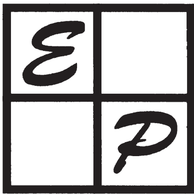

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Tax Reform: Transaction Strategies for Uncertain Times

By Larry Stein, Nick DeNovio, Mark Gerstein and Melissa Alwang, Partners of Latham & Watkins LLP

As is readily apparent in the press, Congress, President Trump and the business community are intensely focused on tax reform in 2017. Multinational corporations, small businesses, financial services entities and investment and private equity funds are all surveying proposed changes, and many are involved directly or through industry associations in efforts to shape the policy discussion.

While the House Ways & Means Committee and the Trump Administration are working on further developing these proposals, business leaders and in-house counsel are faced with the question of how to approach transactions (and, for listed issuers, public disclosures as well) in the face of such uncertainty.

Overview of Tax Reform Proposals

In June 2016, the House Ways & Means Committee released a report entitled "A Better Way—Our Vision for a Confident America" (the Blueprint) proposing fundamental changes to the US Internal Revenue Code (the Code). In addition, the President released a high-level plan entitled "Trump—Tax Reform that Will Make America Great Again" (the Trump Plan) during the presidential campaign.

The below chart provides an overview of the five key issues of concerns to businesses.

Blueprint	Trump Plan
1. Lower Corporate / Investment / Pass-Through Income Tax Rates	
Corporate tax rate of 20% and elimination of corporate alternative minimum tax (AMT).	Corporate tax rate of 15% and elimination of corporate AMT.
Investment income generally taxed at 16.5% and elimination of 3.8% net investment income tax for individuals.	Maximum rate of 20% on long term capital gains and qualified dividend income for individuals.
Special 25% rate on distributive share of business income allocable to partners/members in pass-through entities.	Unclear, but indications of an elective 15% entity level tax for at least some pass-through entities.

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Blueprint	Trump Plan
2. Interest and Other Deductions	
Investments in tangible and intangible assets (other than land) can be fully expensed in the year incurred.	Manufacturing firms may elect to fully expense capital investments in the year incurred.
No net interest deduction, for related or unrelated party debt, with net interest expense instead being carried forward indefinitely to offset interest income.	A manufacturer that elects to immediately expense capital investments may not deduct interest.
"Special interest" deductions are eliminated, but the R&D credit remains in place.	Domestic production and other business credits are eliminated, but the R&D credit remains in place.
3. Territorial System	
Going forward, foreign earnings of US multinationals are generally exempt from US tax regardless of whether those earnings are held offshore or repatriated.	It is not clear that a traditional territorial system would be enacted under the Trump Plan.
4. One-Time Tax	
The existing, deferred foreign earnings of US multinationals are subject to a one-time tax of 8.75% (for earnings held in cash and cash equivalents) and 3.5% (for other earnings), each payable over eight years.	The existing, deferred foreign earnings of US multinationals are subject to a one-time tax of 10% (for earnings held in cash) and 4% (for other earnings), each payable over 10 years.
5. Destination-Based Cash Flow Tax (DBCFT)	
Businesses are taxed on cash flow rather than income. Border adjustments are imposed that are intended to subject imports to full tax while exempting exports. Net effect is a business tax that is akin to a tax on US consumption.	There is no indication in the Trump Plan that a similar border adjustment tax would be enacted, though possibly a border adjustment tax would dovetail with some of the trade concerns the Trump Administration has raised.

The proposals in the Blueprint reflect a potential sweeping overhaul of the US corporate tax system. While uncertainty remains regarding which, if any, of the proposals will be enacted, there is a high expectation in the business community that some form of tax reform will become a reality in the near term.

The remainder of this article summarizes the key considerations for executing capital markets, finance, private equity and M&A transactions, and for complying with SEC disclosure requirements, in light of this uncertainty. It also considers the impact on certain industries.

Key Considerations for Capital Markets & Finance

The proposed reforms would impact the factors issuers consider when they determine where to raise capital and whether to do so by issuing debt or equity. The lower stakes of recasting debt as equity (and vice

versa), may result in the use of more hybrid instruments tailored to meet the specific economic needs of the issuer and the market rather than to satisfy traditional definitions of debt or equity.

Similarly, proposed changes to the deductibility of interest expense could also reduce the relative disadvantage of pay-in-kind debt with a maturity longer than 5.5 years (when compared to cash-interest-paying debt), which exists under current tax law.

Whether, during the interim period until adoption of any of the proposed tax reform, bespoke redemption provisions emerge that allow bonds to be redeemed at a reduced premium upon a change in the deductibility of interest expense remains to be seen.

Alternatively, there may be a rush to issue debt in advance of any deadline that may be set for debt to be "grandfathered" (if that is part of an adopted regime). Note the discussion above regarding the challenges policymakers might face in deciding whether to allow grandfathering.

The Blueprint's territorial system would likely eliminate Code Section 956. The elimination of Code Section 956 would allow non-US subsidiaries to both borrow directly and then upstream proceeds of such borrowing or to simply provide guarantees and security for global credit support.

Additionally, the unavailability of a US net interest deduction may cause multinationals to push debt to their foreign affiliates that can benefit, under local tax law, from net interest expense.

The removal of Code Section 956 may also affect existing credit agreements, in that, depending on the wording of the relevant credit documents, additional guarantees or security, or mandatory prepayments, may be triggered.

Key Considerations for M&A: Strategic & Private Equity

In the context of M&A, the implications of pending tax reform may cause difficulty in planning and executing deals. Most commentators attempt to provide guidance for deals that may be agreed to after the effective date of tax reform, as to which the consequences of reform would then be foreseeable, such as offshore cash coming onshore or changes in deductibility.

Of equal concern, however, are pending deals that may be entered into while reform is pending. During this period, the definitive deal terms and timing may be clouded, including as to how the future value of an acquired business may be meaningfully impacted by the contemplated tax reform. The issues to be considered for M&A transactions taking place during this interim period are outlined below.

Tax Attributes. A target's tax attributes can have substantial implications for value and deal structure. Net operating losses, for example, are often used by the acquirer to shelter income. The value of that use is often reflected in the purchase price.

If lower tax rates are implemented, that attribute has less value to the buyer and, as a consequence, will receive less consideration in the value of the purchase price. Conversely, the Blueprint preserves and enhances the notional value of net operating losses which could potentially compensate for any diminished value associated with lower tax rates.

Changes to corporate tax rates create similar valuation implications for depreciation deductions. However, the Blueprint provides for the immediate deduction of investment costs, which may include the cost of acquiring business assets and which would enhance the tax benefits of asset investments/acquisitions and perhaps compensate for any diminished value associated with lower tax rates.

Financing. As commitments begin to reflect the uncertainty and risks associated with tax reform — particularly those commitments that are longer dated — covenant packages and even conditions of closing may become tied to the terms and timing of the implementation of tax reform. Such tying may result in a discontinuity between the conditions of closing for the underlying transaction and the financing, creating uncertainty for the buyer, seller or both.

In the case of private equity buyers, a misalignment of conditions under debt financing commitments and definitive acquisition agreements could increase the likelihood that reverse termination fees become payable to sellers in the event of a financing failure and, consequently, impact the size of reverse termination fees.

As a result, private equity sponsors and other acquirers may seek matching conditionality in acquisition agreements. Further, private equity sponsors may look for optionality to fund additional equity if there is tax reform limiting or eliminating the deductibility of interest on debt financing, and/or negotiate for the ability to prepay outstanding debt at any time without penalty.

Deal Structure. If immediate deduction is obtainable, buyers will prefer asset deals over stock acquisitions. Two elements of friction, however, are worth considering. First, taxation at the corporate and shareholder level will result in an additional tax cost to the seller. Whether the reduction in effective rates will offset this cost sufficient to overcome this friction will depend on the final terms of reform.

Second, there are transaction costs associated with asset transfers as well as commercial concerns regarding assignment of contracts and similar agreements. Even so, the Blueprint's provision for immediate deductibility may drive asset structures in whole or in part.

Structural Costs Associated with Operating Structures. Certain changes included in the Blueprint may have significant implications for the structural costs of operating structures. Among these, the mandatory one-time tax on accumulated earnings, the DBCFT and the implementation of a territorial system may affect the amount and destination of a business' cash flows.

For example, if a US target has substantial offshore production, its cash flow after taxes could be adversely impacted. Conversely, "trapped cash" — cash and cash equivalents that historically cannot be repatriated except at a substantial tax cost — will be calculated fairly differently, as offshore cash can be repatriated with lesser or no tax cost in the long run (or conversely there will be a near-term one-time significant tax cost associated with legacy offshore profits), and the acquisition agreement will likely want to account for this trapped cash in, for example, the calculation of working capital.

Domicile of Holding Company. The potential for tax reform and Brexit have furnished the proverbial perfect storm as parties in cross-border mergers work to decide on the corporate and tax domicile for the combined companies. Many of the combinations in recent years have chosen the UK for a variety of reasons, including tax efficiencies.

Notwithstanding the Brexit uncertainty and the prospect of the US adopting historically low corporate rates, in the near-term, parties will likely continue to utilize non-US domiciles for holding companies. The UK will likely remain attractive for reasons beyond tax efficiency, including soft considerations associated with governance and other concerns, as well as the uncertainty associated with the specific terms of legislative and regulatory implementation of tax reform in the US.

How Should M&A Agreements Best Address Tax Reform Uncertainty?

The Challenges. From the seller's perspective, it's important to avoid unintended traps in representations and warranties. This concern is more applicable to private deals rather than public, since generally these representations are brought down to closing by way of a material adverse event provision. However, private deal representations can be brought down to closing on a materiality standard, and there is often indemnity.

Purchase price adjustments may also become distorted. A company's working capital may be reduced due to increases in tax costs. Thus, valuation for purposes of working capital adjustments would likely need to be addressed (including the potential for adjusting the net working capital target based on a formula taking into account any relevant tax reform enacted between signing and closing) as well as the ability to repatriate trapped cash.

In addressing fundamental value implications of tax reform, buyers may find the material adverse change (MAC) condition too blunt and unreliable an instrument for instilling confidence in creating an effective buyer termination right. A MAC condition customarily provides exclusions for changes in law, including tax law. Moreover, the seller would likely argue that such changes were foreseeable under the circumstances. Therefore, specificity is important if the parties agree that enactment of tax reform would provide a basis for termination.

Conversely, the "disproportionate effect" exception to industry-wide changes in a MAC condition may create issues for the seller. These carve-outs for similarly situated companies are often limited by the disproportionate effect on a single company.

Viewed through the lens of a MAC condition, a US manufacturing company with substantial offshore production may be affected disproportionately as compared to a company in the same industry but with substantial onshore production.

Alternative Approaches Now. Despite the uncertainty attendant to tax reform, parties may employ the following practical strategies when executing deals in the face of such uncertainty:

- Consider including an affirmative disclaimer specifying that none of the representations and warranties will be deemed breached or any condition failed as a consequence of tax law changes, and paring back any representations or warranties that address the availability of certain types of tax assets in the post-closing period.
- If fundamental elements of value may be impacted by tax reform, the parties may want to negotiate termination rights associated with the enactment of certain changes. Conditions linked to tax treatment of the transactions may require particular scrutiny.
- Even at the earlier stages of the delineation of tax reform, parties may wish to seek good faith covenants on more narrow and manageable issues. For example, an obligation to negotiate or restructure in good faith or to adjust consideration so as to mitigate, reflect or reduce the consequences of tax changes may be prudent.
- If a substantial difference between the purchase price and tax basis arises, a covenant providing for flexibility in opting for a stock or an asset acquisition structure may similarly enhance tax efficiencies.
- As reform progresses and its terms become more specific, some issues may be addressed by alternative formulae in the acquisition agreement, including purchase price adjustments. For example, there may be differing treatments of trapped cash, accumulated and previously untaxed earnings and accrued taxes for circumstances in which either (1) tax reform implements a territorial system and a one-time deemed repatriation or (2) the trapped cash remains subject at closing to an excessively high tax cost if repatriated to the US.
- Private equity sponsors and lenders may look for similar flexibility in their debt commitment letters and definitive agreements.

The Launch of "John Tales": Nothing but rave reviews for our new M&A Blog on DealLawyers.com: "John Tales." Here's just a sampling of the entries so far:

- I Hate Letters of Intent
- Materiality of Mid-Quarter Results
- Confidentiality Agreement Practice Points
- "Don't Ask, Don't Waive" & The Three Wise Monkeys Problem
- Corporate Torts: Just Doing Your Job? You're Still on the Hook.

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Coming to Grips With Appraisal

By William Lawlor and Eric Siegel, Partners, and Michael Darby, Associate, of Dechert LLP[1]

The Arrival of the New Asset Class

As readers are well aware, within the last few years the number of M&A cash-out transactions with respect to which stockholders have exercised statutory appraisal remedies under Delaware law has exploded.[2] The forces animating this development are many.

Driven by favorable case law regarding appraisal eligibility requirements,[3] a statutory interest rate on the carried appraisal investment that compares favorably to historically low interest rates, the availability of dedicated funding sources and several spectacular judgments and settlements–a cottage industry of professional appraisal arbitragers and hedge funds and their copy cats has emerged to exploit this new asset class.[4]

Institutional investors, unhappy with proposed deal consideration, have been willing to join the fray and provide further scale to the dissenting group. At the same time, recent developments in Delaware case law with respect to traditional deal litigation have made that avenue less desirable for plaintiff stockholders.[5] With their deal hold-up leverage reduced, and facing the omnipresent threat of early case dismissal and discovery hurdles, it is no surprise that many stockholder plaintiffs have opted for the post-deal appraisal forum despite its expense and time commitment.[6]

In an effort to quell this tsunami of appraisal actions, the Delaware legislature made two changes to the appraisal statute in 2016. First, de minimis claims are now generally prohibited. Instead, appraisal shares must represent more than 1% of the target's outstanding shares and must be worth more than $1 million at the deal price.

Second, companies can now partially or completely eliminate the interest rate arbitrage opportunity afforded to dissenting stockholders by Delaware's relative high statutory interest rate by prepaying all or part of the potential appraisal award. The statutory rate, which is 5% over the Federal Reserve discount rate, runs from the date of the transaction to the date of payment of the award. Appraisal actions can take years to litigate or settle. The ability to prepay now allows companies to cut off this accrual.

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[1] The views expressed herein are the authors' and do not necessarily represent the views of the authors' law firm or its other lawyers.

[2] According to a recent study, 62 appraisal actions were filed in 2016 (representing shares otherwise entitled to $1.9 billion in aggregate merger consideration), compared to 16 appraisal actions in 2012 (representing shares otherwise entitled to $129 million in aggregate merger consideration). *See* Guhan Subramanian, Using the Deal Price for Determining "Fair Value" in Appraisal Proceedings, February 6, 2017 Draft, Forthcoming in the Corporate Contract in Changing Times: Is the Law Keeping Up? (U. Chicago Press) (hereinafter "Using the Deal Price").

[3] A stockholder is eligible to seek appraisal if it, among other things, has not voted for the merger. The Delaware appraisal statute notes that "stockholder" in this context means a stockholder of record, such as Cede & Co., which is the stockholder of record for the vast majority of public company certificated shares. Delaware courts have ruled that a beneficial owner holding shares in "street name" through a broker is not required to prove that each appraisal share was not voted for the merger. Rather, it is adequate if Cede & Co. owns a sufficient number of shares that are not voted for the merger. *See In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007). This means opportunistic appraisal arbitragers can jump into deals post-announcement.

[4] According to a recent study, Merion Capital, which has a dedicated appraisal arbitrage fund, filed numerous appraisal actions in Delaware between 2009 and 2016, representing shares otherwise entitled to $1.8 billion in aggregate merger consideration (or 36% of the total value of all claims for such period). *See* Using the Deal Price.

[5] In a recent line of cases, Delaware courts held that when a transaction that does not involve a controlling stockholder standing on both sides of the transaction is approved by a fully informed, uncoerced vote of disinterested stockholders, the business judgment rule will irrebuttably apply in a post-closing damages lawsuit even if some higher standard of review, such as *Revlon or Unocal*, would otherwise apply. *See Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015). Delaware courts also extended this rule to two-step tender offers under Section 251(h) of the DGCL where disinterested stockholders who are fully informed and uncoerced tender a majority of their shares. *See In re Volcano Corporation Stockholder Litigation*, 143 A.3d 727 (Del. Ch. 2016). In another well-known case, the Delaware Court of Chancery warned that disclosure settlements are likely to be met with disfavor unless the requested disclosures address a plainly material misrepresentation or omission and the release is narrowly tailored. *See In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).

[6] Appraisal actions typically take about three years to resolve and involve significant costs, including lawyer and expert fees. *See* Gaurav Jetley and Xinyu Ji, Appraisal Arbitrage—Is There a Delaware Advantage?, The Business Lawyer; Vol. 71, Spring 2016.

In our view, neither of these amendments alone is likely to materially curtail the number of appraisal actions. The minimum claim requirement is easy for sophisticated players to satisfy and it is unlikely that the favorable statutory interest rate was the deciding factor for stockholders weighing whether to dissent in most instances. In addition, the prepayment option can actually free up capital for the dissenting stockholders, tempering the effect of the lost interest rate arbitrage. There is currently no legal mechanism to claw back prepaid amounts if they end up exceeding the court's appraisal award.

Deal Price and Appraisal Price: Venus and Mars

Of course, the increase in the incidence of appraisal might be only a minor nuisance for dealmakers were it not for the risk that the appraisal price might significantly exceed the deal price. That risk exists because deal price and appraisal price are products of fundamentally different processes influenced by different policy considerations.

Appraisal under Delaware law is a legislative remedy designed to provide the minority of target stockholders who disapprove of a deal with a judicial determination of the intrinsic worth of their holdings.[7] In contrast, the deal price is a negotiated price determined by the buyer and the target. In overseeing the negotiation of the deal price as agents on behalf of the target stockholders, target boards are focused on satisfying their fiduciary duties, including the duty of care. In this context, the Delaware case law has developed to protect target boards from the very thing the appraisal statute provides—a judicial determination of the correct fair price.

Quite intentionally, through the creation of the business judgment rule presumption, the Delaware courts have insulated target boards from judicial second-guessing as long as the board is not conflicted and has acted in an informed manner. Accordingly, case law has generally focused on the target board's *process* for determining a fair price and not the *determination* or *output* of that process.

Target boards have responded by seeking to ensure an informed decision-making process. Following the *Smith v. Van Gorkom*[8] case in 1985, a centerpiece in this process has become the target board's receipt of one or more fairness opinions from investment banks.[9] Of course, a fairness opinion is not an appraisal, but rather is the opinion of a financial advisor that a specified transaction is within a range of values encompassing financial fairness.[10]

As these two similar but distinct branches of target company valuation have matured over time, practices and patterns have developed around the inputs and methodology that can result in vastly disparate outputs. In appraisal actions, Delaware courts have typically focused on the discounted cash flow approach,[11] among a wide range of valuation metrics, and have more recently placed an emphasis on the deal price if there is meaningful and arm's length price competition for the target.[12]

In M&A transactions, target boards and their financial advisors also rely on a wide range of valuation metrics, most frequently relying on three valuation methods,[13] but often emphasizing the premium over the pre-announcement trading price and how the deal compares to similar M&A transactions. For example, in the controversial *Dell* case, in which the appraised value exceeded the deal price by 28%, the financial

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7 *See In re Appraisal of Dell, Inc.*, 2016 WL 3186538, at *20 (Del. Ch. May 31, 2016).

8 488 A.2d 858 (Del. 1985).

9 *See* DGCL 141(e).

10 *See* Steven Davidoff, Fairness Opinions, 55 AM. U.L.REV. 1557 (2006).

11 *See, e.g., Dell*, 2016 WL 3186538, at *45 ("The DCF analysis is a well-established method of determining the going concern value of a corporation.").

12 *See, e.g., In re DFC Global Corp.*, 2016 WL 3753123 (Del. Ch. July 8, 2016); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *Huff Fund Inv. P'ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013). Commentators and legal scholars have also proposed frameworks, including that if a deal process involves an adequate market canvass, meaningful price discovery and an arms-length negotiation, then a court should presume that the deal price constitutes "fair value." Others have argued that the deal price should prevail unless there are material disclosure violations or the target board is misinformed or biased. Still others argue that the Delaware Court of Chancery should have broad discretion in determining "fair value." *See* Using the Deal Price.

13 *See* Study of Publicly Disclosed Fairness Opinions – Sneak Peek at Some Interesting Findings, Duff & Phelps, January 28, 2017.

advisors relied heavily on a leveraged buyout valuation model given that the interested potential buyers were private equity funds.

However, the *Dell* court noted that the LBO model did not yield a "fair value."[14] This was exacerbated by the fact that the pre-signing and post-signing market checks only yielded interest from other financial sponsors who relied on a similar valuation model. The court in *Dell* also noted that there was a widespread gap between the market's short-term valuation of the company, based on quarter-to-quarter results, and the operative reality of the company following an approximately $14 billion investment in its transformation.

A rough summary of key differences between the appraisal approach and the fairness opinion approach, focusing on a typical cash-out deal, includes the following:

Appraisal Approach	**Fairness Opinion Approach**
• "Fair value"	• "Fairness from a financial point of view"
• Granular analysis, including growth rates, terminal value, discount rates and multiples, capital structure, cost of equity and debt, risk and size premiums, nature of comparable companies or deals, affordability models of buyer	• Broader and more generalized approach
• Single valuation number	• "Range of fairness"
• Date of completion of transaction[15]	• Near or at the date of execution of agreement
• Exclusion of "any element of value arising from the accomplishment or expectation of the merger"[16]	• Inclusion of all or a shared portion of synergies
• Among the wide range of valuation metrics, a focus often on the discounted cash flow valuation approach and, recently, deal price based on a robust market check	• Among a wide range of valuation metrics, a focus often on offers from a robust market check
• "Comparable company" valuation approach should gross up minority discount	• Often no gross up
• "Comparable transaction" and discounted cash flow valuation approaches should discount control or synergy premiums	• Often no discount
• Battle of competing experts under oath	• Non-adversarial professional opinion
• More focus on pre-deal, "unbiased" management projections	• More tolerance of adjustments due to changed circumstances or imperfect prior models

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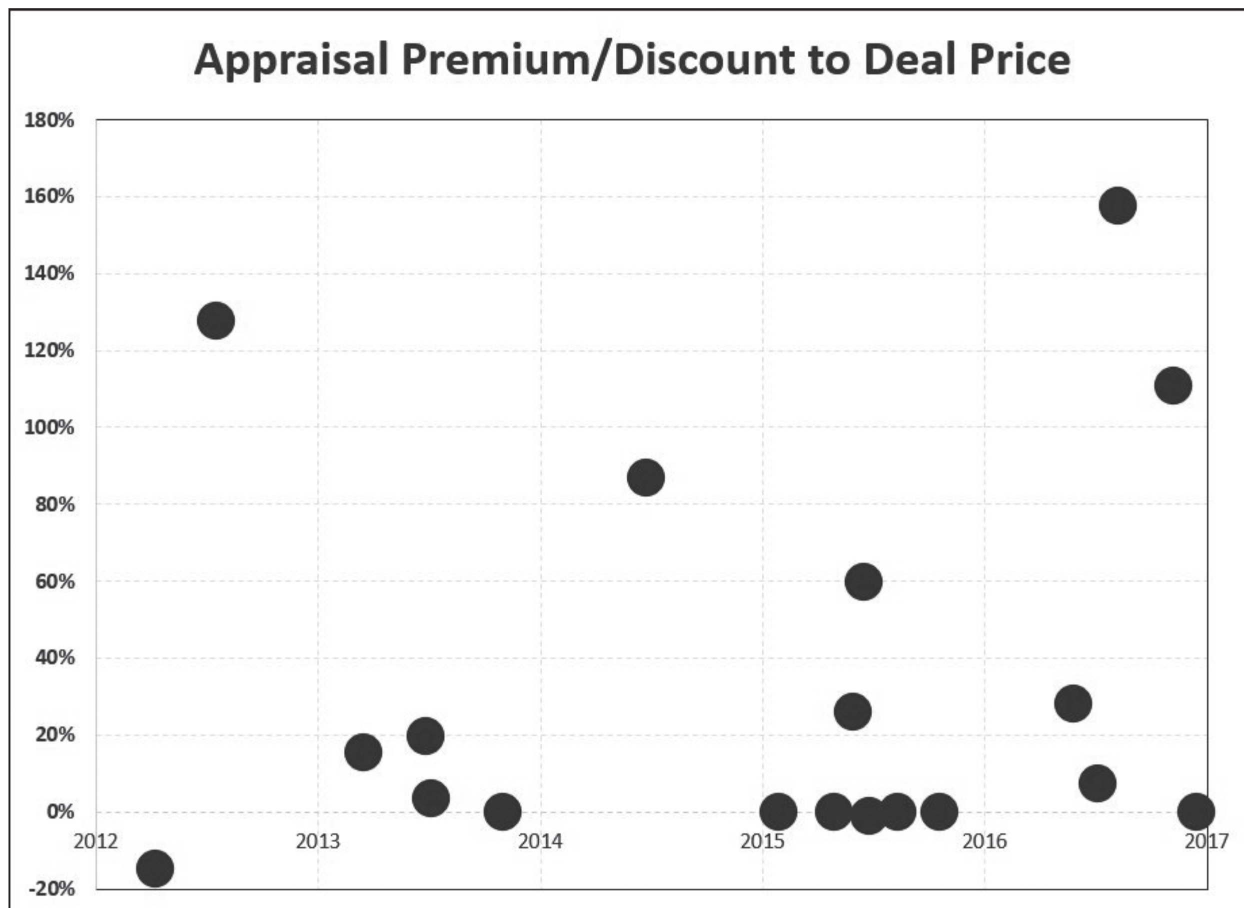
[14] *See Dell*, 2016 WL 3186538, at *29. Note, as of this date, the *Dell* case is currently on appeal to the Delaware Supreme Court.

[15] *See Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988).

[16] In *Merion Capital v. Lender Processing Services Inc.*, 2016 WL 7324170 (Del. Ch. Dec. 16, 2016), the court seemed receptive to the idea of deducting synergies in its calculation of "fair value" if timely raised and argued.

Given these different criteria, valuation conclusions can vary, sometimes dramatically. Set out below are the premium or discount, if any, to deal price that dissenting stockholders have realized through selected appraisal actions or settlements between 2012 and 2016. Perhaps one reason for the continued deluge of appraisal actions is that dissenters see little risk given how seldom courts have ruled that the deal price exceeds the appraisal value.



Source: Using the Deal Price and other publicly available data.
Note: Premiums exclude any interest payable in respect of the appraisal award.

Considerations for Buyers

Buyers, which are ultimately on the hook for any incremental appraisal liability over the deal price, have the greatest interest in taking steps to evaluate and possibly mitigate that liability. For obvious reasons, buyers typically do not have access to the target's fairness opinion before agreeing to the deal price. But buyers typically make use of fairness opinion-style valuation techniques (generated internally or by their own financial advisors) when negotiating the deal price. Buyers can use an understanding of the differences between the appraisal approach and the fairness opinion approach to prepare a valuation under each approach and factor into their deal price the risk of appraisal awards at the higher price.

In the current environment, buyers will need to better assess the importance of pushing for an appraisal condition, and its threshold. This condition, which gives the buyer a termination right if a specified threshold percentage (often 10% to 15%[17]) of the target's shares demand appraisal, has been limited in use in stock deals and is exceedingly rare in cash deals.[18]

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[17] *See* Using the Deal Price; American Bar Association, Strategic Buyer/Public Target M&A Deal Points Study (for transactions announced in 2015) (hereinafter "Deal Points Study").

[18] The American Bar Association sampled strategic deals valued at over $200 million in 2015 and found that no cash deals had appraisal conditions, compared with 6% of stock deals. *See* Deal Points Study. Another recent study found that only 3% of public company deals larger than $2.5 billion between 2009 and 2016 included appraisal conditions. *See* Using the Deal Price.

A buyer can argue that imposing the condition does not materially increase the uncertainty of the transaction occurring because the condition should chill the number of appraisal requests—after all, if the condition is triggered and the buyer walks, there is no appraisal opportunity. Nevertheless, sellers have often been successful pushing back against this condition, and the appraisal condition thresholds are typically so high that they lose relevancy as a liability management tool for buyers. It remains to be seen if the needle will move on the customary terms in this area.

Stock-for-stock deals, which are generally exempt from Delaware's appraisal statute,[19] could provide protection to buyers, but other deal considerations, including the sheer deal economics and the potential need for buyer shareholder approval, will likely supersede any appraisal-related benefits. In stock and cash mixed consideration deals, buyers can attempt to negotiate for protection by pointing to the potential threat of an appraisal award to the tax-free nature of the transaction, a typical condition in these deals.[20]

The rise of Section 251(h) "medium form" tender offers, which permit a buyer to simultaneously close a tender offer and a back-end merger (typically even if only a simple majority of the target's shares have been tendered), has helped buyers mitigate the risk of a substantial gap between signing and closing,[21] but there is still a significant risk that the deal price at signing may differ materially from "fair value" at closing, particularly if the deal involves a lengthy regulatory approval process.

Buyers could also seek to decrease the risk of a significantly higher appraisal price by cooperating with targets to bolster the perceived reliability of the deal price as a proxy for fair value.[22] However, it can be counterproductive for buyers to agree to terms that permit a more robust market check of the deal price.

Considerations for Targets

Experience suggests that target boards and their advisors do not typically analyze in much detail, if at all, the potential for different outcomes between the fairness opinion and appraisal approaches in their assessment of a potential sale transaction. After all, the duty of care fiduciary standard focuses on process, an appraisal condition may not be present in the acquisition agreement, and if appraisals are perfected and pursued after the consummation of the deal, it is the buyer's sole risk. Although it will be necessary for a dissenting stockholder not to vote for the transaction, dissenters as a group infrequently represent a large enough bloc to exercise control or negative control over the outcome of the vote.

It is possible that the plaintiff's bar, faced with *Corwin, Trulia* and their progeny, might try to construct a new type of fiduciary duty claim around the alleged failure to negotiate for a deal price as high as the likely appraisal price, or the failure to disclose the difference between the deal price and the likely appraisal price. The plaintiffs might also argue that a target board should not be in a position to recommend to its stockholders that they vote for a deal or tender their shares unless the target board has reasonably satisfied itself that the estimated appraised value is not higher than the deal value.

However, it seems unlikely the Delaware judiciary would allow such claims to gain any traction given the weight of jurisprudence against second-guessing a target board's determination of fair price, absent bad faith or gross negligence. The fact that a judicial determination of fair price after an adversarial

[19] See DGCL 262(b).

[20] For a typical mixed stock and cash deal seeking tax-free treatment for the stock component, cash ("boot") can represent no more than 20% of the aggregate consideration in a reverse triangular merger under Section 368(a)(2)(E) of the tax code, and not more than 60% of the aggregate merger consideration in a forward triangular merger under Section 368(a)(2)(D) of the tax code. Payouts under appraisal actions, if available, count as boot in either kind of transaction. A mixed stock and cash deal is often structured as a reverse triangular merger into the target followed by a forward merger into the acquiring parent or another limited liability company directly owned by the public parent. These transactions are eligible to use the more generous boot limitation afforded to forward mergers and also avoid corporate level taxes on the targets' assets in case the transactions do not qualify for tax-free treatment. Forward mergers, including reverse mergers followed by internal forward mergers, can take advantage of the signing date value for measuring the cash versus stock limitation if the merger consideration meets the requirements for fixed consideration under the regulations, but reverse mergers relying on Section 368(a)(2)(E) of tax code must use the value on the closing date.

[21] *See Technicolor*, 542 A.2d 1182. Where regulatory or other conditions, or the need for extended financing marketing periods, results in longer closing dates, the parties will often use a merger rather than a tender offer structure to secure target shareholder approval and cut off "fiduciary outs."

[22] *See supra* note 12 and accompanying text.

proceeding might differ from a negotiated deal price is not surprising. Valuation is not an exact science and reasonable people can disagree.[23]

In some situations a target board will wish to make deeper appraisal value inquiries as part of their process. The use of the investment bankers on the deal to assist in this inquiry may be challenging, however, as it is not part of their customary engagement mandate or field of expertise. It is possible that in particularly delicate matters a target board might employ a second financial advisor to perform this service under a non-contingent fee structure.[24]

* * *

It remains to be seen whether the recent surge in appraisal actions represents a new normal in M&A deals or a blip, with such actions eventually settling back to historical levels and Venus and Mars more or less coming back into alignment. Continuing developments in deal and appraisal case law, legislation, deal technology and the broader markets will all play a part in answering that question. For the time being, this appraisal development poses continuing challenges for both buyers and sellers, with no easy solutions.

Purchase Price Adjustments for Tax Benefits

By Rahul Patel and John Sweet, Partners, and John Anderson, Associate, of King & Spalding LLP

A letter of intent for the sale of a private company will often specify that the purchase price takes into account the value of all tax benefits. In many cases (and especially in the last few years), sellers will ask for a purchase price adjustment that requires the buyer to pay the seller for the value of any tax deductions that would produce tax benefits for the buyer following the closing to the extent those tax deductions were generated by transaction-related expenses (for example, option cancellation payments, change-of-control bonuses and investment banker fees) incurred by the target on or prior to the closing.

In certain cases involving a target that is a C corporation, these "transaction tax deductions" do not result in immediate benefits to the target because the target has not generated enough taxable income in the year of sale to take advantage of the tax deductions.

In those cases, the target generates a net operating loss ("NOL"), which can be carried back (up to two taxable years) to create a refund for prior taxes paid. Any NOL remaining after any carryback can be used to offset future income, subject to applicable limitations under the Internal Revenue Code.

In other cases, the target may have pre-existing NOLs or other potentially valuable tax attributes for which the seller wants to be paid (in addition to being paid for the value of any transaction tax deductions).

There are several options with respect to negotiating the treatment of tax benefits and NOLs, outlined below. We have seen the spectrum of these alternatives, ranging from buyers paying a significant premium being able to insist that the headline purchase price includes the value of all tax benefits, to buyers in competitive auctions agreeing to pay for the net present value of the tax benefits at closing.

The outcome is transaction-specific and depends on many factors, including negotiating leverage, the number (and importance) of other "money points" being negotiated and what type of process is involved (*e.g.*, a broad auction versus a limited process).

Buyer-Favorable Approach

[23] *See, e.g., Dell*, 2016 WL 3186538, at *45.

[24] Even if the investment banker were willing to provide some form of advice as to what a hypothetical appraisal value would be, a further question is whether the built-in conflict with respect to investment banker deal fees renders such advice too suspect to rely on. The case law regarding conflicts with respect to deal fees has generally been favorable to the traditional investment banker fee structure. *See, e.g., In re Smurfit–Stone Container Corp. Shareholder Litigation*, 2011 WL 2028076 (Del. Ch. May 24, 2011). However, a standalone fairness opinion from a second investment banker is sometimes employed to alleviate any concern. It is debatable whether the buyer could then use the same advisor with respect to actual post-deal appraisal litigation.

The buyer would not give credit to the seller for transaction tax deductions or any NOLs (or other tax attributes) and the buyer retains all tax refunds. In other words, the value of the tax deductions and any NOLs or other tax attributes is reflected in the headline purchase price.

To the extent NOLs or other tax attributes are priced into the deal, the buyer may also seek representations regarding the amount of such tax attributes and assurance that they are not subject to limitation (for example, as a result of a prior "ownership change" of the target).

Seller-Favorable Approach

The seller would be entitled to receive all tax refunds relating to pre-closing tax periods. For example, to the extent the target has paid estimated taxes for the current tax year (which in many cases will end on the closing date), any refund of those taxes would be paid over to the seller.

In addition, the target would be required to carry back any NOL, to the extent possible, to offset taxable income from its previous two years. Any refund generated from carrying back the NOL would be payable to the seller.

The buyer would be obligated to pay over to the seller the amount of any tax benefit realized by the buyer in post-closing tax periods to the extent attributable to any NOL carryforward (together with any benefit realized as a result of any transaction tax deductions being deductible in post-closing rather than pre-closing tax years).

Potential Compromises

The seller would be entitled only to refunds for the current taxable year (and the buyer, not the seller, would be entitled to retain any refunds/benefits attributable to any NOL carryback or carryforward).

The seller would be entitled to refunds for all pre-closing tax periods. The seller would get the benefit of any refund for the current taxable year and any refund for prior years resulting from any NOL carryback, but any NOL carryforward would be for the benefit of the buyer.

With respect to any future benefits, adopt a "pay as you go" approach in which the buyer would be obligated to pay over benefits relating to the utilization of NOLs only as they are actually realized, provided that they are realized within a specified period (*e.g.*, within 3 or 5 tax years following the closing date).

In lieu of an approach where any applicable refunds/benefits are paid over to the seller as and when they are realized, some agreements provide for the net present value of those amounts to be estimated and paid at closing. The advantage of this approach from the buyer's perspective is that the buyer has no continuing obligations to the seller with respect to tax refunds/benefits.

The risk to the buyer is that actual benefits will turn out to be less than estimated benefits. For example, a buyer that estimates the value of future tax benefits using today's tax rates could end up overpaying if tax rates were to go down in the future (a distinct possibility with tax reform on the agenda in Washington). Accordingly, the prospect of tax reform could impact the willingness of a buyer to pay for future tax benefits up front.

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