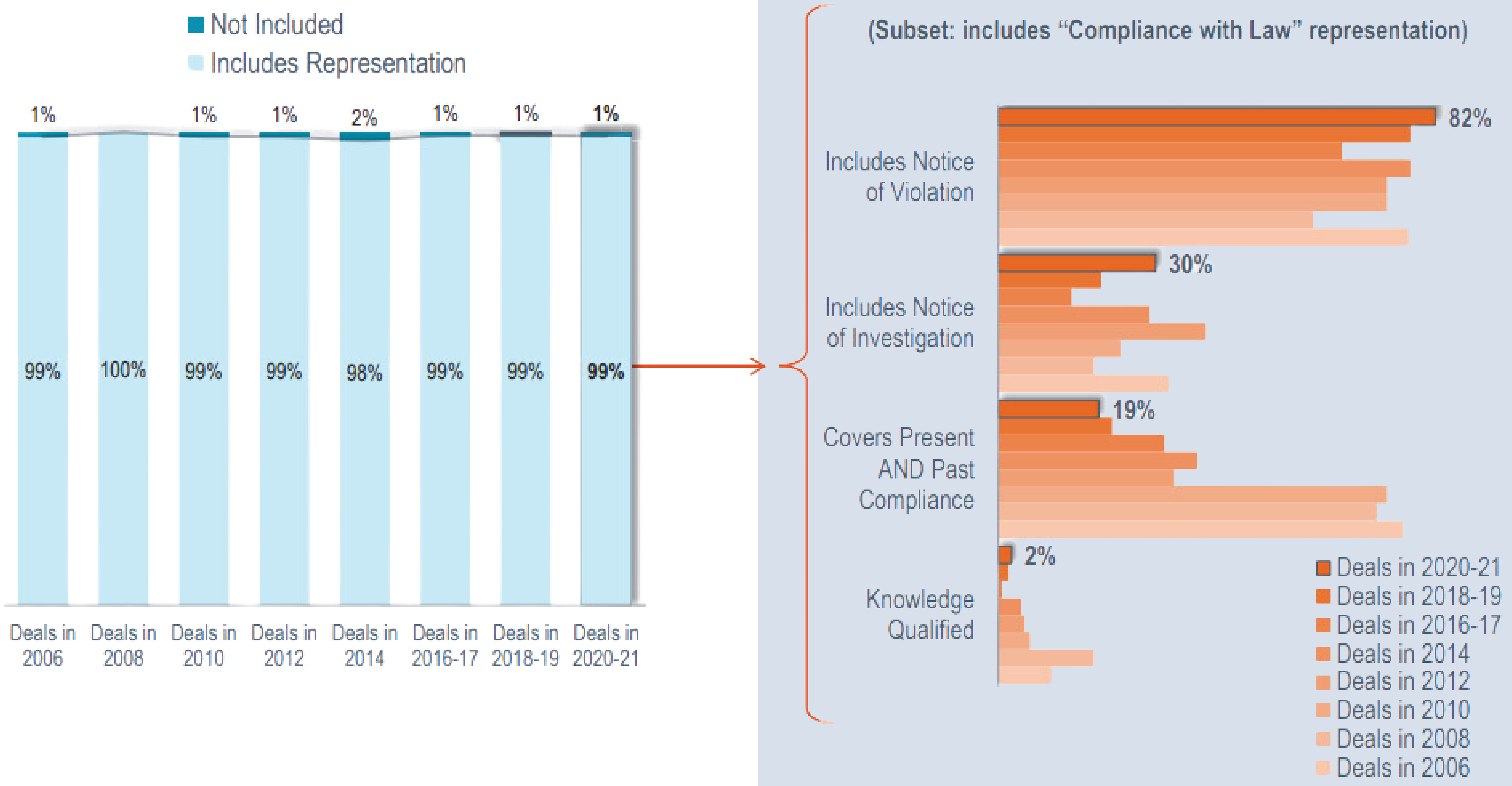
Source: SRS Acquiom 2023

Compliance with Law

[To the Seller's Knowledge,] the business of Target [has been and] is being conducted in compliance with all applicable laws.

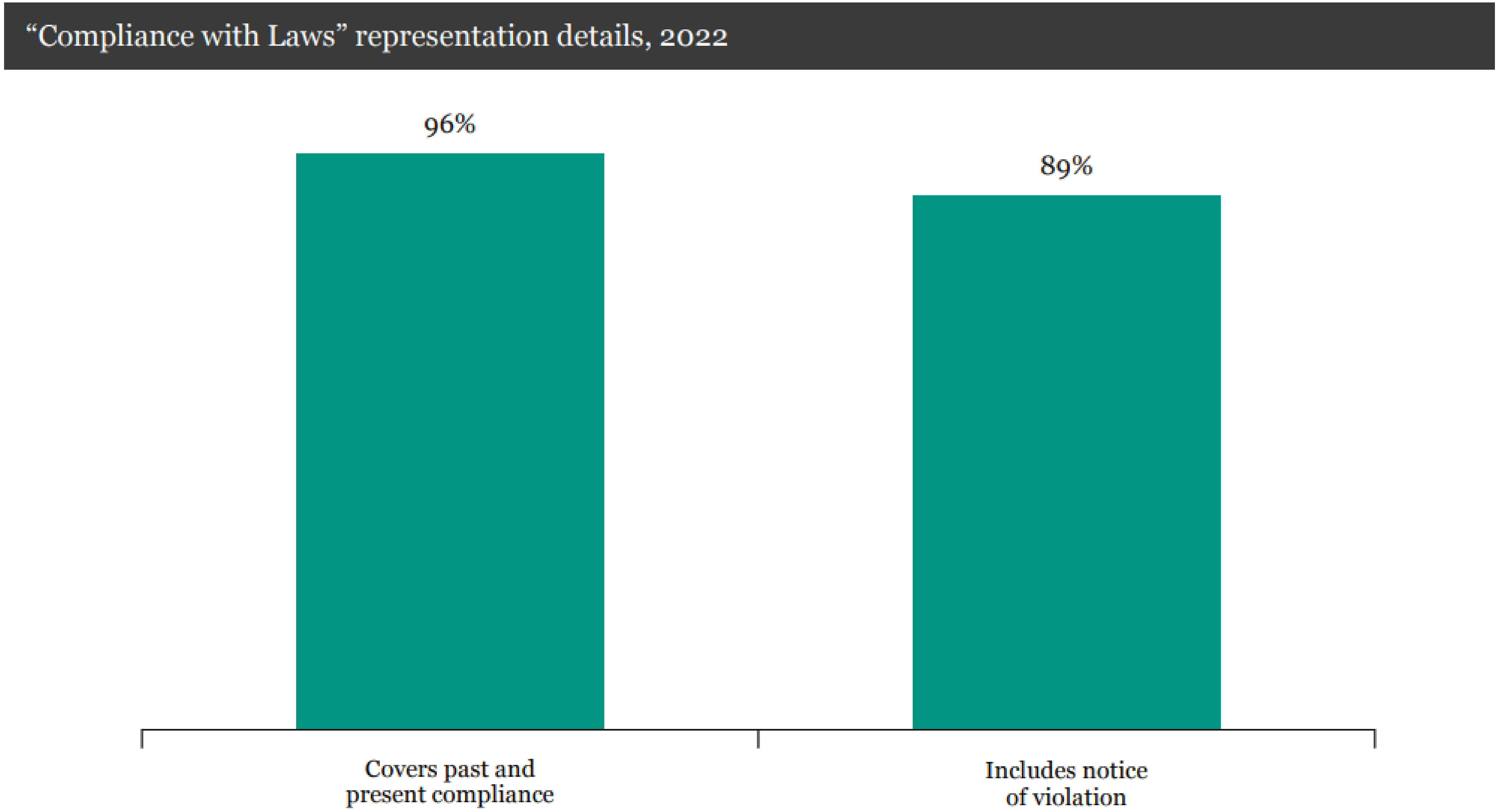
Source: ABA Private Target Study 2021

Compliance with Law cont.



Source: ABA Private Target Study 2021

Compliance with Law cont.



Source: SRS Acquiom 2023

Survival/Time to Assert Claims

Survival

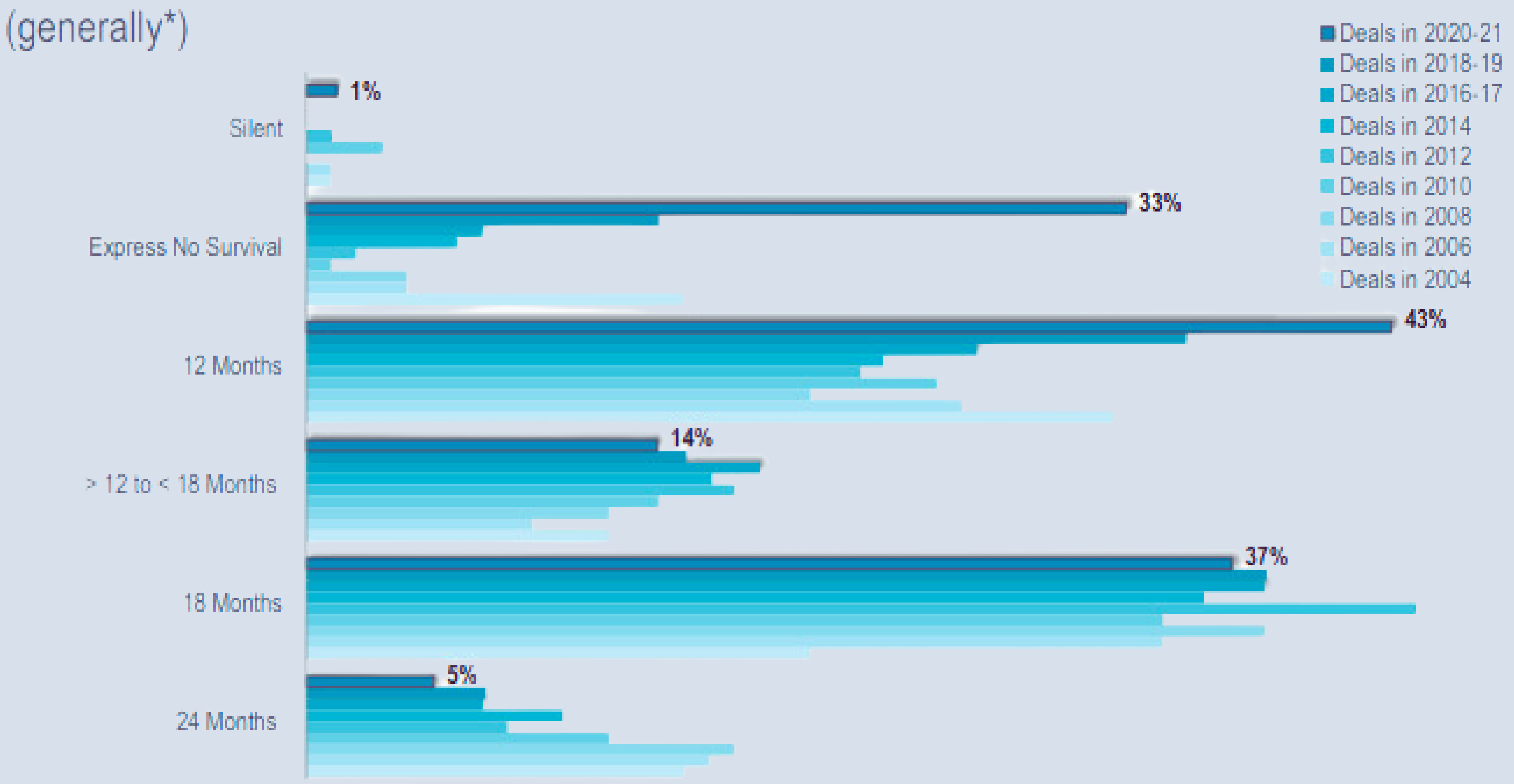
- All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, and any certificate, document, or other writing delivered pursuant to this Agreement will survive the Closing and the consummation and performance of the Contemplated Transactions.

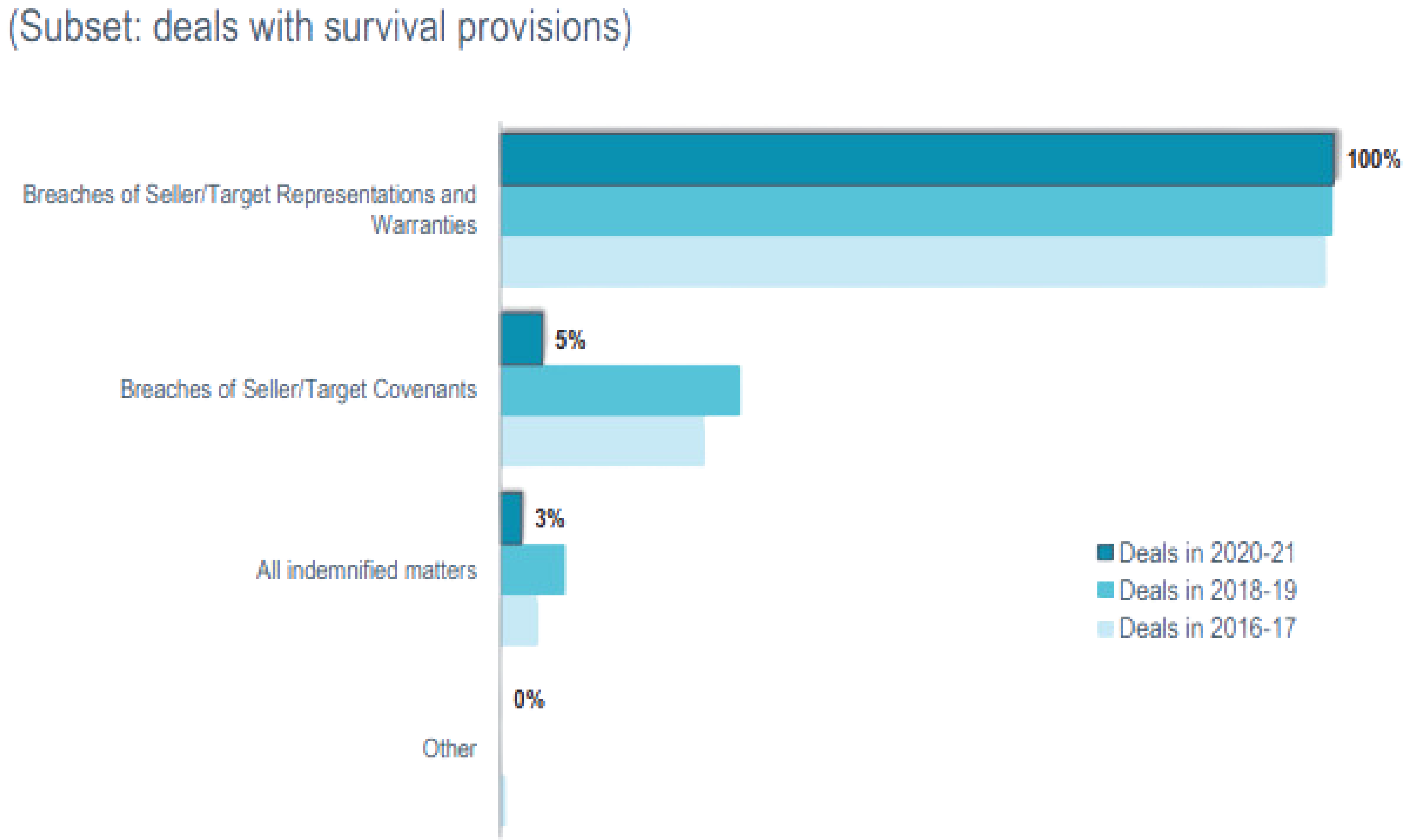
Time Limitations

- If the Closing occurs, Sellers shall have liability under Section ___ with respect to any Breach of a representation or warranty (other than those in Sections..., as to which a claim may be made at any time), only if on or before the date that is ___ years after the Closing Date, Buyer notifies [Target's representative] of a claim, specifying the factual basis of the claim in reasonable detail to the extent known by Buyer.

Source: ABA Private Target Study 2021

Survival/Time to Asset Claims cont.





*Tax is usually carved out and survives generally 5-6 years

Source: ABA Private Target Study 2021

Baskets

Deductible

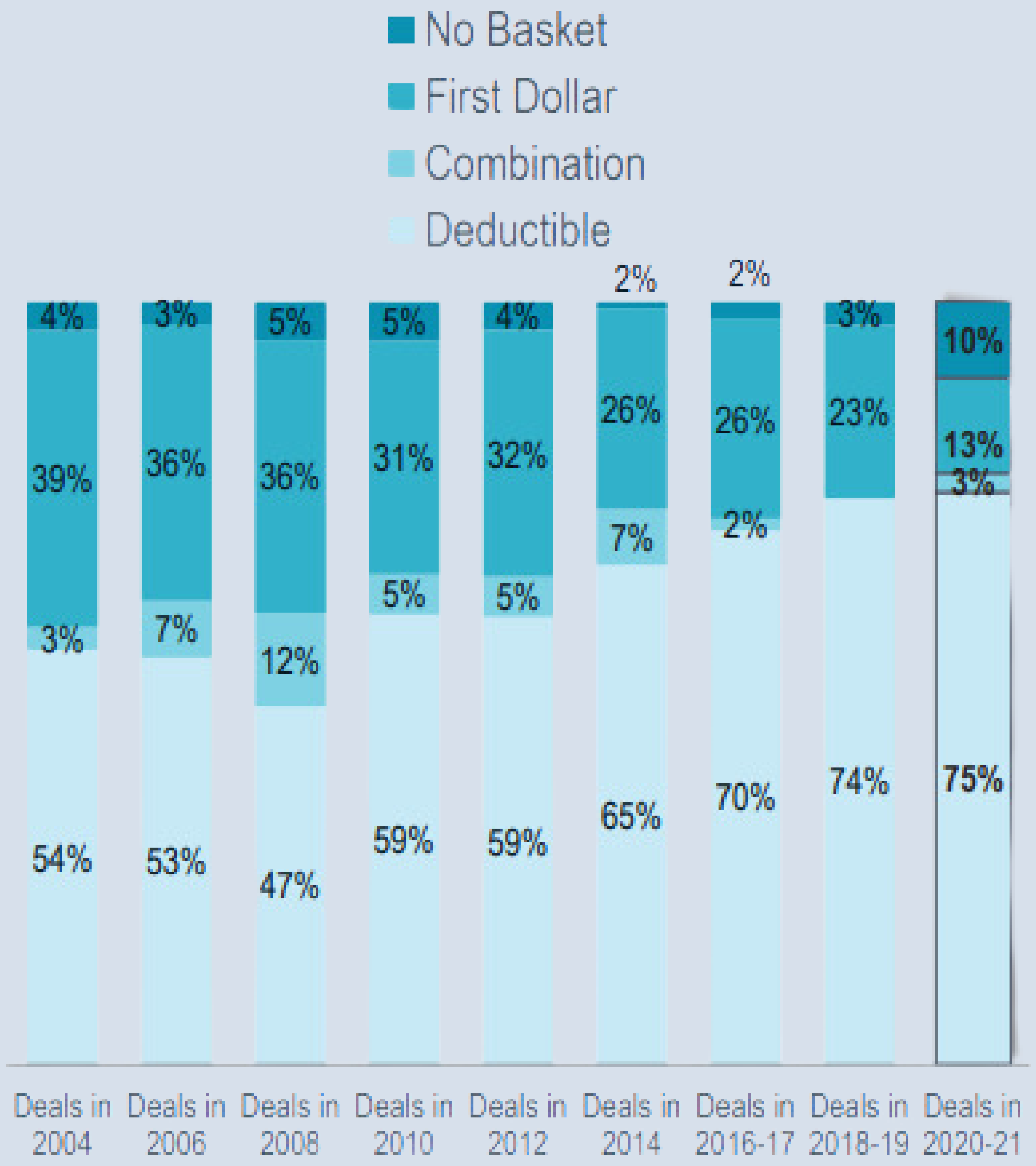
Sellers shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $300,000 (the "Deductible") in which event Sellers shall be responsible only for Losses exceeding the Deductible

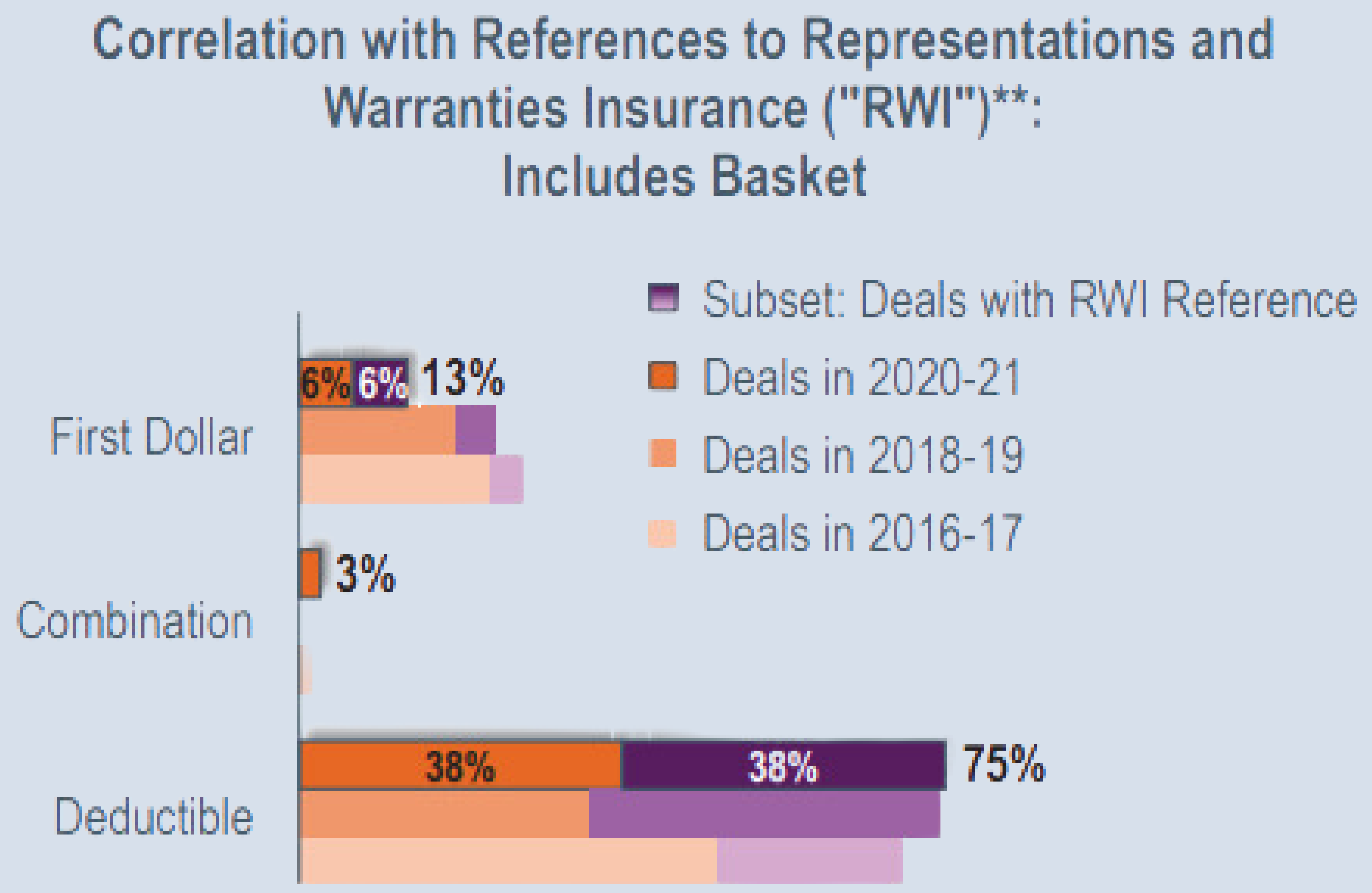
First Dollar

Sellers shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $500,000 (the "Threshold") in which event Sellers shall be responsible for the aggregate amount of all Losses, regardless of the Threshold.

Source: ABA Private Target Study 2021

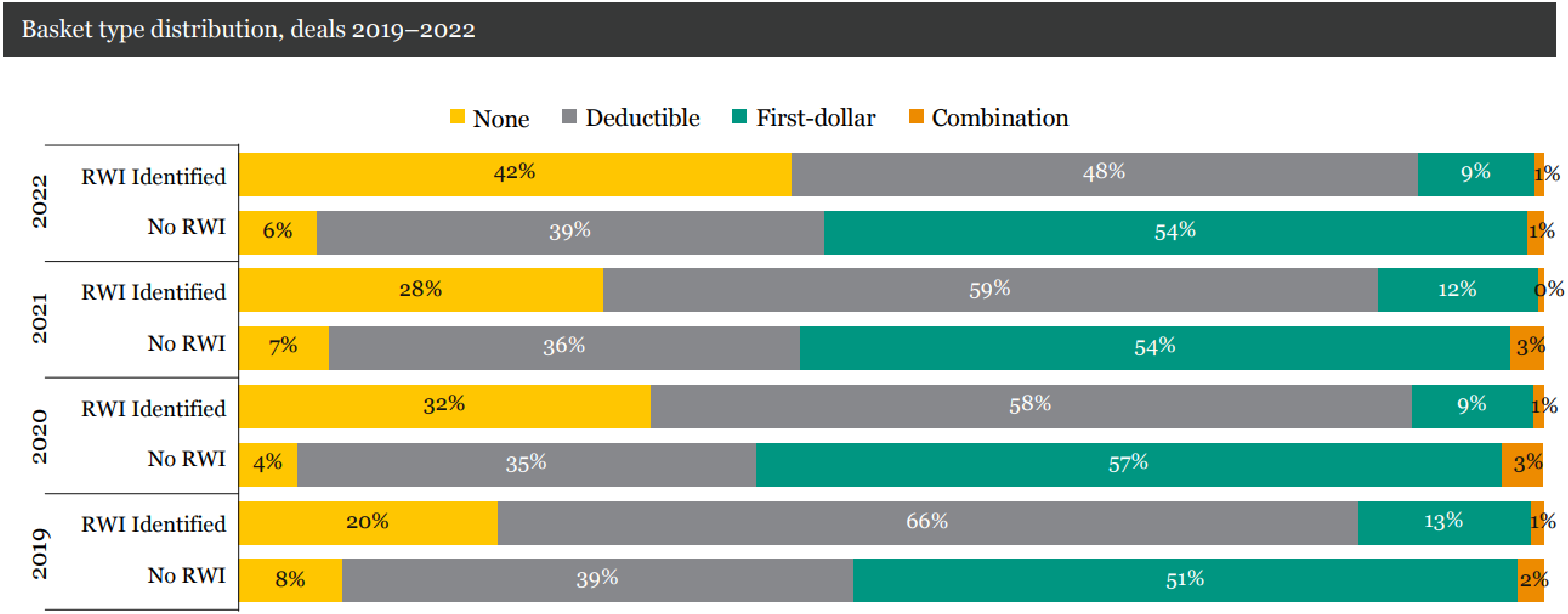
Baskets cont.





Source: ABA Private Target Study 2021

Basket: Influence of RWI



Innovative Tax Insurance Products

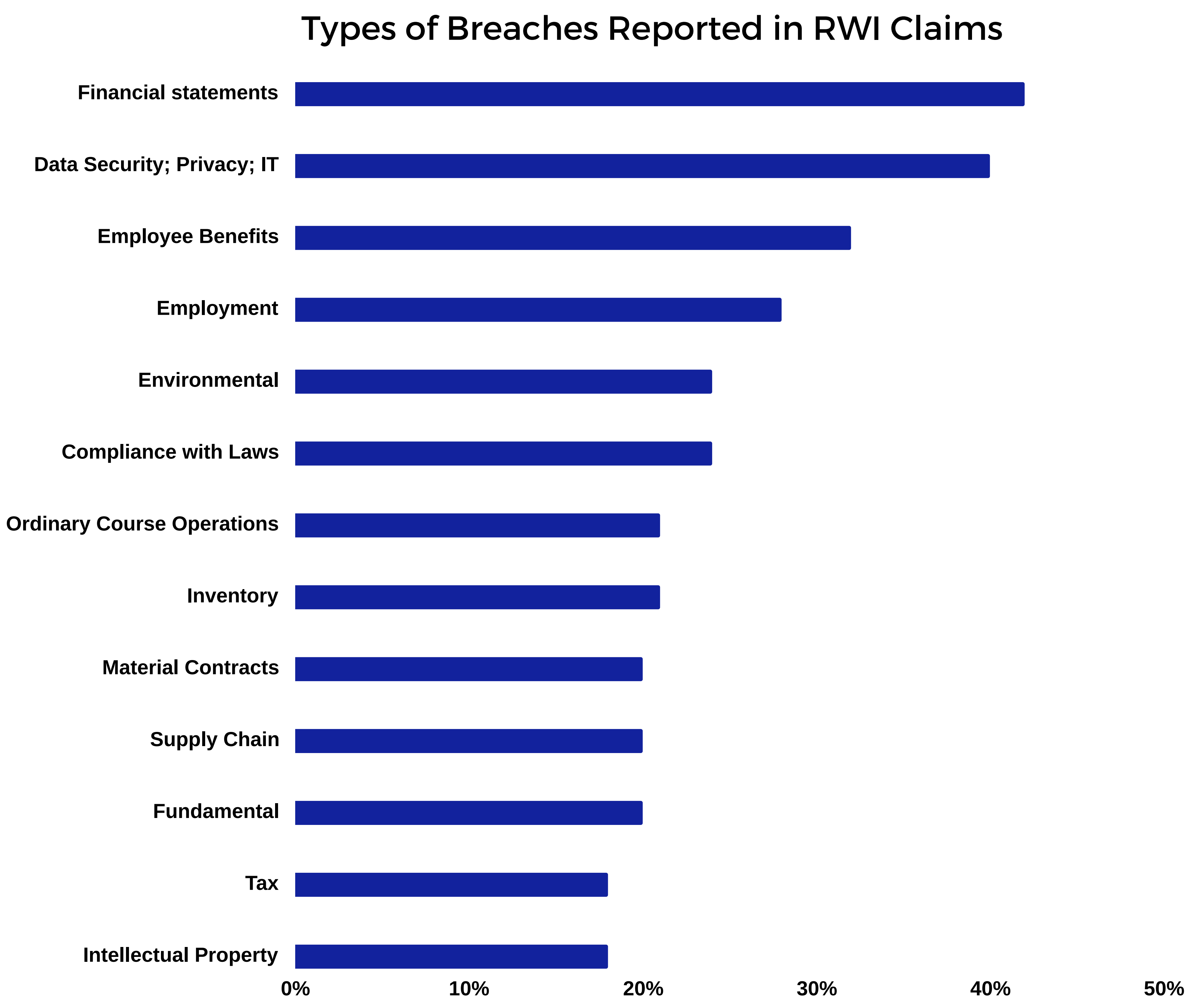
Types of Transaction Risk Insurance

- Representations and Warranties
- Tax Indemnity
- Contingent Liability

Representations & Warranty Insurance

- Representations & Warranty Insurance (RWI) largely addresses unknown risks, covering potential breaches in the representations and warranties made in M&A deals.

- RWI policies generally cover all reps and warranties made in connection with a purchase agreement, bridging the gap between the “wants and needs” of the seller and buyer



Reps & Warranties Insurance: The Process

Days 1 – 2
Engage broker (earlier in the process is better)

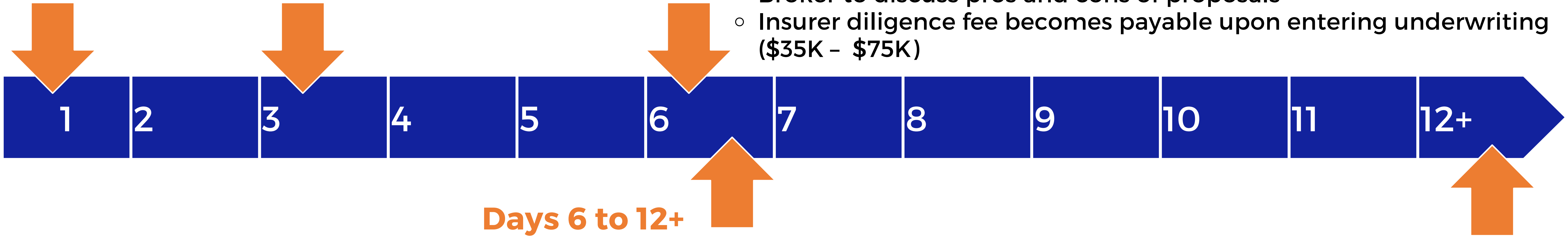
Broker and potential underwriters execute NDAs

Days 3 – 6
Obtain quotes from underwriters

- To get quotes, we need a recent draft acquisition agreement, information memorandum and target's financials
- No cost to obtain quotes

Day 6
Select underwriter

- Broker to discuss pros and cons of proposals
- Insurer diligence fee becomes payable upon entering underwriting ($35K – $75K)



Days 6 to 12+
Underwriting of policy

- Underwriter to gain access to data room and legal, financial, tax and other diligence reports (subject to non-reliance letters)
- Conference call with deal team and advisors

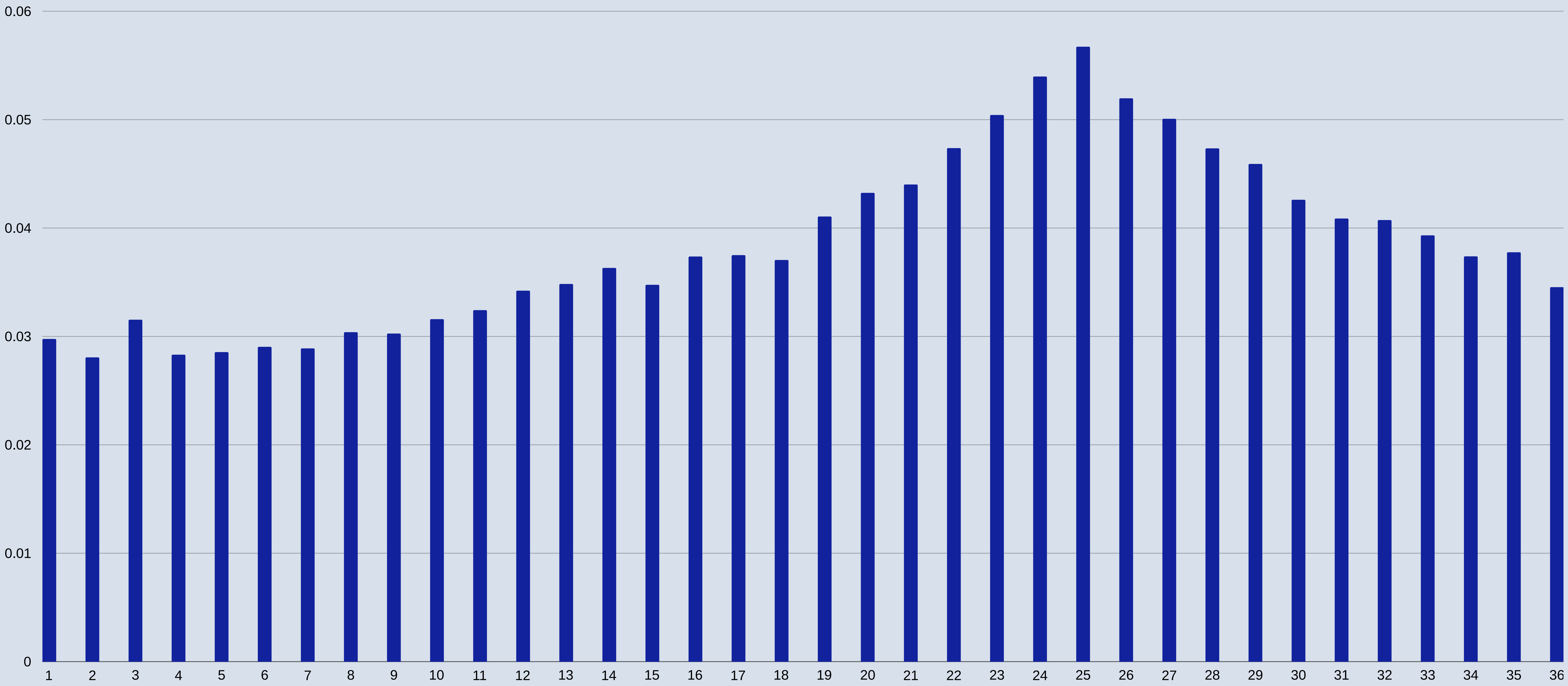
Policy negotiations

- Done in parallel with underwriting; outside counsel typically involved

Source: Marsh

Trends in R&W Insurance Pricing

Primary R&W Insurance Pricing Data 2020 - 2022



Deal count and Avg. ROL figures are based on the policy effective date (i.e. policy inception) Data as of 12-1-2022

Trends in R&W Insurance Claims

- Increase in new product concepts
- Decrease in retention rates
- Rise in claim activity

RWI - Buyer Side Policy Benefits

- Generally includes additional fraud coverage that are often not provided in sell-side policies
- Provides safeguards against seller post-closing credit risks
- Extends survival period for breaches of reps and warranties
- Permits the buyer to offer lower escrows in an auction making a bid more attractive.
- Offers the buyer an alternative method of recourse when seller indemnity not possible or expected to be difficult (insolvency, foreign jurisdictions, multiple sellers)

RWI – Seller Side Policy Benefits

- Permits the seller to maximize indemnification
- Provides a smoother exit by reducing contingent liabilities
- Reduces or eliminates the need for an escrow from the seller
- Protects passive and minority investors

Reps & Warranties Insurance: Policy Considerations

Duration of Policy	Policies generally survive for longer periods than in the underlying acquisition agreement (3 years for general reps / 6 years for tax and fundamental reps)
Cost and Coverage Limits	Total costs are approximately 4% +/- of the policy limit (one-time payment; % may be lower for larger deals), including premium, taxes, underwriting fees and broker compensation
Retention / Deductible	Retentions on R&W policies are typically 1% of enterprise value (lower for larger deals) and normally drop down to 0.5% of enterprise value at 12-month anniversary of Closing
Definition of Loss	Carriers are typically willing to be silent with respect to consequential and multiplied damages (as opposed to having exclusions for those types of damages)
Materiality Scrape	Carriers are typically willing to recognize materiality scrapes for purposes of determining the existence of a breach of a rep and losses related thereto
Exclusions	Policies contain "Actual Knowledge" exclusion and exclusions for forward looking statements, working capital adjustments, asbestos and PCBs, and pension underfunding/withdrawal, NOL's/deferred tax assets and transfer pricing

How it Looks: R&W Provisions

- **Example Representation and Warranties**

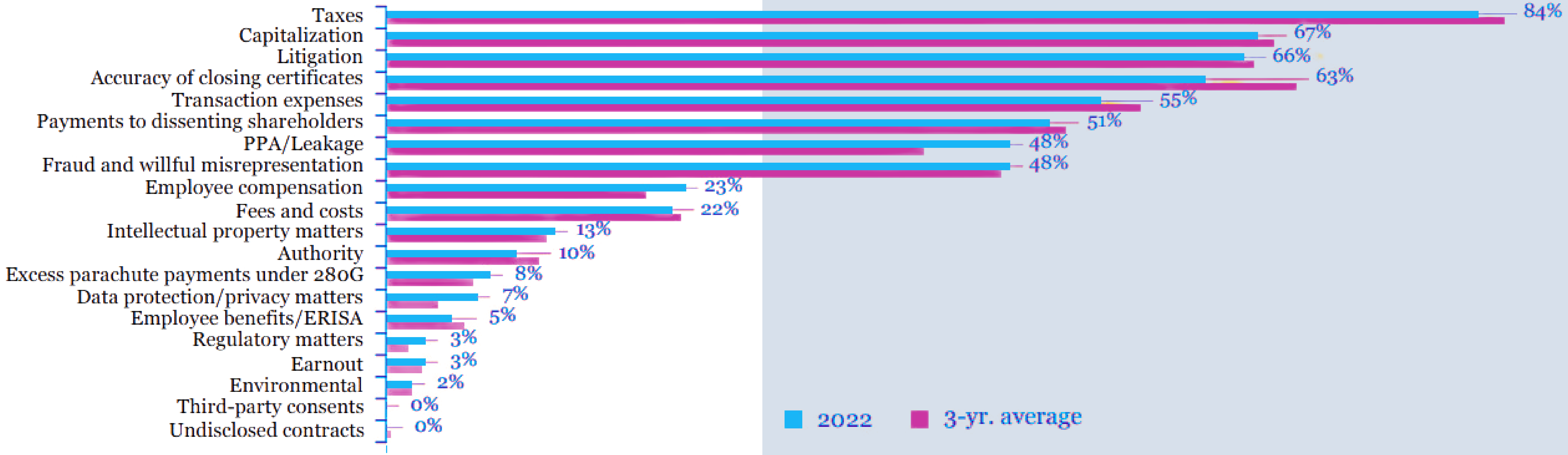
(i) all Taxes (whether or not shown on any Tax Return) due and owing by the Company have been timely paid;

(ii) all Tax Returns required to have been filed by or with respect to the Company have been timely filed; and

(iii) all such Tax Returns filed by the Company are true, complete and accurate in all material respects and disclose all Taxes required to be paid by or with respect to the Company for the periods covered thereby...

Innovative Products: Tax Indemnity Insurance

- **Tax Indemnity Insurance Coverage**
  - Covers known tax risks and tax attributes not normally covered by R&W policies (such as the amount of NOLs)
    - Replaces tax indemnity and/or escrow in the purchase agreement



Line items for which indemnification is expressly provided beyond the standard line-item indemnities for seller's breaches of (i) representations and warranties and (ii) covenants

Tax Risks - What Can Be Covered?

- Validity of 338(h)/336(e) elections
- Tax Free Reorganizations under Section 368
- Tax Free Spinoffs under Section 355
- ESOP Risks
- Capital Gain v. Ordinary Income Treatment
- Withholding Taxes
- Debt/Equity Characterization
- Determination of certain S-Corp issues

Tax Insurance: Policy Considerations

Duration of Policy	Typically 7 years. 10 year policies are also common for forward looking risks (e.g., renewable energy tax credits); non-cancellable
Cost and Coverage Limits	All-in costs are 2.5% to 4.5% of the policy limit (one-time payment); varies depending on facts and circumstances; typical policy minimum of $5 million
Retention / Deductible	Varies based on particular risk (often limited to "Contest Costs Only")
Definition of Covered Tax Position	Bespoke language related to specific issue
Covered Items	(a) Additional Taxes; (b) Fines and Penalties; (c) Interest; (d) Contest Costs; and (e) Tax Gross-up
Jurisdictions	US (including, federal, state, and local) and foreign income and non-income tax risks

Source: Marsh

Tax Insurance: Policy Considerations cont.

Standard Exclusions	(a) Inconsistent filing position; (b) material misrepresentation; (c) change of law; and (d) settlement by insured without consent
Definition of Knowledge	Buyer-side M&A: generally limited to actual conscious awareness (no constructive or imputed knowledge), with no duty to inquire and the carrier having the burden of proving knowledge
Contest by Tax Authority	Insured is responsible for any contest. Underwriter must be kept informed and have the ability to comment and provide input
Settlements	Any settlement must be with the consent of the underwriter
Underwriting	Varies based on risk covered: may include statement of facts; recent draft acquisition agreement (if any); CIM (if any); tax memo/opinion or statement of facts; tax loss exposure calculation; other relevant/supporting information
Signing vs. Closing	Underwriters typically bind coverage at signing subject to a 10% to 20% premium deposit or termination fee.

Source: Marsh

Contingent Risk Insurance

- Transfers known or uncertain liability from the deal parties to an insurance company
- Coverage:
  - Ongoing Litigation
  - Shareholder Disputes
  - IP or Employment Disputes
  - Contingent Environmental Risks
  - Complex Title Risks
  - Regulatory Exposures
  - AND all kinds of tax risks

Contingent Risk Insurance cont.

- Seller or buyer can be covered (costs can be shared)

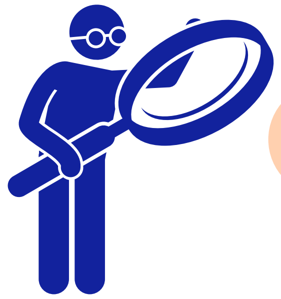
- **Benefits**
  - Mitigates exposure to potentially catastrophic losses
  - Enables a smoother close, without impairing sale proceeds from the transaction

- **Parameters**
  - Insurable risks must have well-developed facts where legal questions determine the outcome
  - The position taken in the litigation must be defensible and possess strong legal arguments likely to prevail.

Example Cases:
Hill v. LW Buyer, LLC

- General Context

- Indemnification claim procedure stipulated in the agreement stated that the seller party would be liable for breaches...only if, on or before the survival period termination date the seller party is notified "of a claim, specifying the factual basis of the claim in reasonable detail to the extent known by Buyer."



- Though the term "tax" was within the definition of the term "losses," the focus remained on the fact that this independently defined term "taxes" was further characterized by the words "imposed, assessed or collected."

Example Cases:
Hill v. LW Buyer, LLC cont.

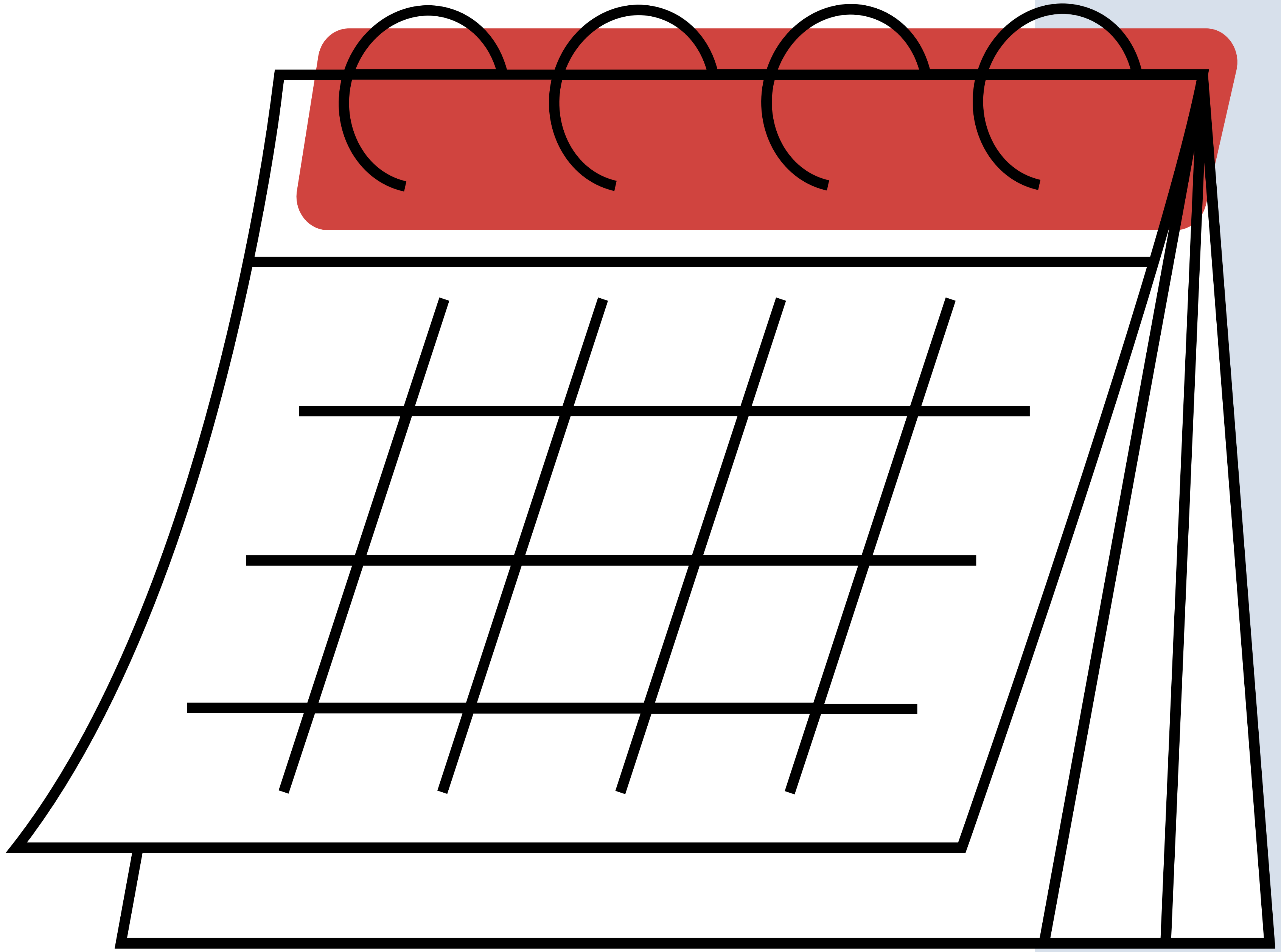
- **Future Deal Considerations**
  - Beware Ambiguity of the “Reasonable-detail Standard”
  - The Importance of Defining “Loss”
    - When is there a loss?
    - When can you claim a tax loss?
  - Strict Compliance with Indemnification Claim Procedures

Pulling This All Together: A Hypothetical

A “Customs” Tax Indemnity Mess

- Specific Provisions
  - “Buyer Indemnitees shall be indemnified and held harmless by Seller…for and against all Taxes of the Target Companies allocable to a Pre-Closing Tax Period[.]”
  - “Tax” includes “all federal, state, local or non-U.S. taxes or fees…customs or duties…together with any interest, penalty, or additions to tax or additional amounts with respect thereto imposed by any Taxing Authority[.]”
  - “Losses” include “any and all Liabilities of any kind, actions, costs, losses, damages, obligations, Liens, Taxes, judgments, awards, demands, settlements, fines, penalties, interest, fees and expenses (including reasonable fees and expenses of attorneys and other third party professional fees), court costs and other expenses of litigation.”

Q&A



What's Ahead?

2024

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