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Clean Breaks and Safe Bets: Bringing Public Style Exits to Privately Owned Companies

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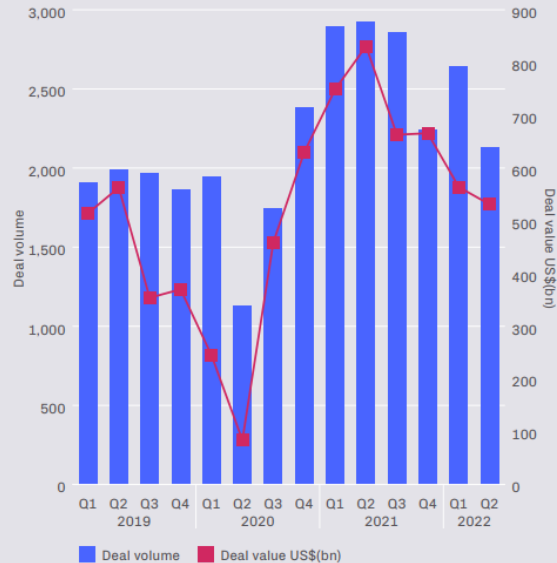
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M&A Market Trends

M&A Market Trends – H1 2022

All sectors M&A activity,
2019-HY 2022



Source: Mergermarket

- The M&A market registered a total of US\$1.1 trillion from 4,771 deals in H1 2022, down 30.7% and 18% respectively year on year.
- TMT was the top sector for deal-making in H1 2022, with a total of US\$471,414 million from 1,712 deals.



Even with the easing off of M&A activity from the end of last year, there is still a considerable margin for deal-making to remain in line, and even above, historic levels.

- Datasite Deal Drivers: Americas H1 2022 Report

M&A Market Trends: H1 2022 M&A Tailwinds

| | |
|---|---|
| Private Equity | <ul style="list-style-type: none">• High levels of “dry powder”• Competition driving high multiples• Need to divest of portfolio companies |
| Debt Financing (Pendulum likely to swing back to Creditors in H2 2022) | <ul style="list-style-type: none">• Interest rates• Availability• Less restrictive covenant packages |
| US Tax Reform | <ul style="list-style-type: none">• Proposals to increase marginal tax rates• Proposals to increase LTCG rates• Corporate AMT/ excise tax on stock buybacks |
| Other | <ul style="list-style-type: none">• Technology disruption, cross-sector and convergence M&A• Shareholder activism continues to drive corporate carve-outs and other M&A activity• Confidence remains high |

M&A Market Trends

- Private equity-style clean exits becoming the norm in **most transactions**
- Traditional pre-closing tax indemnities becoming much less common
- Need alternatives to address known and unknown liabilities

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M&A Tax Trends

M&A Tax Trends

Tax Indemnity

- Representations & warranties insurance (RWI) only – **No indemnity**
- Full blown pre-closing tax indemnity (less common)
- Transferee tax liability of remaining group only in carve-out transaction
- Tax indemnity keyed off of tax return filing covenants
- Purchase price reduction for known tax liabilities
- Mix and Match – RWI + specific tax indemnity + special tax escrow + price reduction + tax insurance for known but uncertain tax risks

M&A Tax Trends

NOLs / Tax Benefits / Refunds / SALT Issues

- NOLs & Loss Companies – Closing Date items and how to address in SPA:
 - Sellers more aggressive but can tell them "no"
 - Increase bid for tax benefits / NOLs using "assumed tax rate"
 - Monitor going forward and pay Sellers as tax benefits actually realized calculated on a "with or without basis"
- Refunds: monitor going forward versus address "upfront" in purchase price
- SALT Issues: VDAs / SALT advisor / purchase price adjustment / escrow

M&A Tax Trends

RWI Today: Cost, Process and Policies

- 1 PREMIUM:** Typically 3–4% (US) of the insured amount. An underwriting fee is also charged (US: \$25 – 50k).
- 2 DEDUCTIBLE:** The policy deductible, or the “retention,” is often 1% of the deal’s purchase price. The 1% deductible typically reduced to 0.5% 12 months after the inception of the policy in the US.
- 3 POLICY FORMS:** Policies are tailored to each transaction, and repeat policyholders can often start with a previously negotiated form if engaging the same insurer.
- 4 PROCESS:** The premium, coverage, and underwriting process each differ slightly depending on which party is insured. The timeline is typically 2 weeks (Quotes/Insurer Selection = 5 days | Underwriting = 5 days).
- 5 POLICY PERIODS:** Typically 6yr coverage for breaches of fundamental and tax reps/pre-closing tax indemnity and 3yr coverage for non-fundamental reps. Policy periods can exceed those given in the SPA.
- 6 ALTERNATIVES TO RWI:** Uninsurable risks can be collateralized with special escrows. Sellers are typically more willing to provide special indemnities after RWI declares a policy exclusion. A separate tax insurance policy could be a solution for tax related policy exclusions.
- 7 POLICY SIZE:** Policies with limits of \$5M to over \$1B+ are now possible.

M&A Tax Trends

Interplay between RWI / Tax Indemnity / Indebtedness-NWC

Reps and Warranties Insurance

- Covers **unknown tax risks** (i.e., taxes not identified). Not covered = known taxes
- **Known taxes** = (i) taxes identified in due diligence and (ii) ordinary course taxes (e.g. payroll)
- Accounting firm/buyer **must perform due diligence** or likely **no coverage** under RWI policy
- Certain taxes always excluded from policies (recently, NOLs, transfer pricing, etc.)
- Ideal to have “synthetic tax indemnity” included in package

Tax Covenants / Tax Indemnity

- In competitive auctions, where using RWI, often **no tax indemnity**
- If no tax indemnity, **must** include accrued/unpaid taxes in “Indebtedness”/ “NWC”
- If RWI only recourse for taxes, often standard tax covenants not in SPA, such as tax return/tax audit provisions (Buyer’s company and Seller has no “skin in the game”)

“Debt” / Net Working Capital

- In RWI deals, we try to get accrued/unpaid taxes into definition of Indebtedness but at the least **must** be included in net working capital definition.
- Serves effectively as a reduction in purchase price

M&A Tax Trends

Tax Insurance



Types of Risks

- Tax-free reorgs (historical)
- S Corp qualifications
- 338(h)(10) eligibility
- Debt/equity
- Nexus
- Employee Retention Credits, REIT status, Valuations



Benefit

- Transfer of risk to insurer
- Removes tax uncertainty
- Facilitates deal negotiations by eliminating need for tax indemnities and escrows for identified tax issues



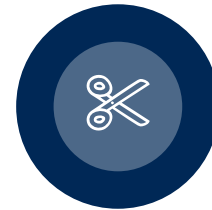
Not Available

- Tax shelters to avoid taxes
- Changes in law going forward
- Less than MLTN position (generally)



Terms

- Period of 7yrs (up to 10)
- Limit: \$5M to \$2B+
- Cost: 1 time payment
- Premium: 2-5% limit range (depends on risk)
- Losses cover additional taxes, interest/penalties contest costs, and gross-up



Exclusion

- Inconsistent filing position
- Material inaccuracy of information provided
- Settlement without consent



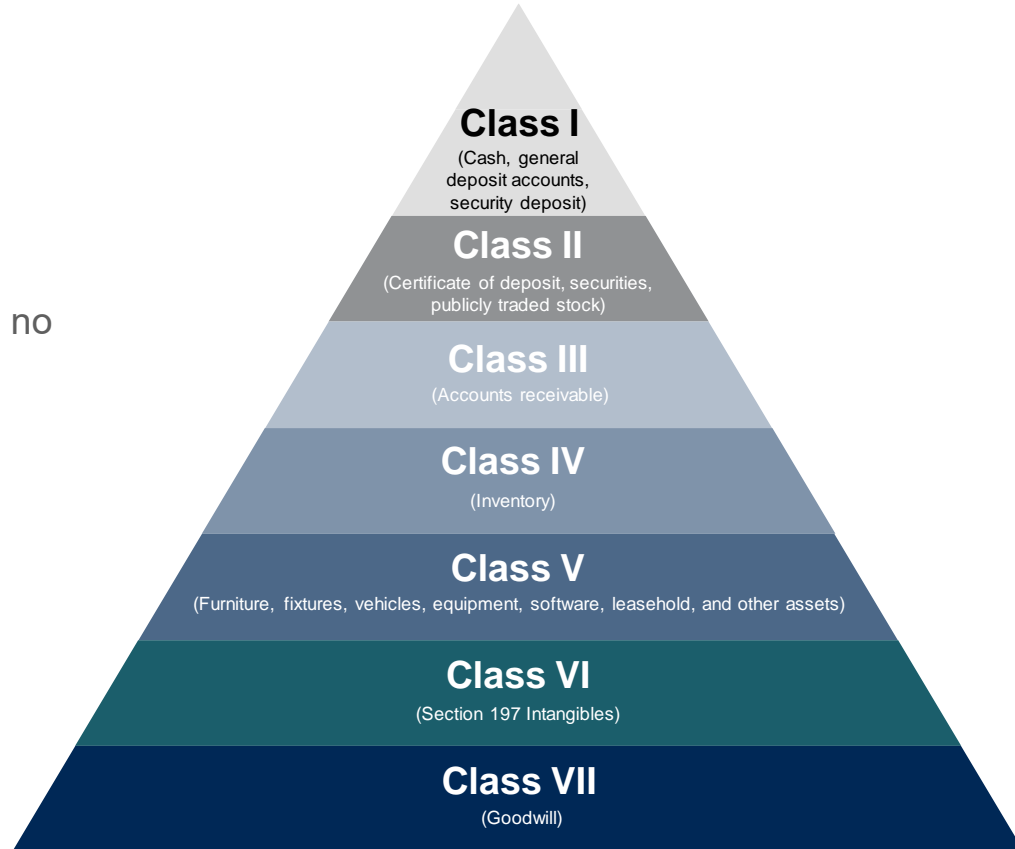
Tax Proceedings

- Insured may control process, but subject to insurer's consent (negotiated)

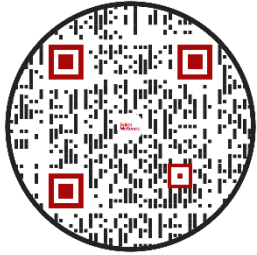
M&A Tax Trends

Purchase Price Allocation

- Importance on cross-border transactions; minimizing income in high-tax jurisdictions
- Binding arbitration vs. “agree to disagree” vs. no PPA; Importance of Form 8594
- Consider whether a “1060 Transaction” / “Applicable Asset Acquisition”
- Methodologies/Principles approach vs. PPA Exhibit
- First mover theory on controlling allocation



Questions



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