THOMSON REUTERS
Westlaw®

Transaction-related tax deductions and the worst words ever spoken by a deal professional

By Glenn D. West, Esq., Mark Schwed, Esq., and Alex Farr, Esq., ***Weil Gotshal & Manges***

FEBRUARY 15, 2018

Contrary to popular belief, Raymond Burr's character in the famous TV series, *Perry Mason*, did not necessarily limit his practice to criminal defense. He was an old-fashioned sole practitioner that, at times, could be seen drafting contracts too (or at least dictating some instructions regarding their preparation to his trusted legal assistant, Della Street (played by Barbara Hale)).

If memory serves, the show would sometimes open with the tail-end of a meeting between Perry and a regular client not accused of murder, discussing some business dealing of some kind, with Della carefully taking notes in shorthand. As the meeting wrapped up, and before the show turned to the meatier matters of some wrongly accused person desperately needing Perry's assistance, Perry would wave his hand and say something to the effect of "Della, please prepare the necessary papers."

While Della was an amazing legal assistant, contract drafting is seldom a function of simply translating some notes from a meeting describing the supposed "deal" into a legally enforceable contract. The devil may well be in the details of the drafting and negotiation of the written agreement, and, as discussed in a prior Weil Private Equity Insights,[1] it is that fully negotiated written contract that constitutes the deal, not what one of the parties may have *thought* was the deal based on pre-contract discussions.

Nonetheless, some deal professionals persist in the mistaken belief that the deal was fully-made between the principals, and the lawyers just need to be Della and "prepare the necessary papers" to document that deal.

Such a mistaken belief was very much in evidence in a recent Delaware Court of Chancery decision, *LSVC Holdings, LLC v. Vestcom Parent Holdings, Inc.*, C.A. No. 8424-VCMR, memo. op. (Del. Ch. Dec. 29, 2017), where the principals on both sides of the sale of a company supposedly agreed to share equally the benefits of the company's transaction-related tax deductions ("TTDs") and then left the lawyers to work out the details.

As with any deal points, but particularly when it comes to TTDs, the worst words ever spoken by a deal professional are: "We have a deal, let's let the lawyers work out the details."

BACKGROUND ON TTDS

First, it is worth a brief detour to explain the mechanics of TTDs and the benefit of such deductions. TTDs are generally tax deductions generated by payments made by a target entity that become deductible in connection with the closing of the transaction, such as professional fees, compensatory payments, and deferred financing expenses, which generally result in ordinary deductions for the target entity.[2]

In a transaction that is consummated early in the year and causes the target's taxable year to close (resulting in a "stub" tax period), the TTDs arising from closing expenses incurred in the stub period may exceed the target's income during such period and generate a "net operating loss" ("NOL").

Historically, such deductions could first be claimed on the stub period tax return to reduce the pre-closing stub period taxable income (and, to the extent relevant, allow the target to claim a refund of estimated tax payments made in respect of such period).

Any excess deduction would create an NOL that could then be carried back to the two taxable years preceding the taxable year in which the NOL was generated to produce refunds to the target for any taxes paid in such preceding years.[3]

Thereafter, the balance of the NOL could generally be carried forward and used to offset post-closing taxes of the buyer. Note, however, that as a result of the passing of the Tax Cuts and Jobs Act of 2017, newly-created NOLs are no longer eligible to be carried back to prior tax years (although they may still be carried forward).

There is no "right" or "wrong" way to allocate the value generated by the TTDs. Often, in a transaction where the seller is bearing the cost of the items giving rise to the deductions by a reduction to the purchase price, the seller may "expect" to receive the benefit of the TTDs via an offset of the pre-closing tax liabilities, as well as the benefit of any refunds generated as a result of the pre 2017-Tax Reform ability to carryback NOLs, and the benefit of the carryforward of the NOLs that are used to offset the company's post-closing tax liabilities.

However, as can be expected in any negotiated transaction, the buyer may price in the value of some or all of these benefits and may negotiate to keep some or all of the benefit for itself.

As there are numerous approaches to allocating the economic benefits of TTDs, and the mechanics for providing such benefits to the buyer or seller, as the case may be, can vary depending upon the facts of the specific transaction, and, in light of the court's analysis in *LSVC Holdings* discussed below, the specific mechanics should be explicitly spelled out in the final agreement.

LSVC HOLDINGS

LSVC Holdings involved a dispute over whether the final stock purchase agreement ("SPA") between the parties to a corporate acquisition contemplated a 50-50 split between Buyer and Seller of all TTDs in *all* respects, pre- and post-closing, or merely required Buyer to share 50% of the benefit of any TTDs utilized to offset post-closing taxes with the Seller.

The executed letter of intent between the parties (the "LOI") merely provided that the Buyer "would pay over *to the seller* 50% of the benefit of any transaction tax deductions on an 'as and when realized' basis." (emphasis added). The final SPA only stated that the Buyer would be entitled "to retain 50% of" the post-closing TTD-related refunds or tax savings.[4]

Nevertheless, the Buyer filed suit alleging a breach of contract after learning that no TTDs would be available to it in the post-closing period because the Seller, anticipating the close of the transaction by year-end, accounted for the TTDs when making its fourth quarter tax payment to the IRS (i.e., claimed the deductions in the *pre*-closing period).[5]

The Buyer argued that doing so was both inconsistent with the deal and explicitly precluded by a provision in the SPA requiring the Buyer to include *all* TTDs on the post-closing tax returns.[6]

The court felt there was a "tension" between the provisions of the SPA necessitating an examination of extrinsic evidence:

> When a contract's plain meaning, in the context of the overall structure of the contract, is susceptible to more than one reasonable interpretation, courts may consider extrinsic evidence to resolve the ambiguity. Such extrinsic evidence may include the history of negotiations, earlier drafts of the contract, trade custom, or course of performance. After examining the relevant extrinsic evidence, a court may conclude that, given the extrinsic evidence, only one meaning is objectively reasonable in the circumstances of the negotiation. (citations omitted).

The court evaluated the history of the parties' negotiations leading up to the executed LOI, the drafting history of the SPA, and the post-closing actions of the parties, among other things. In each instance, the court concluded that the evidence favored the Seller's interpretation of the arrangement.

For example, during initial negotiations each of the parties sought to capture 100% of the benefit of the TTDs, but ended up settling on a "middle ground" approach to split the TTDs 50-50; this was memorialized in the executed LOI which provided for payments from the Buyer to the Seller of 50% of any TTD value as and when realized. The court noted a lack of any explicit provision in the LOI or the final SPA providing for a payment *from the Seller* to the Buyer.

Furthermore, over the course of exchanging drafts of the SPA, the Buyer's counsel proposed language that, if included in the final SPA, would have expressly precluded the Seller from claiming the TTDs pre-closing as it eventually did.[7]

Because the language was omitted in the final SPA, however, and, consistent with the LOI, the SPA contained no explicit provisions obligating the Seller to pay the Buyer for pre-closing benefits attributable to TTDs, the court declined to read into the SPA the interpretation that the Buyer sought to enforce:

> Under basic principles of Delaware contract law, and consistent with Delaware's pro-contractarian policy, a party may not come to court to enforce a contractual right that it did not obtain for itself at the negotiating table. This principle applies with particular force when the supposedly aggrieved party in fact sought the specific contractual right at issue in negotiations but failed to get it. This is because a court's role in interpreting contracts is 'to effectuate the parties' intent.' For a court to read into an agreement a contract term that was expressly considered and rejected by the parties in the course of negotiations would be to 'create new contract rights, liabilities and duties to which the parties had not assented' in contravention of that settled role. (citations omitted)

KEY TAKEAWAYS

LSVC Holdings reminds of the importance of clarity in all aspects of a transaction negotiation.

Clarify the meeting of the minds

Make sure that you and your counsel have a clear and consistent understanding of the fundamental business deal. It is apparent that when the *LSVC Holdings* parties cut their "50-50" TTD deal, there was a disconnect in their respective interpretations of what that meant.

Although the court upheld the plain drafting of the SPA, the parties could have potentially avoided the ambiguity debacle had they given due consideration to both the wording and conceptual meaning of their business deal with respect to TTDs.

Don't leave money on the (drafting) table

Because the "deal" is typically reflected only in the four corners of the written agreement, deal professionals must stay involved and ask hard questions about the drafting — do not simply leave the details to the lawyers.

As the *LSVC Holdings* court highlighted, the Buyer's counsel could have potentially foreclosed the issue had it pushed to include language explicitly proposed during the drafting process but omitted in the final SPA (i.e., explicitly prohibiting the target from accounting for TTDs in its pre-closing returns). And, of course, the Seller's counsel could have avoided a trial involving the introduction of extrinsic evidence if the written agreement did not contain language that created the need for such extrinsic evidence.

Deal professionals must stay involved with their counsel throughout the drafting process; and because the deal isn't done until the final agreement is fully negotiated and signed, they must make sure they have the right counsel familiar with the evolving caselaw regarding private equity deal documentation.[8] Unfortunately a deal professional's job is not done just because they believe they have cut a deal.

NOTES

[1] Glenn West, *A New Year's Resolution for Deal Professionals: Make Sure Your Written Deal Documents Say (And Will Be Interpreted to Mean) What You Meant,* Weil Insights, Weil's Global Private Equity Watch, January 2, 2018.

[2] Note that whether such expenses are deductible will generally depend on whether they are properly treated as a trade or business expense under I.R.C. Section 162(a). Some transaction expenses, such as costs to "facilitate" the acquisition or disposition of a trade or business or costs related to other "covered transactions" may be subject to capitalization rather than deduction. *See* Treas. Reg. §1.263(a)-5.

[3] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried. *See* I.R.C. Section 172(b)(2) (prior to amendment by the Tax Cuts and Jobs Act of 2017).

[4] The court noted that "These clauses only concern post-closing benefits, and compliance with each requires a one-way transfer from [the Buyer] to [the Seller]."

[5] Note that the court concluded that doing so was not in conflict "with the ordinary course of business or past practices of [the target]."

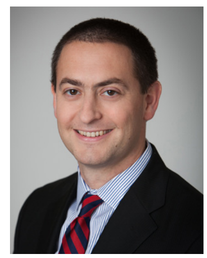
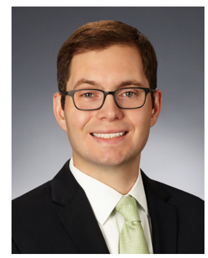
[6] Note that, in response to this argument, the Seller convincingly pointed out that the language only imposed a requirement that Buyer list the total TTDs on the post-closing tax returns, but did not otherwise prevent the target from actually claiming such deductions on pre-closing tax returns.

[7] The language provided that the Seller would be required to file pre-closing tax returns "without regard to the [TTDs]." We would observe that the parties can (and, arguably, should) negotiate the economic sharing of a tax benefit (or any other target company asset) without requiring the company to forgo a benefit prior to the closing (and, query whether, as a matter of tax law, it can).

[8] *See* Glenn West, *Contract Drafting 101 — It Doesn't Matter What You Actually Meant by What You Said; It Only Matters What is Determined to be Meant by What You Actually Said,* Weil Insights, Weil's Global Private Equity Watch, September 19, 2016, https://goo.gl/Zy1goi.

This article appeared in the February 15, 2018, edition of Westlaw Journal Mergers & Acquisitions.

ABOUT THE AUTHORS

Glenn D. West (L) is a partner based in the Dallas office of **Weil, Gotshal & Manges**. He is a member of the firm's corporate department and has extensive experience in leveraged buyouts and dispositions of both public and private companies nationally and internationally. He is dual-qualified as a U.S. lawyer and an English solicitor, and he can be reached at gdwest@weil.com. **Mark Schwed** (C), a partner based in Weil's New York office, is a member of the firm's tax practice and focuses on representing public companies and private equity sponsors and their portfolio companies in connection with domestic and international acquisitions and investments, divestitures, joint ventures, financings, and restructurings. He can be reached at mark.schwed@weil.com. **Alex Farr** (R) is an associate based in the firm's Dallas office. He is a member of Weil's tax practice and participates in the representation of clients with respect to the tax aspects of a wide range of corporate transactions. He can be reached at alex.farr@weil.com. This article was originally published Jan. 31 on the firm's Global Private Equity Watch website. Republished with permission.