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Delaware Opinion Demonstrates Complexity of Negotiating Transaction Tax Deduction Provisions

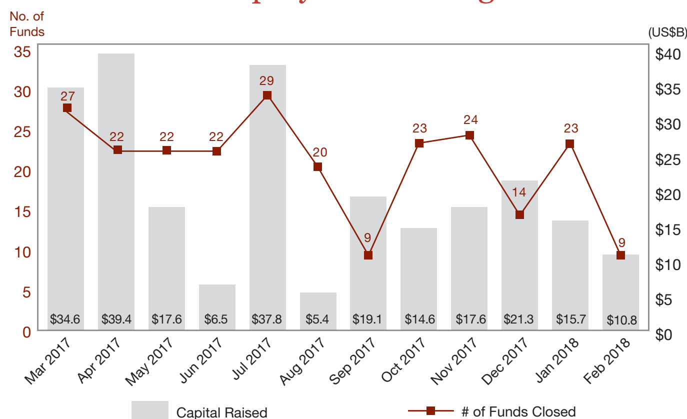
Overview

A common, and potentially complex, issue in private transactions is how the parties will split transaction tax deductions. TTDs are transactional expenses incurred by the target company (including, among others, banker fees, change-of-control payments and payments in respect of in-the-money options cancellations) that can be claimed as tax deductions. Generally, absent any contractual modification, the seller will benefit from any pre-closing TTDs, and the buyer will benefit from post-closing ones. Often, however, the parties will negotiate a modified split of TTDs between them, and as a recent decision by Vice Chancellor Montgomery-Reeves of the Delaware Court of Chancery in *LSVC Holdings, LLC* v. *Vestcom Parent Holdings, Inc.* demonstrates, these negotiations can be complex and lead to somewhat unexpected outcomes if various pieces of the purchase agreement are not properly drafted to work together. In that case, the court held that the target company was entitled to claim all of its TTDs on its estimated tax returns filed pre-closing, despite arguments by the acquiring company that the parties had agreed that the acquirer would be entitled to half of the value of the TTDs, regardless of how or when realized. The case serves as a reminder of the potential high-value impact of pre- and post-closing tax provisions, as well as their interaction with purchase price adjustment provisions.

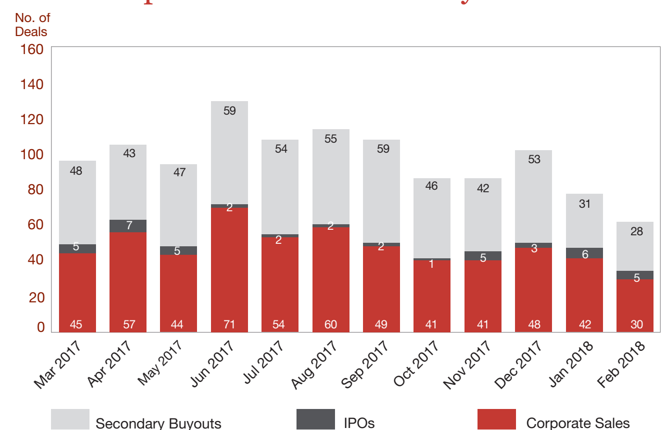
Background

The dispute in *LSVC* arose from the 2012 sale of Vestcom International, Inc. (the "Target Company") by LSVC Holdings, LLC ("Seller") (jointly owned by private equity firms Lake Capital Holdings and The Stephens Group, LLC) to an entity owned by Court Square Capital Partners ("Buyer"). In a letter of intent, the parties initially agreed that Buyer would pay Seller 50% of the benefit of any TTDs on an "as and when realized" basis. Numerous drafts of the stock purchase agreement were exchanged. The TTDs continued to be heavily negotiated by the parties' lawyers, with Seller consistently rejecting Buyer's attempts to include provisions that would have resulted in the Seller not realizing the full benefit of pre-closing TTDs.

The final stock purchase agreement contained numerous provisions pertinent to TTDs, including, among others: (i) an agreement that in connection with the preparation of tax returns, all TTDs (except for TTDs that are "not 'more likely than not' deductible" in the pre-closing tax period) shall be treated as properly allocable to the pre-closing tax period, and that all such tax returns shall include all TTDs; and (ii) provisions that to the extent a tax refund, credit or post-closing tax savings is attributable to a TTD, Buyer has the right to retain 50% of such refund, credit or savings.



Source: Pitchbook



Source: Pitchbook

Between signing and closing, the Target Company, consistent with past practice, claimed the entirety of the TTDs on its estimated tax returns. Buyer argued that the agreement barred the Target Company from realizing the full amount of the TTDs prior to the closing, and that the parties had agreed to an equal split of the value of the TTDs, regardless of how or when realized, while Seller argued that the agreement only required an equal split of any cash benefit of the TTDs realized post-closing.

Court's Holding

The court concluded that the Target Company was permitted to claim 100% of the TTDs to reduce estimated tax payments prior to closing, and that Buyer was only entitled to half of the value of any post-closing tax refunds or other tax benefit received post-closing as a result of TTDs. Therefore, because Target indeed claimed the entirety of the TTDs on its pre-closing estimated tax returns, Buyer was not entitled to the value of any TTDs. In reaching this conclusion, the court examined extrinsic evidence, including the parties' detailed negotiation history, how the TTD provisions interacted with other contractual provisions (including the working capital purchase price adjustment provision) and the Target Company's past practice.

Observations

Negotiations relating to TTD provisions in transaction documents can be complex, which complexity is further compounded by their interaction with other contract provisions, including, in particular, purchase price adjustments. In this regard, there are several key takeaways from the *LSVC* opinion:

- *Courts interpret a contract by reviewing the document as a whole and giving effect to all its provisions without any "absurd" results. Further, if a contract is not clear on its face and susceptible to more than one reasonable interpretation, courts will look at evidence outside the four corners of the contract to find the meaning that is "objectively reasonable in the circumstances of the negotiation". Thus, the interaction of all of the contract's provisions may be more important than any one provision, and the negotiation history may become important if there is a contract dispute.* If a dispute arises among the parties relating to TTDs or any other contractual provision, a court will look beyond the relevant provisions in the contract to the outcome produced by such provisions' interaction with other aspects of the contract (e.g., purchase price adjustment provisions) and so-called "extrinsic evidence" (i.e., evidence beyond the contract itself, such as negotiating history, past drafts, emails and other recorded communications) as guidance for the parties' intent and the provisions' meaning.

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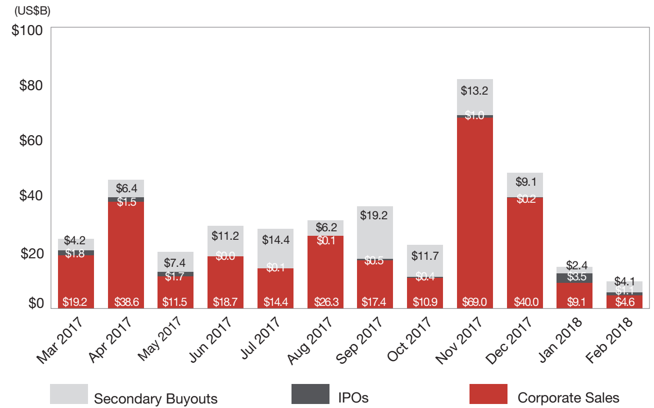

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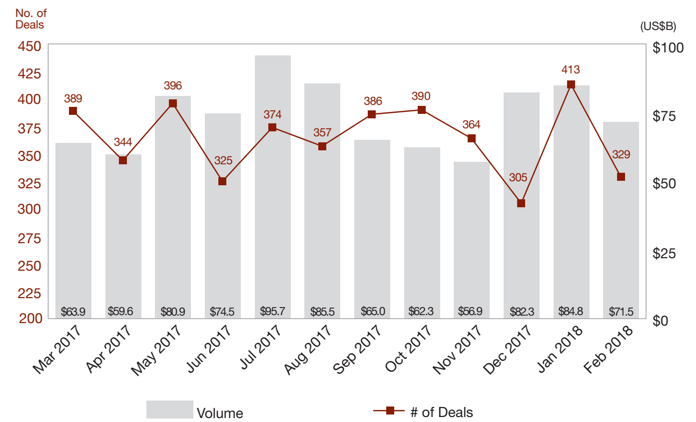
Global Sponsor-Related M&A Activity



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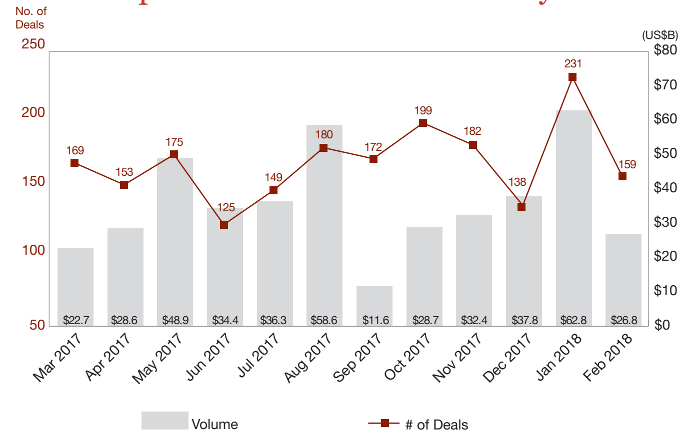
U.S. Sponsor-Related M&A Activity



Source: Dealogic

For example, in *LSVC*, the court rejected Buyer's interpretation of the working capital purchase price adjustment provision to avoid an "absurd" result. Under Buyer's interpretation of the stock purchase agreement, Buyer would have been required to pay Seller for the value of some of the same TTDs twice – once as an adjustment to the purchase price through an increase in working capital (because failing to claim the TTDs pre-closing would have resulted in an overpayment of taxes and created a large tax receivable in the form of the expected tax refund) and then a second time when the Target Company received a refund of the pre-closing overpayment as a result of the TTDs because Buyer would be required to pay Seller 50% of the value of the tax refund received post-closing. Similarly, under Buyer's interpretation of the stock purchase agreement, the Target Company would have been required to pay an additional $6 million to the IRS prior to closing rather than claim the TTDs and not pay any taxes.

The court in *LSVC* also looked extensively at the negotiation history to ascertain the parties' intent. This included reviewing drafts of the stock purchase agreement to see what was added or deleted throughout the course of discussions, reviewing emails and considering witness testimony. When the court weighed it all, it found that Seller had explicitly struck provisions that would have given Buyer a greater portion of the pre-closing TTDs. This reflects the importance for parties to create a clear record of their intent with respect to high-value terms, including weighing the benefit of particularly subtle or nuanced drafting against being clearer with respect to those terms.

- *The court's approach indicates the importance of contract language clearly reflecting deviations from past practice*. In determining whether the Target Company's decision to claim the TTDs pre-closing complied with its contractual obligations to have fully paid all taxes "due and payable" as of closing, and to make any such payments "in the ordinary course of business . . . consistent with past practice," the court relied on testimony about the company's historical practice. The Target Company's CFO testified that he estimated the company's tax payment in line with its normal course of business and, according to testimony by Buyer's own expert, absent some other agreement, there was nothing improper in claiming the full value of the TTDs pre-closing. The court's reliance on this evidence demonstrates that if the parties' intent is to deviate from past practice (e.g., not to claim all available TTDs in a certain tax period), it is important that the contract language be clear as to such intent.
- *Parties that maintain close and adequate communication with counsel are better positioned to ensure that their business understanding of a transaction is reflected in the legal documents produced by counsel*. While the court found that the negotiation history did not demonstrate the interpretation advocated by Buyer, the court did suggest that there was a disconnect between Buyer's principals and their own counsel regarding the treatment of TTDs. Therefore, principals and counsel may want to consider maintaining close and adequate communication throughout negotiations to ensure that big valuation impact provisions, like the TTDs, accurately reflect the principals' business understanding.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Matthew W. Abbott
Partner
New York
+1-212-373-3402
mabbott@paulweiss.com

Scott A. Barshay
Partner
New York
+1-212-373-3040
sbarshay@paulweiss.com

Angelo Bonvino
Partner
New York
+1-212-373-3570
abonvino@paulweiss.com

Marco V. Masotti
Partner
New York
+1-212-373-3034
mmasotti@paulweiss.com

Taurie M. Zeitzer
Partner
New York
+1-212-373-3353
tzeitzer@paulweiss.com

Partners Ariel J. Deckelbaum and Justin G. Hamill, counsel Frances F. Mi, associate Bilal Manji and law clerk Diana Berbece contributed to this publication.

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