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INSIGHT: Tax Warranties and Indemnities on M&A Transactions and Insurance



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In the European mergers and acquisitions (''M&A'') market it is customary for buyers to require comprehensive protection from pre-completion tax liabilities and other issues which may exist in targets. This is usually given by sellers in the form of tax warranties, and tax indemnities in respect of pre-completion matters.

Buyers or sellers may take out warranty and indemnity (''W&I'') insurance to cover liabilities under tax warranties and indemnities, and also to supplement the protections given in transaction documentation.

This article focuses on the tax protections customarily given in the European market, in transaction documentation governed by English law.

M&A transaction documents (such as the share purchase agreement, or ''SPA'') commonly contain a number of tax protections for both buyer and seller, normally in the form of tax warranties and a tax indemnity (or ''tax covenant''). Each of these works slightly differently, but their common purpose is to allocate the economic cost of a target's pre-completion tax liabilities between transaction parties.

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Buyers generally expect sellers to bear pre-completion tax costs, either through an up-front price adjustment or by the seller promising to meet a liability when it falls due (essentially, a future repayment of purchase price).

Tax Warranties Tax warranties are promises that a certain state of affairs exists, such as that the target has paid all of its tax liabilities. If a warranty proves to be incorrect the buyer may seek damages, calculated by reference to the difference between the price paid for the shares in the target it has purchased and their actual value, which could be more or less than the amount of the underlying tax liability.

Tax warranties also serve a secondary purpose. A seller may ''disclose'' against the tax warranties when it is aware of a fact or circumstance rendering a warranty incorrect, which normally prevents the buyer from making a breach of warranty claim for the matter disclosed. Disclosure often provides the buyer with valuable information to supplement its due diligence exercise and, as discussed later, the disclosure process is also important when securing W&I insurance.

Tax Indemnities By contrast, the tax indemnity generally allows a buyer to recover an amount equal to all pre-completion tax liabilities of the target on a pound-for-pound basis, unqualified by disclosures and without the buyer having to first show a reduction in the value

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of shares purchased. This is then limited by commercially agreed exclusions, such as for tax liabilities priced into the transaction (e.g. through a completion accounts mechanism), or those arising as a consequence of post-completion ''voluntary acts'' or changes of law.

Current market practice generally restricts the scope of the tax warranties and tax indemnity to pre-completion matters save in very limited circumstances (such as payroll taxes arising on the exercise of share options granted before completion). Requests for limited post-completion coverage are, however, becoming more common—particularly in the area of transfer pricing where buyers rely on pre-completion transfer pricing studies in respect of post-completion transactions which may subsequently be challenged. This is not, however, market standard.

Tax and W&I Insurance It is becoming increasingly common to insure tax warranties and tax indemnities—either under general W&I insurance or under tax-specific policies, and although it is possible for both buyers and sellers to obtain W&I insurance, it is more common for W&I policies to be taken out by buyers.

Initially, W&I insurance was primarily used in the context of secondary/tertiary buyouts because private equity sellers will generally seek to severely limit recourse under tax warranties and indemnities. Often this is because of a need for such a seller to achieve a ''clean break'' on sale unburdened by contingent liabilities under the SPA which may impact on the calculation of the fund's return on investment or restrict the ability to wind down end-of-life funds.

However, the use of W&I insurance has become much more widespread, as many sellers now find the prospect of limited or no recourse under tax warranties and indemnities to be attractive.

In this context it is common for sellers to either fund, or contribute to, the W&I policy premium as a price for limiting recourse for claims wholly or partly to the W&I policy—and for sellers, limited recourse can often allow cash reserves to be deployed more efficiently than being held as a reserve against a potential claim under an SPA or held in escrow as security.

W&I policies will generally exclude ''known'' risks from cover for both tax warranty and tax indemnity claims, such as those identified as part of the due diligence exercise and matters disclosed against warranties. This is a key difference in cover between an insured and an uninsured deal, as disclosures will not generally qualify a tax indemnity, but will qualify cover under a W&I policy.

This must be remembered at the transaction planning stage, because insurers will need to be comfortable that thorough and properly managed due diligence and disclosure exercises have been undertaken (insurers have, for example, been known to refuse coverage where tax due diligence has been carried out in-house).

From a transaction perspective this approach does mean that both buyers and sellers should be prepared for price negotiations, as known risks may need to be priced into the deal or dealt with through an escrow. Depending on the profile of the tax risk, a bespoke tax insurance policy could also be considered.

In addition to known risks insurers will typically exclude from cover certain tax matters, such as transfer pricing, the availability of tax assets and secondary tax liabilities. This is because there is often insufficient, if any, due diligence conducted in these areas; but if detailed due diligence is available, some insurers may be willing to offer cover. This most commonly occurs in relation to the availability of capital allowances on real estate and renewables transactions.

Due to the potential value of capital allowances in these transactions buyers are likely to have modeled their availability into financial forecasting and it may therefore be more commercially viable to instruct advisers to thoroughly diligence their availability than would otherwise be the case where the future use of tax assets is uncertain.

W&I insurance can also be used to bridge commercial gaps which may arise on transactions. For example, in cross-border transactions U.S. buyers will often resist many of the common exclusions from liability for tax which are accepted in the European market, and will often expect very detailed and comprehensive warranties to be given on a full indemnity basis (giving pound-for-pound recovery for breach of warranty claims).

This will often have a significant impact on the risk profile of a transaction for sellers and create commercial tensions. Insurers commonly offer ''enhancements'' to W&I policies which can resolve these tensions, allowing the insured to benefit from an enhanced coverage position under a W&I policy compared to the protection provided in the SPA.

For example, a W&I policy could provide for loss resulting from a breach of warranty to be calculated on a full indemnity basis, even though the warranties are not given on an indemnity basis in the SPA. Furthermore, where a seller is not willing or able to offer a tax indemnity, insurers may be prepared to provide ''synthetic'' cover by inserting the indemnity into the policy rather than the SPA.

Interaction of Tax W&I Insurance and Transaction Documentation Although the primary purpose of the tax provisions is to protect the buyer from the cost of pre-completion tax liabilities, many of the tax provisions contained in the SPA and other transaction documents are actually for the seller's benefit. This includes exclusions from liability and more mechanical provisions regulating the preparation of tax returns and the conduct of tax authority inquiries and disputes.

The interaction of these provisions with insurance should be carefully considered, particularly as insurers may wish to take control of disputes where they are ''on risk.'' This is likely to be of particular concern to sellers to whom recourse is limited, but who are still liable for claims up to a specified level (such as the policy excess).

How the W&I policy interacts with the SPA predominantly depends on whether the buyer or the seller is the insured party. Where the seller is the insured, in the event of a claim the buyer will pursue the seller in the first instance in accordance with the terms of the SPA. In turn, the seller will make a back-to-back claim under the terms of the W&I policy. Where the buyer is the insured, it may choose to pursue both the seller under the SPA and the insurer under the W&I policy, or just the insurer (subject to the commercially negotiated terms).

In competitive auctions it has become common for sellers to not offer financial recourse under an SPA (by way of a 1 pound ($1.3) liability cap for claims). This

means a buyer would only be able to recover for breach of warranty or under the tax indemnity by taking out a W&I policy. Despite the seller having no ''skin in the game,'' insurers will still expect to see balanced transaction documents negotiated on an arm's length basis.

Alternatively, the seller may provide financial recourse up to an amount that is equal to the buyer's ''excess'' amount under the W&I policy. This means that the buyer would not have a gap in financial cover before the W&I policy excess was met. Typically, an SPA would state that where a buyer is able to pursue both the seller under the SPA and also claim under a W&I policy (perhaps because the parties have commercially agreed that the seller has a financial limitation under the SPA that is higher than the policy excess, which is not uncommon outside of an auction process), they will pursue the claim under the W&I policy.

Planning Points The use of W&I policies to manage tax risk in M&A transactions is becoming increasingly popular, both to supplement SPA protection (in the case of tax-specific policies) and also to bridge commercial gaps between transaction parties.

If tax risk is to be insured early planning is key, to ensure that insurers have confidence in the quality of due diligence and disclosure in order to secure the best possible level of cover.

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