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Negotiating Strategic Acquisitions

DRAFTING AND NEGOTIATING THE TAX PROVISIONS OF THE ACQUISITION AGREEMENT

STUART J. OFFER

MORRISON & FOERSTER, LLP

SAN FRANCISCO, CA

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Stuart J. Offer, Partner

Morrison & Foerster LLP

San Francisco, California

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I. Introduction

A. The purpose of this outline is to identify issues arising in the drafting of tax provisions of acquisition agreements. Although sample language is included to illustrate various points, the language should not be taken as "model" language. As discussed below, while it is generally advisable to begin the drafting of agreement language from a common source, the essence of lawyering is in shaping the language to fit the transaction at hand.

B. The discussion in this outline generally assumes that the transaction involves the purchase in a taxable or non-taxable transaction of 100% of the stock of a subsidiary member of a controlled group of corporations filing a consolidated federal income tax return. It does not discuss the additional representations and warranties which would be appropriate if the common parent of the consolidated group were being acquired.

II. The Tax Lawyer as Team Member

A. Consider how effective you would be as a business lawyer if you were regularly brought into a transaction after its essential provisions had been agreed, were asked to review one or two pages of an agreement without information regarding the entire transaction, and were then kept in the dark regarding the process of negotiations until the last moment when you were given a few hours to "clean up the language." The answer is self-evident, and applies with equal or greater force to the tax lawyer. Indeed, in certain circumstances, it may be virtually impossible to obtain a

desired tax result if the deal is agreed before the tax lawyer is consulted.

B. There are several forces tending to separate the tax lawyer from the guts of the business transaction. Tax law is technical; in today's environment of legal specialization there is a tendency to have specialists talk to specialists. In many corporations, the head of the tax department is outside of the core officer group; general counsels and CEOs talk to business lawyers and are not accustomed to involving tax people in structuring discussions.

C. Another key factor, in my experience as a tax lawyer, is that there are tax lawyers who appear to *prefer* to be treated like specialists, and to be called in like brain surgeons. A tax lawyer can assure himself or herself of this treatment if he or she: (i) is unwilling or unable to explain to colleagues and clients who are not tax specialists why the tax lawyer's role is important; (ii) seeks to compartmentalize his or her knowledge of the transaction to the tax particulars; and (iii) treats the tax provisions of the acquisition agreement as specialized techno-speak which any but the initiated are incapable of understanding. Unfortunately, that is also a sure-fire way of having your client's key tax points negotiated away in the final stages of the process in the rush to complete the transaction.

III. A Preliminary Matter of Form

This outline assumes that the tax provisions with respect to the business transaction will be spread throughout the agreement. Some tax lawyers prefer to have all tax matters included in a separate agreement. The arguments in favor of the separate agreement are that it provides the tax lawyer more control over the document and it makes it easier to assure consistent treatment for tax issues. The arguments against the separate agreement are that it makes it easier to divorce tax considerations from the business deal, even though taxes are part of the business deal, and it can lead to conflicting documents. Either method can work; what is to be avoided, if possible, is the hybrid, where some tax matters are dealt with in the acquisition agreement and others are dealt with in a separate tax

agreement.

IV. The Drafting Process

A. The Five O'Clock Phone Call . What the tax lawyer does when late in the afternoon (local custom may vary the time an hour or so) a call is received from a business lawyer (generally a younger associate) advising that he/she needs a tax section for an acquisition agreement which needs to go to the client that evening may determine the success or failure of the tax lawyer's role with respect to the transaction.

B. What's the Deal? In order to prepare useful tax provisions for an acquisition agreement the tax lawyer needs to know as much about the deal as you can. Who are the parties? What is being acquired, stock or assets? What is the nature of the business? Does the transaction involve a specialized industry? Are there foreign aspects? What is the tax status of the parties (*e.g.*, C corporations, S corporations, LLCs, partnerships?). Is the deal intended to be taxable or tax-free? How will the transaction be accounted for--pooling or purchase?

C. Start Fresh. Young business lawyers are frequently cautioned against marking up the last documented deal as the starting point for the next deal. Invariably, the closing document for the last deal reflects negotiating compromises between the parties on a number of points. It is a rare and unusual circumstance (frequently involving embarrassed explanations to the client) where it is possible to negotiate a tougher position in a document than tendered in the initial draft. This advice to young business lawyers should apply with equal force to the tax sections of the agreement, but the young business lawyer frequently is not involved in the negotiation of the tax section and may be unaware of the compromises involved. Moreover, (surprise, surprise), the tax law changes!

V. The Basics of Acquisition Documents

A. Read the Book. If you have not already done so, find a copy of "Anatomy of a Merger: Strategies and Techniques for Negotiating

Corporate Acquisitions" by James C. Freund (Law Journal Press: 1975). Although the book is 20 years old, it is the most readable account I have found of how an acquisition document is structured and then negotiated. If you have read the book, make sure that the people working for you have read it too!

B. Freund outlines 11 basic articles in a typical acquisition agreement. Tax provisions may appear in many of them:

(1) The operative terms of the transaction, such as the assets or stock to be transferred or consideration paid.

(2) Terms of ancillary transactions, such as covenants not to compete and employment contracts.

(3) Provisions relating to registration of any securities issued in the transaction.

(4) Representations and warranties of the seller.

(5) Representations and warranties of the buyer.

(6) Covenants of buyer and seller pending and following closing.

(7) Conditions to the buyer's obligation to close.

(8) Conditions to the seller's obligation to close.

(9) Closing and termination provisions.

(10) Indemnification provisions.

(11) Miscellaneous matters, such as finders' fees, expenses, notices and the like.

VI. Tax Representations and Warranties

A. Representations and warranties are a way for the seller or buyer to describe the condition of the business at a particular point in time. From a

buyer's perspective, representations and warranties serve three principal functions:

(1) They require the seller to disclose any problems with the business (a due diligence function);

(2) They provide a basis for the buyer to walk away from the transaction if they are untrue at closing (an escape function); and

(3) They provide a basis for recovery after closing if the buyer is injured as a result of a breach (an indemnification function).

B. Due Diligence. In a typical acquisition transaction, a buyer relies extensively on due diligence to uncover potential business issues. Representations and warranties may assist this process by forcing the seller to do its own homework to identify items of potential concern. Thus, representations and warranties are frequently stated broadly (*e.g.*, "no taxes due; all returns filed") with the intention that the seller disclose to they buyer any exceptions to the representation, frequently on a "disclosure schedule").

C. Escape. In almost all cases, acquisition documents permit the buyer to walk away from a transaction without liability to the seller if there is a material breach of a representation and warranty. Although it is fairly unusual for this right to be exercised, the fact that it can be exercised provides the buyer with leverage to renegotiate price if problems are found during the due diligence process. In many cases, particularly with publicly-held companies, the escape out is the only protection available to the buyer; it is frequently not practicable to include post-closing indemnification provisions.

D. Indemnification. Ultimately, representations and warranties may serve a risk allocation function, by permitting the buyer to recover damages from the seller following closing for breaches of representations and warranties. How long this right remains available, and how much of the risk the seller will retain are frequently difficult issues in the negotiation. Moreover, as

discussed *infra*, the tax representation and warranty frequently is in addition to separate tax indemnity provisions in the agreement.

E. Why A Separate Tax Representation? Assume that the seller is a publicly-traded company which files regular reports with the SEC and is audited by a highly reputable accounting firm. Assume also that the acquisition agreement includes a representation that the financial statements of the seller have been prepared in accordance with GAAP on a consistent basis, fairly present the financial position of the seller, and contain all necessary reserves in accordance with GAAP. What is the need for a separate tax representation and warranty?

The answer is "several." In the first place, it is the seller's financial statements to which the representation relates. Although the financial condition of the seller may be important, it is the target subsidiary that the client is buying. Moreover, implicit within GAAP is a materiality standard; what is immaterial (and, therefore, not disclosed) to the financial statements of the seller, as a consolidated entity, may be may quite material to the target subsidiary. In addition, financial statements reflect only certain liabilities; many unasserted liabilities, such as potential tax audit items, properly may not be reflected in financial statements. The buyer, however, will want to know of these risks.

F. A Sample Seller Representation and Warranty.

Tax Matters. Seller and Target make the following representations and warranties with respect to tax matters.

(1) The term "Group" shall mean, individually and collectively, (i) Target, (ii) Seller, and (iii) any individual, trust, corporation, partnership or any other entity as to which Target is liable for Taxes incurred by such individual or entity either as a transferee, or pursuant to Treasury Regulations Section 1.1502-6, or pursuant to any other provision of federal, territorial, state, local or foreign law or regulations.

(2) The term "Taxes" shall mean all taxes, however, denominated, including any interest, penalties or other additions to tax that may become payable in respect thereof, imposed by any federal, territorial, state, local or foreign government or any agency or political subdivision of any such government, which taxes shall include, without limiting the generality of the foregoing, all income or profits taxes (including, but not limited to, federal income taxes and state income taxes), real property gains taxes, payroll and employee withholding taxes, unemployment insurance taxes, social security taxes, sales and use taxes, ad valorem taxes, excise taxes, franchise taxes, gross receipts taxes, business license taxes, occupation taxes, real and personal property taxes, stamp taxes, environmental taxes, transfer taxes, workers' compensation, Pension Benefit Guaranty Corporation premiums and other governmental charges, and other obligations of the same or of a similar nature to any of the foregoing, which the Group is required to pay, withhold or collect.

(3) The term "Returns" shall mean all reports, estimates, declarations of estimated tax, information statements and returns relating to, or required to be filed in connection with, any Taxes, including information returns or reports with respect to backup withholding and other payments to third parties.

Comment: The definition of "Group" is intended to encompass all persons and entities for which the target may be liable for taxes. This includes any consolidated return group of which it was a member, as well as transferees and passthrough entities.

(b) Returns Filed and Taxes Paid. All Returns required to be filed by or on behalf of members of the Group have been duly filed on a timely basis and such Returns are true, complete and correct.

Comment: "Materiality" and "Knowledge." The battle with Seller over "materiality" and "knowledge" will begin here. Seller's revised

version of this language is likely to look like the following:

(b) Returns Filed and Taxes Paid. *To the knowledge of Seller*, all *material* Returns required to be filed by or on behalf of members of the Group have been duly filed and, *to the knowledge of Seller*, such Returns are true, complete and correct *in all material respects*.

There is nothing morally wrong with Seller attempting to limit its representations, but its impact on the three purposes for representations and warranties in acquisition agreements, described above, need to be considered. From a due diligence perspective, a knowledge exception may be acceptable, provided the knowledge of a sufficiently broad group of people is ascribed to Seller. If "knowledge" is limited to the CEO and General Counsel of Seller, they may not have knowledge of what's happening in the Tax Department. Similarly, if the tax function of the Seller Group is decentralized, there may be significant issues at the operating subsidiary level which are fully "known" at the Seller level.

A materiality exception, on the other hand, has greater impact on "due diligence," since it allows the Seller to pre-screen its disclosure using its own standard. Moreover, what is "material" to Target under Seller's method of operation may be different than what is material to Buyer. The failure of Target to file a tax return in Missouri, for example, may be viewed as immaterial if Target has few operations in Missouri, but may be quite material to Buyer if (i) it has significant operations in Missouri or (ii) plans to expand Target's operations in Missouri in a big way.

From an escape perspective, Seller's lack of knowledge with respect to a tax problem should not preclude Buyer from walking away from the deal (or renegotiating price) if Buyer discovers the problem through its own due diligence. How strongly one argues this point depends upon the likelihood that Buyer, in fact, will discover a tax problem of which Seller is unaware.

From an indemnification perspective, the question becomes who should bear the risk if, in fact, returns have not been filed or are not true? In some cases the question will be academic, since there will be a separate tax indemnity provision not tied to the representation and warranty. If there is not a separate tax indemnity, then it is difficult to argue that Buyer should not be protected from pre-acquisition tax liabilities; this can be handled by permitting the Seller to include "materiality" outs for "escape" purposes (*i.e.*, Buyer cannot walk away or renegotiate because of immaterial problems with the representation) but eliminating the materiality exception for indemnification purposes.

All Taxes shown to be payable on the Returns or on subsequent assessments with respect thereto have been paid in full on a timely basis, and no other Taxes are payable by the Group with respect to items or periods covered by such Returns (whether or not shown on or reportable on such Returns) or with respect to any period prior to the date of this Agreement [or an adequate reserve established therefor]. Each member of the Group has withheld and paid over all Taxes required to have been withheld and paid over, and complied with all information reporting and backup withholding requirements, including maintenance of required records with respect thereto, in connection with amounts paid or owing to any employee, creditor, independent contractor, or other third party. There are no liens on any of the assets of Target with respect to Taxes, other than liens for Taxes not yet due and payable or for Taxes that a member of the Group is contesting in good faith through appropriate proceedings and for which appropriate reserves have been established.

Comment: Sellers often attempt to limit the "taxes paid" representation to taxes shown on tax returns or subsequently assessed. From Buyer's perspective there are several things wrong with this. First, not all taxes require the filing of returns. Second, taxpayers, in the normal course of tax compliance, make

decisions on a variety of tax issues which may result in the under-reporting of income or over-reporting of expenses. From a disclosure and escape perspective, Buyer need to know of these decisions so that it can evaluate the risk and adjust the purchase price if it feels the risk is significant. The bracketed language "or an adequate reserve established therefor" is substantively acceptable (see the tax reserve language below), but including the exception may allow the Seller to make the representation without disclosing any questionable items covered by the reserve. Thus, Buyer should be prepared to accept the bracketed language once if and when it is comfortable it understands the components of Seller's tax reserves.

The disclosure of potential tax items is frequently uncomfortable to Sellers, who fear that the disclosure simply creates an audit trail for the taxing authorities. There is no simple answer for this. Assuming that the Seller remains on the hook for pre-closing taxes, the Buyer may be willing to live with oral disclosure and the Seller may get comfortable that Buyer will not use the existence of the liability as the basis for escape.

(c) Tax Reserves. The amount of Target's liability for unpaid Taxes for all periods ending on or before the date of this Agreement do not, in the aggregate, exceed the amount of the current liability accruals for Taxes (excluding reserves for deferred Taxes) solely with respect to Target as of the date of this Agreement, and the amount of Target's liability for unpaid Taxes for all periods ending on or before the Closing Date shall not, in the aggregate, exceed the amount of the current liability accruals for Taxes (excluding reserves for deferred Taxes) as such accruals are reflected on the balance sheet of Target as of the Closing Date (the "Closing Balance Sheet").

Comment: The intricacies of tax accounting are for another day (and, more importantly, for another speaker). Broadly speaking,

deferred tax items reflect the tax effect of timing differences; deferred tax reserves are carved out of the representation to assure that the existence of deferred tax reserves do not mask the under-accrual of current tax liability.

If one accepts the purpose of representations and warranties to reflect the status of the acquired company at a particular point in time, the language of the tax reserve representation highlights the difficulty in taking a snapshot of a moving target. In many cases, the acquisition agreement will be signed well in advance of closing, and there will be a condition to closing (as discussed, *infra*) that all representations be accurate when made and at closing.

<u>The representation also reflects the existence of a closing balance sheet</u>. In many acquisition transactions, there is a purchase price adjustment mechanism which adjusts the purchase price upward or downward based upon differences in Target's balance sheet between some historic date and at closing. To the extent that, through the due diligence process, Buyer is able to identify tax items for which reserves or accruals have not been made on Target's opening balance sheet which are established on the closing balance sheet, there will be a reduction in the purchase price. If there is no closing balance sheet, a revision of the representation, along the following lines, would cover the gap between available financials and closing:

(c) <u>Tax Reserves</u>. The amount of Target's liability for unpaid Taxes for all periods ending on or before [the date of the last available Financial Statements] does not, in the aggregate, exceed the amount of the current liability accruals for Taxes (excluding reserves for deferred Taxes) reflected on the [date] Financial Statements solely with respect to Target, and the amount of Target's liability for unpaid Taxes for all periods ending on or before the Closing Date shall not, in the aggregate, exceed the amount of the current liability accruals for Taxes (excluding reserves for

deferred Taxes) as such accruals are reflected on the [date] Financial Statements, as adjusted for operations and transactions in the ordinary course of business of Target since the [date] Financial Statements in accordance with past custom and practice.

(d) Returns Furnished. Buyer has been furnished by Seller or Target true and complete copies of (i) relevant portions of income tax audit reports, statements of deficiencies, closing or other agreements received by the Group or on behalf of the Group relating to Taxes, and (ii) all federal and state income or franchise tax returns for the Group for all periods ending on and after [five years back]. Target has never been a member of an affiliated group filing consolidated returns other than a group of which Target and Seller were the only members. Neither Target nor any member of the Group do business in or derive income from any state, local, territorial or foreign taxing jurisdiction other than those for which all Returns have been furnished to Buyer.

Comment: Note that the return language, as drafted, includes only income and franchise tax returns; depending upon the nature of the business, there may be other types of returns which are material and which the Buyer will wish to receive.

(e) Tax Deficiencies; Audits; Statutes of Limitations. The Returns of the Group have never been audited by a government or taxing authority, nor is any such audit in process, pending or threatened (either in writing or verbally, formally or informally). No deficiencies exist or have been asserted (either in writing or verbally, formally or informally) or are expected to be asserted with respect to Taxes of the Group, and no member of has received notice (either in writing or verbally, formally or informally) or expects to receive notice that it has not filed a Return or paid Taxes required to be filed or paid by it. The Group is neither a party to any action or proceeding for assessment or collection of Taxes, nor has such event been asserted or threatened (either in writing or verbally, formally or

informally) against the Group or any of its assets. No waiver or extension of any statute of limitations is in effect with respect to Taxes or Returns of the Group. Target and each member of the Group have disclosed on its federal income tax returns all positions taken therein that could give rise to a substantial understatement penalty within the meaning of Code Section 6662.

Comment: Although "never" may seem like a long time, keep in mind that all the Seller needs to do to comply with the representation is disclose the audits. Note, however, that unlike the "returns furnished" provision, discussed above, this representation encompasses all Returns.

Sellers may also resist given a representation with respect to unwritten and/or informal assertions of tax liability. Buyer, however, is looking for an early warning; both "knowledge" and "materiality" exceptions may be appropriate here.

Note that this representation serves primarily a due diligence function; Buyer may not be able to identify recoverable damages for breach of this representation by Seller.

(f) Tax Sharing Agreements. Target is not (nor has it ever been) a party to any tax sharing agreement and has not assumed the liability of any other person under contract.

Comment: Tax sharing agreements may be beneficial or detrimental to Target. For example, the Seller may have acquired Target from a third party which, as part of the sales contract, agreed to indemnify Target from liability for taxes arising prior to the sale. Buyer will want to determine whether the protection of that agreement will be available to it following the purchase of Target. Target may also have entered into transactions in which it assumed liability for taxes of another, such as tax indemnities in leveraged lease transactions, financial product transactions or joint ventures. All of these obligations need to be evaluated.

(g) Tax Elections and Special Tax Status. Target has not filed a consent pursuant to the collapsible corporation provisions of Section 341(f) of the Code (or any corresponding provision of state, local or foreign income tax law). No member of the Group is a party to any safe harbor lease within the meaning of Section 168(f)(8) of the Code, as in effect prior to amendment by the Tax Equity and Fiscal Responsibility Act of 1982. No member of the Group is or has been a United States real property holding corporation within the meaning of Section 897(c)(2) of the Code during the applicable period specified in Section 897(c)(1)(A)(ii) of the Code and Buyer is not required to withhold tax on the purchase of the stock of Target by reason of Section 1445 of the Code. Seller is not a "foreign person" (as that term is defined in Section 1445 of the Code). No member of the Group has entered into any compensatory agreements with respect to the performance of services which payment thereunder would result in a nondeductible expense to the Group pursuant to Sections 162 or 280G of the Code or an excise tax to the recipient of such payment pursuant to Section 4999 of the Code. Target has not been the "distributing corporation" (within the meaning of Section 355(c)(2) of the Code) with respect to a transaction described in Section 355 of the Code within the 3-year period ending as of the date of this Agreement. No member of the Group has participated in an international boycott as defined in Code Section 999. Target has not agreed, nor is it required to make, any adjustment under Code Section 481(a) by reason of a change in accounting method or otherwise. No member of the Group has a permanent establishment in any foreign country, as defined in any applicable Tax treaty or convention between the United States of America and such foreign country. No member of the Group is a party to any joint venture, partnership or other agreement, contract or arrangement (either in writing or verbally, formally or informally) which could be treated as a partnership for federal income tax purposes. Target is in compliance with the terms and conditions of any applicable Tax

exemptions, Tax agreements or Tax orders of any government to which it may be subject or which it may have claimed, and the transactions contemplated by this Agreement will not have any adverse effect on such compliance.

Comment: This is by no means an exhaustive list of the types of special tax items to be considered. For example, it may be worthwhile to inquire about tax-exempt financing transactions, and any manner of foreign-tax-related elections. The representation with respect to Section 355 transactions is to identify potential issues under IRC § 355(e). The last sentence in the representation applies not only to foreign tax concessions but also to state and local tax concessions which might be adversely affected by a change in control of Target.

It should be noted that this tax representation does not include a representation that there are no tax liens encumbering Seller's property. This is an important representation, and should be included in the tax representation if it is not already included in the general "no liens" representation in the purchase agreement.

(h) Tax Basis and Tax Attributes. The Disclosure Schedule contains accurate and complete description of Target's basis in its assets, Target's current and accumulated earnings and profits, Target's tax carryovers, excess loss accounts in the Target group, tax elections made by any member of the Group affecting Target, and deferred intercompany transactions in the Target group. Target has no net operating losses or other tax attributes presently subject to limitation under Code Sections 382, 383, or 384, or the federal consolidated return regulations.

Comment: If Target has favorable tax attributes which Buyer expects to inherit, Buyer will want to include a representation regarding the existence and amount of the attributes, and

additional provisions assuring that it will receive the benefit of these attributes. See Part X, *infra*, for suggested provisions relating to Target net operating loss carryforwards.

Although the acquisition of Target out of a consolidated group will trigger any of its deferred intercompany items in the Seller return immediately prior to the acquisition, if both parties to the deferred intercompany transaction are acquired and continue to join in the filing of a consolidated return, the attributes of the intercompany buyer's corresponding items with respect to any transferred asset will continue to be determined as if buyer and seller were divisions of a single corporation. Treas. Reg. §1.1502-13(d)(3), *Example 1(g)*. For this reason, it is relevant to inquire regarding the existence of deferred intercompany transactions.

Although the tax basis and earnings and profits information requested by this representation may be important to Buyer, a Seller may resist providing a representation regarding the information. Buyer may want to settle for a covenant (see *infra*) that Seller will provide the information prior to closing.

(i) Section 6038A Compliance. Target has filed all reports and has created and/or retained all records required under Section 6038A of the Code with respect to its ownership by and transactions with related parties. Each related foreign person required to maintain records under Section 6038A with respect to transactions between Target and the related foreign person has maintained such records. All documents that are required to be created and/or preserved by the related foreign person with respect to transactions with Target are either maintained in the United States, or Target is exempt from the record maintenance requirements of Section 6038A with respect to such transactions under Treasury Regulation section 1.6038A-1. Target is not a party to any record maintenance agreement with the Internal Revenue Service with respect to Section 6038A. Each related foreign person that has

engaged in transactions with Target has authorized Target to act as its limited agent solely for purposes of Sections 7602, 7603, and 7604 of the Code with respect to any request by the Internal Revenue Service to examine records or produce testimony related to any transaction with Target, and each such authorization remains in full force and effect.

Comment: This representation is included as a sample of the type of tax representation and warranty which may be needed if there is any significant foreign ownership of Seller or Target. In recent years, a number of provisions have been added to the Code regarding the reporting of foreign-related transactions. Under certain circumstances, if more than 25% of the ownership of Target is foreign, Target might find itself unable to defend itself on audit against intercompany pricing adjustments if it is unable to provide information in the hands of its former foreign affiliate. It may be extraordinarily difficult to obtain necessary information after Target leaves Seller's group unless arrangements are put in place before the sale.

[(j) Section 338 Election. Seller has the authority to consent to the Code Section 338(h)(10) election and similar state elections with respect to this transaction.]

Comment: The decision whether to make a section 338 election, and the eligibility requirements, are beyond the scope of this outline. They are, however, issues which should be discussed with the Buyer (and with the business lawyers) before the acquisition document is drafted.

VII. Pre-Closing Covenants

A. Pre-closing covenants arise in transactions where there is a period between the signing of the acquisition agreement and the closing. Deferred closings may occur because of the need to conduct due diligence, obtain governmental or creditor consents,

or obtain shareholder approval of the transaction. During the pre-closing period, the Buyer will want to assure that no actions are taken which could adversely affect Target without its knowledge.

B. Covenants may be negative or affirmative. Negative covenants preclude the Seller from taking actions without the consent of the Buyer. Affirmative covenants require the Seller to take an action, and the action may, itself, be a condition to the Buyer's obligation to close the transaction.

C. Typical Tax-Related Pre-Closing Covenants and Closing Conditions.

1. Preparation of Returns and Payment of Taxes. Seller and Target shall prepare and timely file all Returns and amendments thereto required to be filed by them and the Group on or before the Closing Date. Buyer shall have a reasonable opportunity to review all Returns and amendments thereto. Seller, Target and each member of the Group shall pay and discharge all Taxes, assessments and governmental charges upon or against it or any of its properties or assets, and all liabilities at any time existing, before the same shall become delinquent and before penalties accrue thereon, except to the extent and as long as: (a) the same are being contested in good faith and by appropriate proceedings pursued diligently and in such a manner as not to cause any material adverse effect upon the condition (financial or otherwise) or operations of Target or any member of the Group; and (b) Target shall have set aside on its books reserves (segregated to the extent required by sound accounting practice) in the amount of the demanded principal imposition (together with interest and penalties relating thereto, if any).

Comment: In addition to regularly scheduled tax returns, there may be pre-closing tax returns attributable to the pendency of the transaction. For example, prior to its recent repeal, the New York

Real Property Gains Tax required pre-closing filings. Similarly, in some states it may be advisable to obtain pre closing tax clearances with respect to sales tax or unemployment tax liabilities of the Seller.

2. Access to Records. Between the date of this Agreement and the Closing Date, Seller and Target shall give Buyer and its authorized representatives full access to all properties, books, records and Returns of or relating to Target, whether in possession of Target, Seller or third-party professional advisors or representatives in order that Buyer may have full opportunity to make such investigations as it shall desire to make of the affairs of Target. Seller and Target shall ensure that all third-party advisors and representatives of Seller and Target, including without limitation accountants and attorneys, fully cooperate and be available to Buyer in connection with such investigation.

Comment: In the absence of cooperation by Seller, it may be difficult or impossible for Buyer to obtain information regarding Target in the hands of Target's attorneys and accountants. From a due diligence standpoint, the tax accrual workpapers may be particularly important.

3. Tax Sharing Agreements. Seller and Target shall, as of the Closing Date, terminate all tax allocation agreements or tax sharing agreements with respect to Target and shall ensure that such agreements are of no further force or effect as to the Target on and after the Closing Date and there shall be no further liability of Target under any such agreement.

4. Certification of Non-Foreign Status. Seller shall furnish to Buyer on or before the Closing Date a certification of Seller's non-foreign status as set forth in Treasury Regulation §1.1445-2(b).

D. Where the Buyer and Seller intend to structure the acquisition as a reorganization described in IRC §368, each may seen

contractual undertakings from the other regarding actions to be taken (or avoided) prior to and following the acquisition. In addition, Buyer and Seller may wish to condition their obligations to close the transaction on the receipt of favorable tax opinions from their respective counsel. Although opinions of counsel provide some comfort that a transaction has been properly structured to qualify as a tax-free reorganization, they invariably rely on factual representations of the parties to the transaction and statements of the parties future intentions with respect to such matters as continuity of business enterprise and continuity of interest. In the absence of contractual undertakings, it is questionable whether either Buyer or Seller would have recourse if the other acted in a manner which defeated tax-free reorganization treatment. Accordingly, some or all of the following covenants should be considered if the parties intend the transaction to qualify as a tax-free reorganization:

1. Conduct of Business. Except as required by applicable law, Seller and Target will not take or cause to be taken any action which would prevent the transactions contemplated hereby from qualifying as a tax-free reorganization under Section 368 of the Code [or from being accounted for as a pooling of interests under Opinion No. 16 of the Accounting Principles Board].

2. Federal Tax Opinion. It shall be a condition to closing that Buyer shall have received from its counsel, an opinion, in form and substance reasonably satisfactory to Buyer, substantially to the effect that on the basis of facts, representations, and assumptions set forth in such opinion which are consistent with the state of facts existing on the Closing Date, the transaction contemplated by this Agreement will be treated for federal income tax purposes as a reorganization within the meaning of Section 368 of the Code. In rendering such opinion, such counsel may require and, to the extent it deems necessary or appropriate, may rely upon representations made in certificates of officers of Buyer, Target

and principal shareholders of Target.

Comment: A similar condition to Target's obligation to close, regarding a tax opinion from its counsel, will be included.

3. Covenants with Respect to Tax-Free Reorganization

(a) Following the Closing Date, Buyer covenants that, to the extent necessary to preserve the treatment of the transaction as a tax-free reorganization under Section 368 of the Code:

(1) Target will hold at least ninety percent of the fair market value of its net assets and at least seventy percent of its gross assets and at least ninety percent of the fair market value of Sub's net assets and at least seventy percent of the fair market value of Sub's gross assets held immediately prior to the transaction. For purposes of this covenant, amounts paid by Target or Sub to dissenters, amounts paid by Target or Sub to shareholders who receive cash or other property, amounts used by Target or Sub to pay reorganization expenses, and all redemptions and distributions (except for regular, normal dividends) made by Target will be included as assets of Target or Sub, respectively, immediately prior to the transaction.

(2) Buyer will not reacquire any of its stock issued in the transaction.

(3) Target will not issue additional shares of its stock that would result in Buyer losing control of Target within the meaning of Section 368(c) of the Code.

(4) Buyer will not liquidate Target; merge Target with or into another corporation; sell or otherwise dispose of the stock of Target except transfers of stock to corporations controlled by Buyer; or cause Target to sell or otherwise dispose of any of its assets or of any of the assets acquired from Sub, except for dispositions made in the ordinary course of business or transfers of

assets to a corporation controlled by Target.

(5) Buyer will cause Target to continue its historic business or to use a significant portion of its historic business assets in a business.

Comment: This covenant raises the issue of the responsibility of the Buyer and Seller, to each other, to preserve tax-free reorganization treatment. This particular covenant is crafted for a reverse triangular reorganization under Code §368(a)(2)(E) and should be modified to fit the particular reorganization.

VIII. Post-Closing Covenants

A. Post-closing covenants relate to performance obligations of Buyer and Seller following consummation of the purchase. Although tax indemnification obligations may be considered a post-closing performance obligation, they are dealt with separately, *infra*.

B. Typical Post-Closing Covenants.

1. Access to Records Following Closing. Buyer and Seller agree that so long as any books, records and files retained by Seller relating to the business of Target, or the books, records and files delivered to the control of Buyer pursuant to this Agreement to the extent they relate to the operations of Target prior to the Closing Date, remain in existence and available, each party (at its expense) shall have the right upon prior notice to inspect and to make copies of the same at any time during business hours for any proper purpose. Buyer and Seller shall use reasonable efforts not to destroy or allow the destruction of any such books, records and files without first offering in writing to deliver them to the other.

Comment: Particularly when the Buyer is acquiring Target out of an affiliated group of corporations, it may find that essential tax records are not housed in Target. Buyer may want assurance not

only that the tax records will be retained and made available, but also that it will have an opportunity to obtain or copy the records before they are destroyed.

2. Section 338 Elections. If requested by Buyer, Buyer and Seller shall join in an election to have the provisions of Section 338(h)(10) of the Code and similar provisions of state law ("Section 338 Elections") apply to the acquisition of Target. Buyer shall be responsible for, and control, the preparation and filing of such election. The allocation of purchase price among the assets of Target shall be made in accordance with Code Sections 338 and 1060 and any comparable provisions of state, local or foreign law, as appropriate. Seller shall, unless it would be unreasonable to do so, accept Buyer's determination of such purchase price allocations and shall report, act, file in all respects and for all purposes consistent with such determination of Buyer. Seller shall execute and deliver to Buyer such documents or forms (including Section 338 Forms, as defined below) as Buyer shall request or as are required by applicable law for an effective 338(h)(10) Election. "Section 338 Forms" shall mean all returns, documents, statements, and other forms that are required to be submitted to any federal, state, county or other local taxing authority in connection with a 338(h)(10) Election, including, without limitation, any "statement of Section 338 election" and IRS Form 8023 (together with any schedules or attachments thereto) that are required pursuant to Treasury Regulations.

Comment: The decision to make a Section 338(h)(10) election may be a Seller decision. Although the decision is generally favorable for the Buyer, it may not be favorable in some state jurisdictions. In negotiating the terms of any election provision of this nature, you should keep in mind that in some states (e.g., California) it is possible to elect out of Section 338(h)(10) treatment even though the federal election is made.

3. Tax Matters and Post-Closing Cooperation.

(a) Seller shall pay all Taxes arising from or relating to the transactions contemplated by this Agreement.

Comment: This is a document drafted by Buyer's counsel, after all! One may expect this provision to be the subject of some discussion. Here is an alternative formulation when there is to be a Section 338(h)(10) election:

(a) Seller shall be responsible for and shall pay any income, franchise or similar Taxes arising as a result of any Section 338(h)(10) Election or any comparable or resulting election under state law filed by Buyer or Seller. Notwithstanding the preceding sentence, (i) Buyer shall pay any state or local transfer, sales or use, notarial or similar fees or Taxes arising as a result of the sale of the shares and the transactions contemplated hereby and (ii) Buyer shall be responsible for and shall pay any income, franchise or similar taxes imposed by any state or local taxing authority as a result of any Section 338(g) election (or any comparable election under state law) if such state or local taxing authority does not allow or respect a Section 338(h)(10) Election (or any comparable or resulting election under state law) with respect to the purchase and sale of the shares of Target contemplated hereby.

(b) Seller shall pay all Taxes that may be due after the Closing Date that are allocable to the period prior to and including the Closing Date. In order appropriately to apportion any of these Taxes relating to a period that includes (but that would not, but for this section, close on) the Closing Date, the parties hereto will, to the extent permitted by applicable law, elect with the relevant taxing authorities to treat for all purposes the Closing Date as the last day of a taxable period of Target, and such period shall be treated as a "Short Period" and a "Pre-Closing Period" for purposes of this Agreement.

Comment: The question of who pays Taxes arising on the Closing Date is always a concern. If a Section 338(h)(10) election is not being made, Seller will want to be certain that it is not responsible for any Taxes that might arise if Buyer makes a regular Section 338 election. In addition, Seller may want to protect against liability for Taxes from unusual transactions by Target on the Closing Date after Buyer has taken control of Target. See Treas. Reg. §§1.1502-76(b). It is worth noting that the consolidated return regulations permit the Buyer and Seller to elect, in certain circumstances, to ratably allocate income for the tax year of the sale rather than use a closing of the books method. See Treas. Reg. §1.1502-76(b)(2)(ii). The election is available only when the acquisition does not require Target to change its annual accounting period or its method. If the election is potentially available, Buyer should consider adding a provision requiring Seller to make the election if requested by Seller.

(c) In any case where applicable law does not permit Target to treat the Closing Date as the last day of a Short Period, then for purposes of this Agreement, the portion of such Taxes that is attributable to the operations of Target for such Interim Period (as defined below) shall be (i) in the case of Taxes that are not based on income or gross receipts, the total amount of such Taxes for the period in question multiplied by a fraction, the numerator of which is the number of days in the Interim Period, and the denominator of which is the total number of days in the entire period in question, and (ii) in the case of Taxes that are based on income or gross receipts, the Taxes that would be due with respect to the Interim Period, if such Interim Period were a Short Period. "Interim Period" means with respect to any Taxes imposed on Target on a periodic basis for which the Closing Date is not the last day of a Short period, the period of time beginning on the first day of the actual taxable period that includes (but does not end on) the Closing Date and ending on and including the Closing Date. Seller shall pay to

Buyer the amount by which any Taxes are imposed on Target or Buyer to the extent such Taxes exceed the amount of Taxes that would have been imposed if Target had never been part of a unitary group or combined group for state tax purposes.

Comment: Depending upon the particular circumstances of the Seller and Buyer, Target's tax year may not end on the Closing Date for federal, state, local or foreign tax purposes. In these circumstances, there needs to be proration of the tax obligation for the year.

In a combined reporting jurisdiction, the issue may involve not only an allocation of Target's income to a pre- and post-acquisition period, but also a determination of the allocation and apportionment factors to be used in allocating Target's income to potential taxing jurisdictions.

(d) If in any period ending after the Closing Date Target earns any credit or recognizes any loss which cannot be applied against its tax liability for such period, and is permitted by law to carry back such credit or loss to a period ending on or prior to the Closing Date, at Buyer's request and expense Seller shall file refund claims reflecting such carryback, and if the Group shall receive a tax refund with respect to such claim, Seller shall immediately remit the refund, together with interest received with respect thereto, to Buyer. In the event that the Group would have received a refund (including interest) with respect to such claim (or a larger refund than actually paid) had such refund not been offset by the taxing authority against tax, interest or penalties imposed by the taxing authority against the Group (other than tax, interest or penalties attributable to the operations of Target) then, in addition to remitting the amount of any refund (including interest) received from the taxing authority, Seller shall pay to Buyer within 10 days after receipt of notice of such offset, an amount equal to the amount of such offset, together with interest calculated at the rate

applicable to tax refunds. Seller agrees that it will cooperate with Buyer and Target and their respective representatives, in a prompt and timely manner, in connection with (i) the preparation and filing of, and (ii) any administrative or judicial proceedings involving, any return of tax or information filed or required to be filed by or for Target or the Buyer.

Comment: Where Target is a member of a consolidated group, only the common parent can deal with the Internal Revenue Service on carryback/refund matters. In the absent of a contractual provision, the Seller is not obligated to file a refund claim or to pay a refund over to Target.

(e) Buyer shall not file an amended tax return for any period ending on or prior to the Closing Date without the consent of Seller.

Comment: In most acquisitions, the Seller indemnifies the Buyer for any tax liability arising in pre-Closing periods. See infra. Particularly where there is a time limit on the indemnification, or where the indemnification agreement does not reduce indemnity payments by post-Closing tax benefits, it may be in the interest of Buyer to file amended returns, reporting and paying tax on any questionable items.

C. <u>Additional Provisions Relating to Target Net Operating Losses</u>

1. <u>Purchase Price Adjustment Relating to Target Losses</u>. Within __ days following the close of Seller's tax year which includes the Closing Date, Seller shall report to Buyer the amount of Target's net operating loss carryforward for its first taxable year beginning on or after the Closing Date. In the event that the amount reported by Seller to Buyer is less than $___________, Seller shall pay to Buyer, as an adjustment in the purchase price, an amount equal to [35]% of the difference.

2. <u>Covenant With Respect to Target Net Operating Loss</u>

Carryforwards. In the event that any portion of the consolidated net operating loss carryforward allocable to Target under Treas. Reg. §1.1502-79(a) is subject to a consolidated section 382 limitation (or a subgroup section 382 limitation), Seller shall elect in accordance with Treas. Reg. §1.1502-95T to apportion to Target a portion of the consolidated section 382 limitation sufficient to permit Target to absorb the apportioned consolidated net operating loss carryforward in ___ years.

3. Indemnification With Respect to Lost Carryforwards. In the event that an adjustment of the income of any member of the Group after the Closing Date (whether as a result of audit, amended return or otherwise) with respect to any tax year in which Target was a member of the Group has the effect of reducing the federal net operating loss carryforward available to Target for its first taxable year beginning on or after the Closing Date, Seller shall pay to Buyer, as an adjustment in the purchase price, an amount equal to the greater of (i) any liability of Target for Taxes with respect to a Post-Closing Period federal income tax return of Target in which Target utilized such loss to reduce its current liability for Taxes, or (ii) [35]% of the reduction in the net operating loss carryforward.

Comment: Where Target is a member of a consolidated group, a portion of any consolidated net operating loss will be allocable to it when it leaves the group. However, the loss allocable to it will be reduced by any taxable income of Seller's consolidated group for the Seller's tax year, including the period of the year after Target leaves the group. Treas. Reg. §1.1502-79(a)(ii). Moreover, in certain circumstances, Seller may be permitted to reattribute to itself any losses of Target. See Treas. Reg. §1.1502-20(g).

The net operating loss allocable to Target may be subject to limitation under IRC §382 as a result of an ownership change occurring while Target was a member of the Seller group (or subgroup). Under the consolidated return regulations, Seller, as

common parent of the group, may choose to allocate a portion of the applicable section 382 limitation to Target (including both the annual limitation and any accumulated unused annual limitation from prior periods). See Treas. Reg. §1.1502-95T. It Seller does not elect to make the allocation, the portion of Target's net operating loss carryforward subject to the section 382 limitation will be valueless to Buyer.

Where Target's net operating loss carryforward is an important asset to Buyer, it will wish to assure that the loss is not reduced by Seller's post-sale income (or, more accurately, that the purchase price reflects any lost benefit, since Seller may not be able to control the timing of its income). Buyer will also wish to assure itself that there is a reasonable allocation of any required section 382 limitation. Finally, Buyer will wish to be indemnified if, as a result of subsequent tax audits increasing the pre-sale income of the Seller group, Target's tax losses available to Buyer are reduced. These provisions address these issues (similar provisions may be used for other carryforward attributes, if they are material); they might also be appropriately included with the indemnification provisions described infra..

IX. Indemnification

A. The scope of the Seller's indemnification obligation is likely to be one of the most heavily negotiated features of the acquisition agreement. From the tax lawyer's perspective, what is important to note is that the Buyer's potential exposure to tax liabilities differs markedly from its exposure to other potential liabilities. For this reason, the provisions of the acquisition agreement relating to taxes are likely to be separately negotiated, although they will need to be dovetailed to the general indemnity provisions as well.

B. Almost all agreements have a "basket" or "deductible" provision which limits the Seller's obligation to indemnify the Buyer. To the extent that claims for indemnification fall within the basket, Buyer

has no obligation to indemnify Seller.

1. In some cases a "basket" is only a "hurdle." For example, the agreement may provide for a basket of $100,000; if total indemnity claims are $100,100, the Seller is liable for only $100. If the basket is only a hurdle, the Seller is fully liable from the first dollar if the deductible is exceeded. Thus, in the prior example, since the $100,000 threshold is exceeded, the Seller would be fully liable for $100,100.

2. There is a reasonable argument for excluding tax claims from the deductible, so that the Seller will be liable for the first dollar of tax claims regardless of the basket. [There may be a nuisance level exclusion, say $500.]

C. Seller's may also bargain for a "cap" on the overall indemnification obligation. Once the cap is reached, the Seller has no further indemnification obligation, in the absence of fraud or willful misconduct.

1. The "cap" concept may leave the Buyer significantly exposed in a tax context. Under the consolidated return regulations, the Target is severally liable for the entire consolidated tax liability of the former consolidated group of which it was a member. Treas. Reg. §1.1502-6. This liability exists even if a Section 338(h)(10) election is made with respect to the acquisition. Treas. Reg. §1.338(h)(10)-1(e)(5).

2. If Target is kept as a separate entity, the Buyer can avoid infecting itself with Target's liability; however, new capital infusions or transfer of existing Buyer business to Target can effectively expose Target to risks in excess of the purchase price paid to Seller. For these reasons, Buyer should take the position that the cap will not apply to tax obligations.

D. There is generally a cutoff period after which no indemnity

claims may be made. Tax claims should be excluded from the cutoff, since audits may not even commence prior to the expiration of the cutoff period. The agreement should provided that tax claims will survive until expiration of the statute of limitations. As Buyer's counsel you will want to be certain that the survival period is increased by any extensions of time for assessment granted to the taxing authorities.

E. It is generally advantageous to the Buyer for indemnification payments to be treated as purchase price adjustments. Although this treatment is probably required in most cases under the tax law, language binding the Seller to this treatment should be included in the acquisition agreement.

F. In most cases, acquisition agreements provide the indemnifying party the opportunity to control the litigation of any claim which could give rise to an indemnification obligation.

1. In most indemnification situations, the particular claim can be isolated from the normal operations of Target and Buyer, so that Seller control of the matter is not unduly intrusive.

2. Tax audits, on the other hand, frequently involve operations and issues which cannot be easily separated out. The audit may span pre- and post-acquisition years; even when it does not, resolution of an item may carry forward into post-acquisition years. Thus, the contest provisions which are appropriate for non-tax indemnity may be inappropriate for tax matters.

G. In some cases, the Seller's indemnification obligation may be backed up through an escrow of a portion of the purchase price or a hold-back of a portion of the purchase price by the Buyer. Escrow arrangements may constitute separate taxable entities (see IRC §468B(f)), and the tax reporting obligations of the parties need to considered. Of course, escrows and contingent payouts may present particular problems in tax-free reorganizations. *See*

Rev. Proc. 77-37, 1977-2 C.B. 568, modified by Rev. Proc. 84-42, 1984-1 C.B. 521.

H. Typical Tax Indemnification Provisions

Seller's Indemnification.

(a) From and after the Closing Date, Seller shall protect, defend, indemnify and hold harmless Buyer and Target from any and all Taxes which are imposed on Target in respect of its income, business, property or operations or for which Target may otherwise be liable (A) for any taxable period ending prior to the Closing Date and for any Pre-Closing Period (as defined and determined in Section __), (B) resulting by reason of the several liability of Target pursuant to Treasury Regulations section 1.1502-6 or any analogous state, local or foreign law or regulation or by reason of Target having been a member of any consolidated, combined or unitary group on or prior to the Closing Date, (C) resulting from Target ceasing to be a member of the affiliated group (within the meaning of Section 1504(a) of the Code) that includes Seller, (D) in respect of any Post-Closing Period, attributable to events, transactions, sales, deposits, services or rentals occurring, received or performed in a Pre-Closing Period, (E) in respect of any Post-Closing Period, attributable to any change in accounting method employed by Target during any of its four previous taxable years, (F) in respect of any Post-Closing Period, attributable to any items of income or gain of a partnership reporting Target as a partner, to the extent such items are properly attributable to periods of the partnership ending on or before the Closing Date, (G) attributable to any discharge of indebtedness that may result from any capital contributions by Seller (or an affiliate of Seller) to Target of any intercompany indebtedness owed by Target to Seller (or an affiliate of Seller), (H) resulting from the making of the Code Section 338 election (or analogous provision of state, local or territorial law), and (I) resulting from the breach of Seller's covenant

set forth in [Tax Covenants]; provided, however, that Seller's liability under the foregoing provisions of this paragraph shall be reduced as to any item to the extent that such item was specifically and fully reserved for in the [Closing Balance Sheet].

Comment: Note that subparagraph (H) of the indemnity language assumes that a Section 338(h)(10) election will be made.

A Seller may seek to limit the indemnification to Taxes "to the extent the payment of such taxes has not been reflected or reserved on the financial statements of the Target as of the Closing Date." If this exception is requested, it should be agreed to only if there is a purchase price adjustment based on the Closing Date Balance Sheet. Moreover, it should be clear that deferred tax liability provisions are not taken into account. Finally, there should be a clear understanding what taxes are reflected on the Balance Sheet; the tax reserve should not operate as a second indemnity basket for unidentified claims.

(b) Buyer will, as to any as to any Taxes in respect of which Seller has agreed to indemnify Buyer or Target, promptly inform Seller of, and permit the participation of Seller in, any investigation, audit or other proceeding by or with the Internal Revenue Service or any other taxing authority empowered to administer or enforce such a tax and will not consent to the settlement or final determination in such proceeding without the prior written consent of Seller (which consent will not be unreasonably withheld).

Comment: It is unlikely that many Sellers will agree to a provision providing full control over matters for which it may have an indemnification obligation. However, if the Sellers are individuals, they may well not have the means or inclination to manage an audit. Assuming a more sophisticated Seller, the following provision is more likely to provide a basis for a successful negotiation.

(b) In the case of any audit, examination or other proceeding

("Proceeding") with respect to Taxes for which Seller is or may be liable pursuant to this Agreement, Buyer shall promptly inform Seller, and shall afford Seller, at Seller's expense, the opportunity to control the conduct of such Proceedings. Buyer shall execute or cause to be executed powers of attorney or other documents necessary to enable Seller to take all actions desired by Seller with respect to such Proceeding to the extent such Proceeding may affect either the amount of Taxes for which Seller is liable pursuant to this Agreement. Seller shall have the right to control any such Proceedings, and, if there is substantial authority therefor, to initiate any claim for refund, file any amended return or take any other action which it deems appropriate with respect to such Taxes. If requested by Buyer, Seller shall provide to Buyer an opinion in form and content reasonably acceptable to Buyer from counsel reasonably acceptable to Buyer that there is substantial authority for the position that Seller is taking with respect to such action, and Buyer need not and Seller shall not take such action until such opinion is delivered to Buyer. Any Proceeding with respect to Taxes for a period which includes but does not end on the Closing Date shall be controlled jointly by Seller and Buyer. Notwithstanding any provision of this Section __ to the contrary, Seller shall not have the right to control any Proceeding, to initiate any claim for refund, to file any amended return or to take any other action if, as a result of such Proceeding, claim for refund, amended return or other action, the Taxes payable by Buyer or Target for a taxable period for which Seller is not obligated to indemnify Buyer or Target pursuant to Section __ would be likely to be materially increased.

Comment: The level of authority which must support a position being taken by Seller in a tax audit may be the subject of considerable discussion. The possible formulations of the standard range from "reasonable basis" to "more likely than not." This formulation takes a middle ground.

The last sentence of this version of indemnification language

attempts to deal with the issue of the spill-over effect of audit adjustments in indemnified years to post-sale years by taking control of the audit away from Seller. Another formulation of the last sentence would leave audit control in Seller, but preclude settlement without the Buyer's consent:

Notwithstanding the foregoing, Seller shall not agree to any settlement concerning Taxes for any taxable period ending on or before the Closing Date which may result in an [material] increase in Taxes for any taxable period ending after the Closing Date without the prior written consent of Buyer.

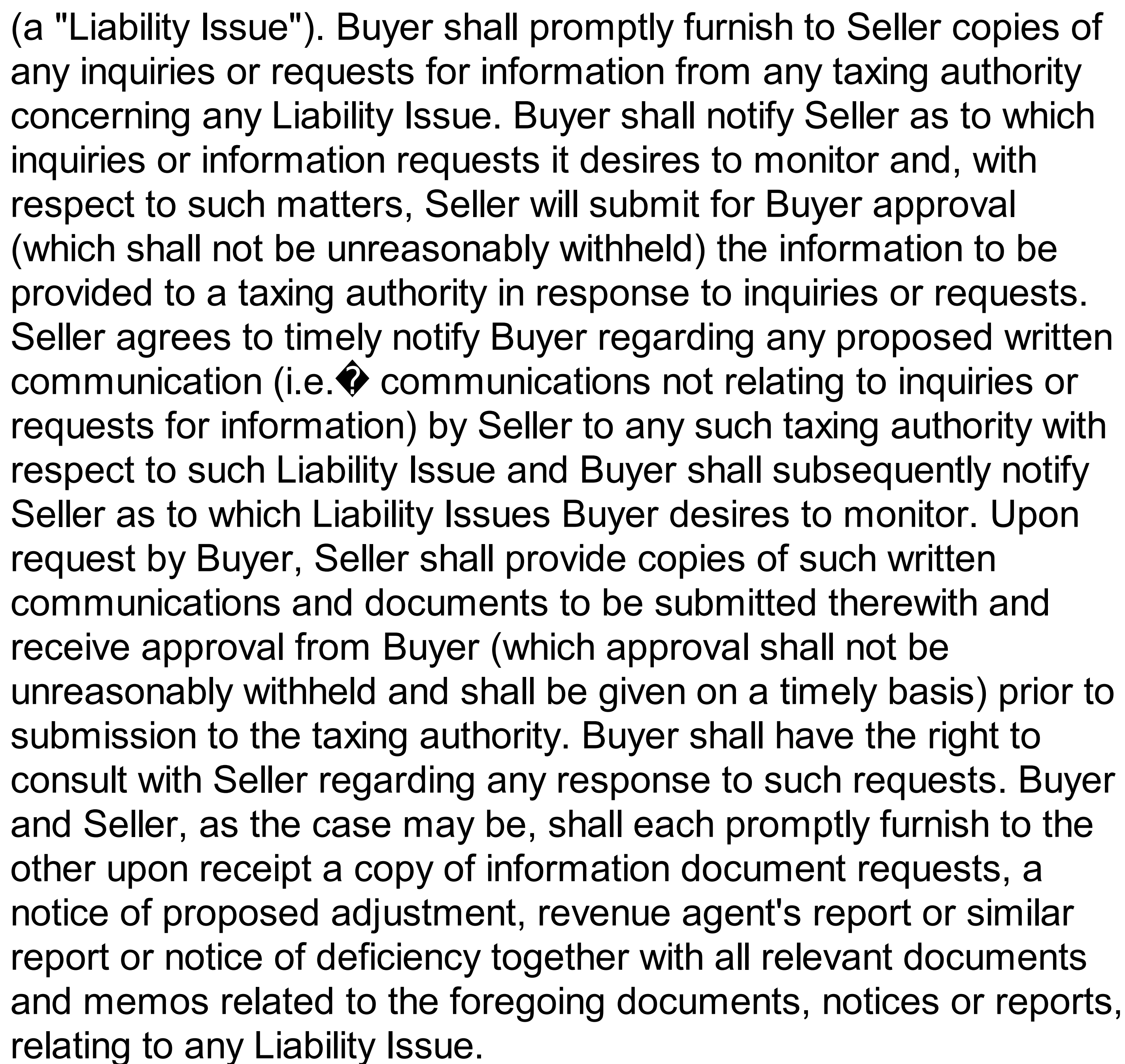
A separate negotiation is likely to ensue as to the standard for Buyer's consent, with Seller wanting to be relieved from liability if Buyer's refusal to consent is unreasonable. This may lead to the insertion of provisions providing for arbitration or dueling opinions.

Buyer may also want to be in a position to cut off pursuit of an audit issue by Seller by waiving the right to indemnity. The important point here is that the language should be drafted on an issue-by-issue basis; Buyer should be able to instruct Seller to concede one issue without having to waive indemnification on other issues:

By written notice to Seller, Buyer shall have the right to instruct Seller to forego Proceedings with respect to one or more items for which Seller may be liable to indemnify Buyer. Such notice shall constitute a waiver of the right of Buyer to indemnification for any Taxes arising out of such item for the period or periods involved, but shall not otherwise waive any rights of Seller under this section.

Here is another version of the audit provision, providing somewhat more detailed supervision by Buyer:

(b)(i) Buyer shall use reasonable efforts to keep Seller advised as to the status of Tax audits and litigation involving any Taxes which could give rise to a liability of Seller to Buyer under this agreement



(a "Liability Issue"). Buyer shall promptly furnish to Seller copies of any inquiries or requests for information from any taxing authority concerning any Liability Issue. Buyer shall notify Seller as to which inquiries or information requests it desires to monitor and, with respect to such matters, Seller will submit for Buyer approval (which shall not be unreasonably withheld) the information to be provided to a taxing authority in response to inquiries or requests. Seller agrees to timely notify Buyer regarding any proposed written communication (i.e.� communications not relating to inquiries or requests for information) by Seller to any such taxing authority with respect to such Liability Issue and Buyer shall subsequently notify Seller as to which Liability Issues Buyer desires to monitor. Upon request by Buyer, Seller shall provide copies of such written communications and documents to be submitted therewith and receive approval from Buyer (which approval shall not be unreasonably withheld and shall be given on a timely basis) prior to submission to the taxing authority. Buyer shall have the right to consult with Seller regarding any response to such requests. Buyer and Seller, as the case may be, shall each promptly furnish to the other upon receipt a copy of information document requests, a notice of proposed adjustment, revenue agent's report or similar report or notice of deficiency together with all relevant documents and memos related to the foregoing documents, notices or reports, relating to any Liability Issue.

(ii) Subject to the cooperation provisions of (i), above, Buyer shall have full responsibility for and discretion in handling any Tax controversy, including, without limitation, an audit, a protest to the Appeals Division of the IRS, and litigation in Tax Court or any other court of competent jurisdiction (a "Proceeding") involving Target. However, upon request by Seller, and subject to the cooperation provisions of (i) above, Seller shall have full responsibility and discretion in handling, at Seller's expense, any Proceeding with respect to any Liability Issue. In the event that Target is required to

pay any Tax, file any bond or deposit any amount in order to undertake a Proceeding, Seller shall loan to Target no later than three (3) business days before such payment is required to be made, without interest and until a final determination with respect to such Tax has occurred, one hundred percent of the amount required to be paid by Target. Within three (3) business days of the receipt by Target of a refund of any amount loaned to it by Seller (including any interest received by Target), Target shall pay such refunded amount to Seller net of any Tax cost incurred by Target as a result of such refund.

X. Asset Purchase Agreements

A. The tax provisions of asset purchase agreements typically contain considerably less tax language than found in stock purchase agreements, reflecting the fact that generally the Buyer generally does not inherit Target's tax liabilities as a result of the purchase of its assets. However, this "general" rule may not apply if the sale transaction results in a fraudulent conveyance of Target's assets or is completed without proper notification under the local bulk sales law. For this reason, it may be appropriate to include full tax representations from the Target.

B. It is always worthwhile to confirm that the "assets" being purchased do not include the stock of a company, such as a dormant "name holding" company. The tax liability of a consolidated group can be assessed against any member or former member of the group, regardless of size.

C. The Buyer will, in any event, require a representation that there are no tax liens encumbering the acquired assets.

D. In some jurisdictions the Buyer of business assets may inherit Target's tax liabilities unless Target obtains a tax clearance certificate from the local tax authorities. See, e.g., California Revenue and Taxation Code §6812 (sales tax) and California

Unemployment Insurance Code §1732 (employment taxes). If there is insufficient time to obtain the clearance certificates and Buyer is comfortable with Target's ability to satisfy an indemnity obligation, the problem can be dealt with through specific indemnification language.

E. The agreement should specify who pays transaction taxes, recognizing that transaction taxes may include Real Property Gains Taxes, sales taxes, recordation taxes, etc. Note that the purchase price allocation, discussed below, may affect the amount of these taxes.

Sample Asset Purchase Tax Representation

Taxes. Seller has filed all tax returns, of every kind, nature, or description, required to be filed by Seller relating to the [acquired Business] and has paid or remitted to the proper authority all taxes and assessments including, without limitation, all excise taxes, sales and use taxes, payroll withholding taxes, FICA taxes, unemployment taxes, business taxes, and real and personal property taxes which are required to be paid or remitted by Seller, and has established adequate reserves for the payment of all taxes and other governmental charges for the current period which are not yet due.

Sample Purchase Price Allocation Language

The purchase price (including assumed liabilities) shall be allocated among the acquired assets in accordance with Schedule ___ hereto. The parties shall file all Tax Returns (including amended returns and claims for refund) and information reports in a manner consistent with such allocation, and shall use their reasonable best efforts to sustain such allocation in any subsequent tax audit or tax dispute.

An alternative:

Seller and Buyer shall cooperate in the preparation of a joint schedule (the "Allocation Schedule") allocating the purchase price (including, for purposes of this Section, any other consideration paid by Buyer and any assumed liabilities), among the purchased assets. Seller and Buyer each agrees to file IRS Form 8594, and all federal, state, local and foreign tax returns, in accordance with the Allocation Schedule. Seller and Buyer each agrees to provide the other promptly with any other information required to complete the Allocation Schedule. If, however, Seller and Buyer are unable to complete such schedule within ___ days following the Closing Date, or by such later date as agreed by the parties, each of Seller and Buyer may file IRS Form 8594, and any federal, state, local and foreign tax returns, allocating the purchase price (as defined for purposes of this Section) among the purchased assets in the manner each believes appropriate, provided such allocation is reasonable and in accordance with Section 1060 of the Code and the regulations thereunder.

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