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Structuring Tax Provisions in M&A Agreements and Protecting Section 382 Tax Attributes

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M&A AGREEMENTS: TRAPS, TRENDS AND TIPS

August 22, 2013

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Agenda

- M&A Agreements – Negotiating Tips
- Income Tax Receivable Agreements
- Section 382 Protective Measures

M&A Agreements – Negotiating Tips

Basic Structure of Purchase Agreement

- Purchase Price
  - Adjustments
  - Allocation
  - Escrows
- Representations and Warranties
- Covenants
- Indemnities

Purchase Price Provisions

- Effective Date v. Closing Date
- Balance Sheet Adjustments
- Escrows
- Allocation of Purchase Price
- Withholding on Purchase Price Payment

Purchase Price Provisions

- Purchase Price Allocation
  - To agree or not
  - Allocation beyond Section 1060 categories
  - Allocation to Noncompete
  - GAAP Impact
  - Appraisal
  - Liabilities
  - Post Closing Payments/Adjustments
    - Treatment as Purchase Price Adjustments
    - Implicit/Explicit Interest Components

Tax Representations and Warranties

- Functions (Due Diligence/Closing Condition/Indemnity)
- Materiality Qualifiers
- Knowledge Qualifiers
- Stock v. Asset Deals
- Acquisitions of Disregarded Entites
- Specific Reps
  - Basis reps
  - NOL reps
  - Other
- Disclosure Schedules

Covenants

- Filing Post-Closing Tax Returns
  - Straddle period returns
  - Control over tax audits for pre-closing periods and straddle periods
  - Entitlement to tax refunds
  - Carryback of NOLs to pre-closing periods

Tax Indemnities

- Breach of tax representations v. special tax indemnity
- Definition of taxes to include successor liability
- Indemnification for Treas. Reg. Section 1.1502-6 liability
- Survival period
- Baskets and caps
- Correlative adjustment provisions
- Net after tax basis provisions
- Coordination with purchase price adjustments

Escrows

- Availability of installment method for seller
- Who pays tax on income from escrowed proceeds
- Tax treatment of release of escrow proceeds

Earn Outs

- Availability of installment method for seller
- Imputed interest income to seller
- Basis recovery under contingent installment sale method
- Disguised payment for services
- Impact on buyer's basis

NOL and Other Tax Attribute Provisions

- Payment for NOLs (Claw Back)
  - Calculation of Section 382 limitation/seller reps
  - Allocation of consolidated Section 382 limitation
  - Stock basis reduction election under Treas. Reg. Section 1.1502-32
- Treas. Reg. Section 1.1502-36(d)

Section 338(h)(10) Election

- Filing of the Election
- State Tax Consequences
- Treas. Reg. Section 1.1502-6 Consequences
- Purchase Price Allocation
- Liabilities
- Adjustments
- Affiliated versus Consolidated Return Considerations
- Section 336(e) Elections vs. Section 338(h) (10) Elections

Miscellaneous Provisions

- Transfer Taxes
- Purchasing Partnership Interests
  - Section 754 election
  - Section 708 terminations
  - Acquisition of corporations owning partnership interests
- Target LLCs
  - Treas. Reg. Section 1.1502-6 liability
  - State tax consequences
- Cancellation of Target “Hook Stock”

Income Tax Receivable Agreements

Income Tax Receivable Agreements

- **Background**

  - Income tax receivable agreements (“TRAs”) can be a useful way to allocate the tax benefits that are realized by a company (“Acquiror”) that acquires the assets or stock of Target in taxable years after the transaction is completed.
  - In general, pursuant to a TRA, Acquiror will make payments to the transferor of Target assets or Target stock to compensate the transferor for a portion of the tax benefits realized by Acquiror or Target in future years on account of:
    - A step-up in basis of Target assets and/or
    - Use of pre-change Target net operating losses (“NOLs”) to offset post-change taxable income of Acquiror or Target.

Income Tax Receivable Agreements

- **General terms of a TRA:**
  - Acquiror will provide transferor with a detailed schedule showing calculation of the “tax benefit” realized by Acquiror for the taxable year and a calculation of the amount payable to the transferor.
  - “Tax benefit” generally means the difference between (a) Acquiror’s tax liability for the year without taking into account the step-up in tax basis and/or pre-change NOLs, and (b) Acquiror’s actual tax liability for the year.
  - Acquiror will be required to make payments to transferor of all or a portion (e.g., 85%) of the “tax benefit” realized by Acquiror at specified intervals (e.g., by reference to estimated tax payment dates with a true-up upon filing of tax returns and any final determination by a taxing authority).
  - “Tax benefit” payments made by Acquiror pursuant to the TRA will be treated as additional purchase price paid by Acquiror to transferor and generally give rise to additional “tax benefits” to Acquiror (e.g., attributable to deductions for imputed interest and additional amortizable asset basis), therefore requiring additional payments to be made by Acquiror to transferor (a fascinating iterative calculation for Acquiror’s in-house tax department).

Income Tax Receivable Agreements

- **Representative transactions**

  - TRAs can be particularly attractive in IPOs or spin-offs by public companies.

  - Deal terms and acquisition price may not be affected by the execution of a TRA, because tax attributes often are not priced into the transaction.

Income Tax Receivable Agreements

- **Examples of TRAs:**
  - Forex Capital Markets (85%)
  - KKR (85%)
  - Graham Packaging Company (85%)
  - Cloud Peak Energy (85%)
  - Turner Investment Partners (85%)
  - Och-Ziff Capital Management (85%)
  - Virgin Mobile (88.7%)
  - Duff & Phelps (85%)
  - Apollo (85%)
  - The Blackstone Group (85%)

Income Tax Receivable Agreements

- **PLR 201027035 (July 9, 2010)**
  - Taxpayer ("Acquiror") acquired assets from Transferor in an exchange which Acquiror represented was taxable under section 1001.
  - In the exchange (a "busted" section 351 transaction), Transferor received common and preferred Acquiror stock, cash, the assumption by Acquiror of Transferor liabilities, and the right to receive contingent payments under a TRA.
  - Transferor (actually, an assignee of Transferor's rights under the TRA) desired to receive a lump-sum payment instead of future contingent payments under the TRA.
  - Transferor and Acquiror entered into a prepayment agreement pursuant to which Acquiror paid Transferor a lump sum in full satisfaction of Acquiror's remaining obligations to make tax benefit payments under the TRA.
  - IRS ruled that Acquiror did not realize any cancellation of indebtedness income because its liability under the TRA was contingent upon its future earnings, future tax rates and, ultimately, its actual realization of tax benefits from the stepped-up asset basis.

Section 382 Protective Measures

Section 382 Overview

- Section 382 generally limits the ability of a corporation (a loss corporation) to use certain of its tax attributes – including NOLs, tax credits, and built-in losses – following an ownership change.
- An ownership change generally occurs when one or more of the loss corporation's 5-percent shareholders (with certain aggregation rules for the loss corporation's less-than-5-percent shareholders) increase their stock ownership by more than 50 percentage points during a three-year testing period.
- If a 50-percent-or-greater shareholder treats the loss corporation's stock as worthless (*i.e.*, claims a worthless stock deduction under Section 165(g)) during any taxable year and continues to hold the stock at the close of that taxable year, the stock is treated as newly acquired on the first day of the following taxable year, resulting in an ownership change.

Protective Measures Outside of Bankruptcy

- Poison Pills
  - Poison pills are generally used by corporations to discourage hostile and unsolicited investors from taking large stakes in the corporation’s publicly traded shares.
  - In general, poison pills are structured as a shareholder rights plan that entitles existing shareholders of a corporation to acquire additional shares of stock in the event that a hostile investor acquires beneficial ownership of more than a specified trigger amount (typically at least 10-20 percent) of the corporation’s shares (a “Triggering Event”).
  - Upon the occurrence of a Triggering Event, the poison pill allows the shareholders (other than the hostile investor) to acquire common shares of the corporation at a significant discount, which results in a significant dilution of the percentage of stock owned by the hostile investor.

Protective Measures Outside of Bankruptcy

- NOL Poison Pills
  - NOL poison pills are designed to deter further acquisitions by shareholders whose stock purchases or sales might cause a Section 382 ownership change.
  - Specifically, an NOL poison pill is designed to reduce the likelihood that a corporation will experience a detrimental ownership change under Section 382 by (1) discouraging any person or group from becoming a 5-percent shareholder and (2) discouraging any existing 5-percent shareholder from acquiring more than a specified number of additional shares of the corporation’s stock (*e.g.*, 0.25 percent of the corporation’s outstanding shares).
  - NOL poison pills are generally structured in the same manner as poison pills designed to prevent hostile investors from taking over a corporation (*i.e.*, a shareholder rights plan that entitles existing shareholders to acquire shares at a discount upon the occurrence of a Triggering Event).

Illustrative NOL Poison Pill Mechanics

Record Date

Stock

Right

- Right trades with common
- Right not exercisable

Detachment Event

- "Acquiring Person" announces intent to commence tender / exchange offer
- "Acquiring Person" acquires 5% of common stock
- Rights redeemable until 10 days after Detachment event

Distribution Date

Stock

Right

- 10 days after a Detachment Event
- Right trades separately
- Right becomes exercisable

Triggering Event

- Acquisition by Acquiring Person of 5% of Company common stock

Flip-In Event

Flip-In

- Right is exercisable to acquire stock of Company valued at twice the Exercise Price

Note: For illustrative purposes, assumes 5% threshold on Common Stock.

Protective Measures Outside of Bankruptcy

- NOL Poison Pills – *Selectica* example:
  - Selectica, Inc. created a poison pill to protect a $150 million NOL. The NOL asset had a value greater than Selectica's market value (based on its share trading price), which, as of July 2, 2009, was approximately $19 million.
  - Versata Enterprises, Inc., a subsidiary of one of Selectica's competitors, increased its ownership stake to 6.7 percent, triggering the poison pill. Under the poison pill, Selectica ordered the exchange of each right for one share of the company's common stock. Selectica's poison pill is the only modern, NOL poison pill known to have been triggered.
  - The Delaware Court of Chancery upheld the adoption of the poison pill as a valid exercise of the board of directors' business judgment. *See Selectica Inc. v. Versata Enterprises Inc.*, Civ. A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

Protective Measures Outside of Bankruptcy

- NOL Poison Pills – *Selectica* example:
  - The *Selectica* court found that the NOLs were a potentially valuable corporate asset and that the prevention of their loss was a valid reason for taking protective action.
  - In addition, the court determined that the measures taken were reasonable because the board had undertaken an extensive decision process, including the appointment of a special committee made up of independent directors and consultation with expert advisors.
  - The court rejected Versata's argument that the 5-percent ownership trigger was unreasonably preclusive because, although waging a proxy contest with less than a 5-percent ownership share is expensive, it is nevertheless possible.
  - Note that Selectica was unusual because it had few assets apart from its NOLs and because of the likelihood that a hostile takeover attempt would trigger an ownership change.
  - On October 4, 2010, the Delaware Supreme Court upheld the Chancery Court's decision relying on both (i) the business judgment rule and (ii) the more stringent *Unocal* standard.

Protective Measures Outside of Bankruptcy

- NOL Poison Pills
  - Other examples of NOL poison pills in the market:
    - Ford Motor Company
    - Lear Corporation
    - Ryland Group
    - USG Corporation

Protective Measures Outside of Bankruptcy

- Charter Amendments
  - Charter amendments can be used to impose transfer restrictions on stock that protect a loss corporation from a Section 382 ownership change.
  - Charter amendments generally void *ab initio* transfers of stock (without board pre-approval) that would
    - increase the holdings of an existing 5-percent shareholder
    - result in a new 5-percent shareholder
    - create a new “public group” treated as a 5-percent shareholder

Protective Measures Outside of Bankruptcy

- Charter Amendments
  - Examples of companies that amended their charters to protect NOLs:
    - Calpine Corporation
    - CIT Group Inc.
    - GenCorp Inc.
    - General Motors Inc.
    - Mirant Corporation
    - Pulte Homes Inc.
    - Radian Group Inc.
    - Toll Brothers Inc.

Which is Better? Charter or Poison Pill

- The advantage of the poison pill compared to a charter amendment is that it can be accomplished without a shareholder vote. However, there are two substantial flaws in the poison pill compared to a charter amendment.
  - The enforceability of the charter provision is generally not subject to challenge.
  - The poison pill does not expressly stop an ownership change. If a shareholder wants to challenge a poison pill or wants to acquire a stock for purposes unrelated to economics, the poison pill does not stop the transaction.
    - This is the fundamental flaw with the poison pill approach.

Protective Measures in Bankruptcy

- The debtor may seek a Bankruptcy Court order to:
  - require ownership disclosure
  - establish notice and hearing procedures for transfers
  - restrict transfers of equity
  - restrict transfers of debt/claims
  - make prohibited transfers void *ab initio*
  - establish “sell-down” procedures
  - prohibit a worthless stock deduction

Protective Measures in Bankruptcy

- Equity Transfer Orders:
  - Requires substantial equityholders (*e.g.*, holders of at least 4.5 percent of all issued and outstanding common stock) to provide a notice of their status to the court and the debtor.
  - Notice must be given to the court and the debtor prior to (*e.g.*, 15 business days) any transfer of stock that would (i) increase a substantial equityholder's holdings or cause a person to become a substantial equityholder or (ii) decrease a substantial equityholder's holdings or cause a person or entity to cease being a substantial equityholder.
  - The debtor may object to a proposed transfer after receipt of such notice (*e.g.*, within 10 business days) on the grounds that the transfer might adversely affect the debtor's ability to use its tax attributes.
  - Any transfer of stock in violation of these procedures shall be void *ab initio*.

Protective Measures in Bankruptcy

- Claims Trading Orders
  - Allows a corporation to qualify for the provisions of Section 382(l)(5):
    - Section 382(l)(5): Section 382 limitation won't apply if an ownership change occurs in bankruptcy and the loss corporation's shareholders and the loss corporation's "old and cold" creditors (plus creditors that fall within a de minimis exception) own 50 percent or more of the loss corporation's stock after the ownership change. The benefits of Section 382(l)(5) are lost if the loss corporation undergoes another ownership change within two years.
  - Flat transfer restriction
    - Notice must be given to the court and the debtor prior to (e.g., 15 business days) any claim transfer that would (i) increase a substantial claimholder's holdings or cause a person to become a substantial claimholder or (ii) decrease a substantial claimholder's holdings or cause a person or entity to cease being a substantial claimholder.
    - The debtor may object to a proposed transfer after receipt of such notice (e.g., within 10 business days) on the grounds that the transfer might adversely affect the debtor's ability to use its tax attributes.
    - Any claim transfer in violation of these procedures shall be void ab initio.
    - Recently used in Mesa Air and CIT Group bankruptcies.

Protective Measures in Bankruptcy

- Claims Trading Orders
  - “Sell-down” procedure
    - Allows electing persons or entities to trade freely and make a market in claims without having to obtain advance approval if such persons or entities file an election notice accepting the terms of the notice.
    - Generally, if reasonably necessary after the debtor’s Section 382(l)(5) plan is confirmed, electing claimholders must sell or otherwise transfer all or a portion of their beneficial ownership of claims in excess of a threshold amount.
    - Allows creditors to fall within the *de minimis* exception contained in Treasury Regulations Section 1.382-9(d)(3).

Protective Measures in Bankruptcy

- Worthless Stock Deductions
  - "If any stock held by a 50-percent shareholder is treated by such shareholder as becoming worthless during any taxable year of such shareholder and such stock is held by such shareholder as of the close of such taxable year, for purposes of determining whether an ownership change occurs after the close of such taxable year, such shareholder (i) shall be treated as having acquired such stock on the 1st day of his 1st succeeding taxable year, and (ii) shall not be treated as having owned such stock during any prior period." Section 382(g)(4)(D).
  - *In re Prudential Lines, Inc.*, 928 F.2d 565 (2d Cir. 1991) holds:
    - NOLs are "property" of the bankruptcy estate.
    - The automatic stay, which prevents actions to exercise control over property of the bankruptcy estate, applies to actions that threaten the debtor's NOLs.

Protective Measures in Bankruptcy

- Worthless Stock Deductions
  - In *Prudential Lines*, the debtor's parent corporation was enjoined from claiming a worthless stock deduction with respect to its stock in the debtor.
  - "In the instant case, [the parent corporation's] interest in its worthless stock deduction is intertwined with [the debtor corporation's] NOL. If [the parent corporation] were permitted to take a worthless stock deduction on its 1988 tax return, it would have an adverse impact on [the debtor corporation's] ability to carry forward its NOL. Accordingly, despite the fact that [the parent corporation's] action is not directed specifically at [the debtor corporation], it is barred by the automatic stay as an attempt to exercise control over property of the estate."

Protective Measures in Bankruptcy

- Issues and objections sometimes raised with respect to Bankruptcy Court orders include:
  - procedural issues, including adequate notice and opportunity for creditor committee participation
  - concerns regarding property rights (debtor vs. shareholder vs. creditor)
  - market disruptions when transfers may be void *ab initio*
  - reluctance to impair creditors' rights when eligibility for the benefits of Section 382(l)(5) is speculative
  - requirement that the debtor post a bond
  - sanction for noncompliance:
    - transfer may be void *ab initio*
    - creditor may be barred from receiving equity in the reorganization
    - shareholder may be required to file an amended tax return to undo its worthless stock deduction

Post-Bankruptcy Protective Measures

- Although certain relief is available to a loss corporation that undergoes an ownership change as a result of a bankruptcy restructuring, that relief is subject to certain exceptions:

  - Section 382(l)(5)(D): "If, during the 2-year period immediately following an ownership change to which this paragraph applies, an ownership change of the new loss corporation occurs, this paragraph shall not apply and the Section 382 limitation with respect to the 2nd ownership change for any post-change year ending after the change date of the 2nd ownership change shall be zero."

- To protect NOLs following bankruptcy, corporations may consider adopting charter amendments as well as shareholder agreements.

Post-Bankruptcy Protective Measures

- Charter Amendments
  - Any attempted transfers of stock before a certain date shall be prohibited and void *ab initio* to the extent that, as a result of such transfer, either (i) a person or group of persons becomes a 5-percent shareholder or (ii) the percentage stock ownership interest in the corporation of any 5-percent shareholder would be increased.
  - Such restrictions shall not apply to transfers of stock if the transferor or transferee obtains the written approval of the corporation's board of directors.