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Ruling Highlights Importance of Drafting to Indemnification

By: Elliot Pisem and David E. Kahen

In transactions involving the purchase of a business through the purchase of stock or other equity interests in a target company, the seller is typically required to indemnify the buyer with respect to any taxes required to be paid by the target company after the closing that are attributable to the activities of the target company for periods before the closing, and that exceed any reserves for taxes reflected on the target's balance sheet as of the closing date.

After the closing, a tax audit or other claim may be asserted by the IRS or other taxing authority with respect to a pre-closing period. In these circumstances, provisions of a stock purchase agreement relating to tax indemnification may affect which party or parties will: control or otherwise have the right to participate in the audit or other tax controversy; determine whether or not a settlement may be entered into; and bear any tax cost resulting from a settlement or other resolution of the claims of the taxing authority.

The last of these points was at issue in *Marathon E.G. Holding Limited et al. v. CMS Enterprises Company* (Dkt No. H-07-2990, July 30, 2008 (S.D. Tex.)), where a sale to one of the plaintiffs (collectively "Marathon") of three target companies owned by a subsidiary of the defendant ("CMS") resulted in litigation between the parties as to which party would ultimately bear the additional tax cost resulting from adjustments to net operating loss carryovers from pre-closing years.

The court ultimately ruled that CMS as the defendant/seller had no responsibility for the tax amount at issue. On the facts as set forth in the second Memorandum and Order issued in response to motions made by the parties for summary judgment, the result was not surprising. The decision, however, underscores the importance of careful drafting of the provisions of the purchase agreement that control indemnification for tax matters (without intending any suggestion that the parties were not careful in this case), and is indicative of the steps that parties may need to take to litigate indemnification issues effectively.

Facts in Marathon v. CMS

As set forth in the Memorandum and Order dated July 30, 2008, and an earlier Memorandum and Order dated May 8, 2008, by the same court in this matter, the tax indemnification claim at issue arose from the sale by a subsidiary of CMS to Marathon of all of the outstanding shares of three Cayman Island companies (collectively the "Companies") owning oil and gas reserves, a liquefied petroleum gas plant, and a methanol plant, all located in the Republic of Equatorial Guinea ("EG"). The sale was effected under a Stock Purchase Agreement ("SPA") dated October 31, 2001, and the transaction closed on January 3, 2002.

Large net operating losses had been incurred by subsidiaries of CMS in EG during the tax years 1997-2001, with one of the Companies having (based on its financial statements) a cumulative net operating loss ("NOL") as of December 31, 2000, of $22,000,000. The tax returns of the seller were regularly audited, and, at the time the SPA was negotiated, aspects of the returns for 1997-2001 had already been challenged by the EG government.

After the closing, Marathon assumed control of the negotiations with the EG government regarding tax issues relating to the Companies for 1997-2001, although CMS was kept informed of the negotiations, discussed with Marathon the responses to questions raised during the audit, and approved each settlement offer made by Marathon to the EG government.

Ultimately, Marathon and the EG government entered into a settlement agreement in May 2007 that resolved all tax issues for the 1997-2001 period. The agreement provided that Marathon's NOL carryforward as of December 31, 2001, was being reduced by $11,000,000 in settlement of all such issues.

That reduction caused a reduction in the NOL available for offset against earnings of Marathon in EG for 2005. The agreement with EG further stated (in what may have been to some degree an attempt by Marathon at self-help with respect to an anticipated claim

***Elliot Pisem** and **David E. Kahen** are partners in the law firm of Roberts & Holland LLP.*

against CMS for indemnification) that the reduction in the NOL would result in an additional taxes of $2,750,000 paid to EG.

Marathon made a demand against CMS for indemnification with respect to this amount under the SPA, which included a provision to the effect that "Seller hereby agrees to protect, defend, indemnify, and hold harmless the Buyer Indemnified Parties … and agrees to pay (a) any Taxes … of the Companies … attributable to the time period prior to January 1, 2002."

CMS refused the demand, on the basis that the indemnity provision did not apply because the payment "'is for taxes Marathon paid EG for tax years occurring after the closing of the sale from CMS to Marathon.'" CMS further asserted that "'CMS did not indemnify Marathon for tax liability for post-closing tax years.'"

Marathon then sued CMS in state court for breach of contract by reason of the denial of this indemnification claim and with respect to another claim relating to withholding taxes. CMS removed the action to the United States District Court for the Southern District of Texas in September, 2007. Thereafter CMS made a motion for partial summary judgment with respect to the $2,750,000 claim.

Analysis

In the district court's initial Memorandum and Order dated May 8, 2008, in response to a motion for partial summary judgment filed by CMS, the court concluded that the indemnification provision of the SPA was "subject to only one reasonable reading," namely, that CMS was obligated to indemnify Marathon for the $2,750,000 tax payment. On that basis the court denied the motion for summary judgment by CMS and directed the parties to show cause as to why Marathon was not entitled to summary judgment under the SPA for indemnification with respect to the payment.

In reaching this conclusion, the district court referred to the dictionary definitions of the terms "attributable" and "attribute" as cited by the parties, which included: "to explain as caused or brought about by: regard as occurring in consequence of or on account of," and "to regard as produced by or originating in the time, period, place, etc., indicated; credit; assign."

The court concluded that both definitions supported Marathon's argument. It observed that the settlement agreement with EG established that the tax payment was caused by the NOL adjustment under that agreement; and that the SPA referred to indemnification for any "Taxes" without qualifying (except insofar as the phrase "attributable to the time period prior to January 1, 2002" itself limited) the indemnification obligation of CMS by reference to when the underlying tax payment was made.

Read closely, the court's initial determination suggests that the court did not at that time fully comprehend the purposes or intended operation of the tax indemnification provisions in the SPA.

Thereafter, the court heard oral argument by the parties on a motion by Marathon for partial summary judgment, and reviewed what the court described as a "comprehensive briefing" by the parties with respect to this motion (in comparison to what was referred to as the parties' "limited original briefing" for the earlier motion). Also before the court was a "Declaration," introduced by CMS, by an attorney with many years' experience in representing energy companies in tax controversies with foreign tax authorities, regarding routine tax practices in this area and the meaning of words and phrases such as "Taxes," "Tax Attributes," and "Tax Items."

Based on the additional information presented, the court reconsidered its original ruling denying partial summary judgment to CMS, and concluded that the motion by Marathon for partial summary judgment should be denied and that partial summary judgment should be granted to CMS with respect to Marathon's claim for indemnification regarding the $2,750,000 amount.

The court found to be persuasive the tax attorney's assertion, not contradicted by Marathon, that, in tax indemnification provisions generally, taxes are considered to be "attributable to" the tax year in which the income that resulted in the tax was earned. In this case, it was undisputed that the income by reason of which the $2,750,000 of additional tax was paid was earned in 2005, rather that in the years addressed by the tax indemnification in the SPA.

It was further noted that the SPA made a distinction between "Taxes" and "Tax Items." The SPA defined "Taxes" to include federal, state, local or foreign income taxes and numerous other taxes, including interest and penalties thereon, but did not refer in that definition to *tax attributes* such as net operating loss carryovers and tax basis.

"Tax Items" were defined in the SPA as "items of income, gain, loss, deduction, credit, or other items" required to be included on the returns of the Companies, and included the NOL carryforward as of December 31, 2001, that was reduced after the closing. The SPA included warranties as to both the payment of Taxes and the Tax Items on the Companies' tax returns, but did not provide an indemnity for a breach of the warranty with respect to Tax Items.

The court also noted that draft language for the SPA that was proposed by Marathon during the negotiation of the SPA included (i) a proposal that CMS be liable for any Tax "occurring after December 31, 2001 to the extent a net operating loss is reduced or disallowed by the relevant Governmental Authority," and (ii) proposed warranties as to (x) the amount of any NOL, net capital loss, or tax credit of the Companies (referred to collectively as "Tax Attributes") and (y) the availability of the Tax Attributes to Marathon.

These provisions were not included in the final SPA, which, of course, suggests that the parties' ultimate understanding was that Marathon was not indemnified against any loss from a post-closing diminution of tax attributes such as NOL carryovers relating to pre-closing periods.

It was further noted that, under Texas law, indemnity agreements are

strictly construed in favor of the indenitor, and that the indemnity must be explicit. Thus, to the extent the indemnity provisions were ambiguous, this rule of construction may have provided the court with a further basis to construe any ambiguity against Marathon as the party seeking to enforce the indemnity.

Overall, however, the court concluded that the SPA indemnification provisions were not ambiguous, and that they supported the interpretation of the contract advocated by CMS, to the effect that Marathon was not entitled to indemnification for the $2,750,000 tax payment to EG in 2007 because that tax payment was made on account of tax liabilities for a post-closing period. Accordingly, the court granted summary judgment to CMS on this issue.

Observations

Overall, the decision confirms the importance of careful drafting of tax indemnification provisions in stock purchase agreements, with due regard to the types of controversies that may be anticipated and the appropriate allocation of the burden of loss or potential for gain with respect to such matters.

It is also noteworthy that the court's final conclusion on the indemnification issue discussed above represented a reversal of the court's initial order, which found Marathon's arguments to be meritorious. The reversal was apparently due to a variety of circumstances that included the declaration of an attorney experienced in the negotiation and application of tax indemnity provisions regarding the meanings customarily assigned to terms commonly used in such provisions, and the introduction of prior drafts of the SPA that strongly suggested that the provision of contractual protection with respect to NOLs had been discussed and rejected in the negotiating process. But for such evidence and the defendant's further briefing based on the evidence, the result might well have been different.

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