$1.50 VOL. 37 NO. 1 www.ocbj.com JANUARY 6-12, 2014

ORANGE COUNTY BUSINESS JOURNAL

RUTAN

RUTAN & TUCKER, LLP

Tax Representations, Warranties, Covenants and Indemnification Provisions in Merger and Acquisition Documents

by Ellis Wasson, Partner, Rutan & Tucker LLP

Tax sections of merger and acquisition documents must be carefully drafted to help ensure that the tax results of a merger or acquisition are consistent with the intentions and expectations of the parties. The tax-related provisions should address the structuring issues in such transactions, and also confirm the negotiated allocation of costs related to known and unknown tax assessments for tax periods prior to the closing date of the transaction. This article discusses and describes tax provisions commonly used in merger and acquisition documents.

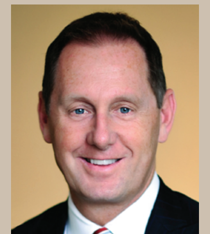
The transaction document may be prepared in a variety of forms. It may be an agreement and plan of merger, an asset purchase agreement, or a stock purchase agreement. Regardless of the form of the transaction documents, the agreement will generally include three categories of tax-related provisions: (i) representations and warranties, (ii) covenants, and (iii) indemnification provisions.

Tax Representations and Warranties

Tax representations and warranties concerning the prior tax positions of seller serve multiple purposes with respect to the transaction. First, buyer's obligation to close a transaction may be conditioned upon the accuracy of representations and warranties as of the closing date, so the tax provisions provide buyer with an option to close or not close the transaction. In this regard, the process of negotiating tax representations and warranties is often a key part of the due diligence process. Additionally, there is usually a close connection between the language of the representations and warranties and the indemnification obligations and protections of the parties. For these reasons, sellers will generally want to limit the scope of representations and warranties with knowledge qualifiers and similar limitations. Buyers will of course want to expand the protections provided by seller's representations and warranties as much as possible.

Fundamental Compliance Representations: At a minimum, seller will usually be asked to represent that: (i) all tax returns have been filed in all jurisdictions in which returns are required to be filed; (ii) all taxes indicated on such returns or otherwise due have been paid in full; (iii) full disclosure has been made with respect to any accrued but unpaid taxes; and (iv) there are no

Ellis Wasson



Ellis Wasson is a partner in the Corporate, Securities and Tax Section at Rutan & Tucker's Costa Mesa office. His practice emphasizes mergers and acquisitions, taxation, tax litigation, financings and general corporate practice. His areas of expertise include Taxation and Tax Controversy, Mergers and Acquisitions, and General Corporate Practice. Wasson can be reached at 714.662.4619 or ewasson@rutan.com.

About Rutan & Tucker LLP

Rutan & Tucker has enjoyed a leading role in shaping Orange County and California businesses and communities, today standing as the largest full-service business law firm based in Orange County. With approximately 151 attorneys, Rutan & Tucker is well-positioned to meet the legal needs of a broad range of clients doing business in California and beyond. Rutan & Tucker represents a broad spectrum of clients, from major multinational corporations and financial institutions to family-owned businesses and private individuals; from high-technology and industrial enterprises to agricultural firms; from real estate developers to governmental agencies, educational institutions and charities. The firm's practice extends throughout the United States and includes both the representation of foreign companies doing business in the United States and domestic companies engaged in activities abroad.

Reprinted with the permission of the Orange County Business Journal

$1.50 VOL. 37 NO. 1 www.ocbj.com JANUARY 6-12, 2014

ORANGE COUNTY BUSINESS JOURNAL

liens or other tax-related encumbrances on target's assets. Additional representations will be required concerning seller's compliance with filing information returns and withholding taxes from payments to payees.

Due Diligence-Related Representations: Due diligence type representations and warranties will vary significantly based on deal structure, but buyer will usually want disclosure of all information indicating that seller may have filing obligations or taxable nexus with any jurisdiction where seller has not filed returns. Seller will also be asked to disclose the details of all tax audits, appeals, and tax litigation to which seller has been a party, as well as the terms of any closing agreements, rulings, or other documents binding seller to any tax filing positions or elections. Buyer will want disclosure of any indemnification rights or obligations seller has with any third parties including any parties with whom seller has engaged in prior merger or acquisition transactions.

Tax Attributes and Deal Specific Representations: Buyer will want assurances that seller has accurately represented all tax attributes of target that transfer to, or otherwise affect, buyer. These include the bases of acquired assets, accounting methods and elections, carry-forward amounts, attributes related to consolidated return filings, target's inclusion in unitary groups and combined reports for state and local tax purposes, and the existence of any special tax status of target or any affiliate of target. Buyer and seller will both want assurances that the other party has not taken any positions that are inconsistent with the negotiated tax structure of the deal. If target is engaged in international operations, buyer will want a number of representations confirming the jurisdictions of formation of subsidiaries, confirmation of where foreign affiliates have permanent establishment, the existence of controlled foreign corporations, target's reliance on exceptions that allow target to avoid inclusion of subsidiary income in the calculation of U.S. taxable income, and details of transfer price agreements and similar related party arrangements. If target is an S corporation, buyer will want to know if target has any prior Subchapter C earnings and profits, and whether or not target has ever terminated its S election.

Covenants

Tax covenants are enforceable promises the parties to a transaction make to each other regarding future tax-related actions. These promises can be crucial in terms of assuring the parties that the transaction will receive the tax treatment that was negotiated. This is particularly true in transactions structured as tax-free reorganizations, as these transactions can be very rigid in terms of formality, and failure to abide by the requirements of applicable law can produce highly adverse results for one or both parties. In many asset purchases, it may be important to have the parties covenant that they will allocate the purchase price among the purchased assets in a consistent manner. Other important matters covered by covenants include confirmation of which party will be responsible for filing tax returns for the target, and confirmation that payments of taxes will be made in a timely manner by the responsible party. Additionally, it is often important to confirm on-going cooperation between the parties to resolve any audit or tax controversy that arises after the closing of the transaction, including assurances of access to records and other resources that may be essential to allow the parties to defend against proposed assessments with which the parties do not agree.

Indemnification

Tax indemnification terms are important negotiated provisions that may vary considerably in transaction documents depending on many factors. Publicly held companies, for example, because of regulatory and disclosure obligations, may be unwilling to provide certain indemnities. Nevertheless, indemnification protection will usually be viewed as essential by the parties, and in most deals the parties will be able to negotiate reasonable indemnification terms. Buyers will generally want protection from all taxes of the target or target's business for all periods ending before or on the closing of the transaction. Sellers will often seek to limit the indemnification commitment to situations where a breach of a specific representation or warranty occurred. The survival period of the indemnification will also be negotiated. Buyers will generally want to be protected for at least as long as the statute of limitations remains open for potential assessments. Issues can also arise as to which party will control the defense of a proposed assessment related to a pre-closing tax period. A well drafted indemnification provision will provide certainty as to how the defense of an indemnified claim will be handled. Given the range of options available to the parties with regard to drafting indemnification provisions and the potentially profound importance these provisions can have on the after-tax economics of the transaction to both parties, indemnification provisions are often some of the most extensively negotiated terms of the transaction document.

Conclusion

Tax provisions are extremely important parts of the documentation of mergers and acquisitions. Every deal is different, and the tax-related representations, warranties, covenants, and indemnification provisions of each will vary based on the unique circumstances of the transaction. In order to properly negotiate the terms of provisions such as those described herein, the parties must be aware of all relevant risks and facts concerning the transaction.

Reprinted with the permission of the Orange County Business Journal