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Tax: Exit Rights Triggered by Tax Law Changes

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Exit Rights Triggered by Tax Law Changes

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A tax law change can materially and adversely affect the tax consequences of a pending deal. In response, some merger and acquisition ("M&A") agreements include a "Tax MAC" provision—a provision that triggers termination or other rights upon a material adverse change in tax law. For example, the Tax MAC provision in the acquisition agreement between Pfizer and Allergan enabled Pfizer to terminate their pending transaction in 2016 after the Treasury Department issued new inversion regulations.[2] Although Tax MAC provisions are not particularly common, they can be crucial in a business deal if a change in tax law would change a party's interest in consummating the deal, particularly at the specified price and on the articulated terms. Tax MAC provisions enable contracting parties to specify which of them bears which consequences that might arise from a possible tax law change. Thus, parties can use Tax MAC provisions in contracts to allocate the risk of tax transition among themselves.[3] These provisions could be useful in any situation where a party's economic decision is a function of tax law. As a result, these provisions are likely to be increasingly important when parties are making decisions in today's political climate, when tax laws could change again soon, perhaps dramatically.

To better understand how these provisions are used in practice, I studied Tax MAC provisions included in publicly filed M&A agreements from 2014 to 2019, focusing on provisions that could trigger termination rights if an adverse tax law change occurs. This Chapter details the study's findings and discusses their implications. More generally, this Chapter provides insights into both strategies for empowering taxpayers to proceed with

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[1] Excerpted and adapted from Heather M. Field, *Tax MACs: A Study of M&A Termination Rights Triggered by Material Adverse Changes in Tax Law*, 73 TAX LAW. 823 (Summer 2020).

[2] Press Release, Pfizer Announces Termination of Proposed Combination with Allergan (Apr. 6, 2016).

[3] *See generally* Heather M. Field, *Allocating Tax Transition Risk*, 73 TAX L. REV. 157 (2020).

desirable transactions that might otherwise be stymied by uncertainty about possible future tax reforms and deal-making practices when tax laws may change.

Background on MAC Clauses

The overwhelming majority of M&A agreements with delayed closings include a "material adverse change" (MAC) provision. These provisions, which I call "regular" MAC provisions (as opposed to "Tax" MAC provisions), can confer a termination right on one or more parties if a material adverse change occurs after signing but before closing. Although the exact details of regular MAC provisions vary because the clauses tend to be heavily negotiated, they generally exclude adverse consequences that arise from tax law changes. Thus, if a party wants to be able to exit the transaction upon an adverse tax law change, they may seek to include a *tax-specific* MAC clause in the agreement in addition to the regular MAC clause.

Study Methodology

To find publicly filed M&A agreements with Tax MAC provisions, I used Bloomberg to search EDGAR for acquisition, reorganization, and other plans filed within a recent five-year period. After eliminating duplicate results and false positives, I identified 13 unique agreements that clearly provided a unilateral termination right upon the occurrence of a Tax MAC. Because these provisions do not employ standardized language, the search may have missed some. Nevertheless, the agreements identified should provide a sample that is comprehensive enough to determine how these provisions are (and could be) drafted, the variables on which they differ, and the range of approaches taken on each variable.

Analysis of Results

The agreements with Tax MAC termination provisions vary considerably. The transactions involved companies in a wide range of industries, including pharmaceuticals, software, gas/energy, and leisure/entertainment. Some transactions were mergers of equals, but others involved a significant disparity between the sizes of the companies. The agreements were signed throughout the five-year search period. Three deals failed to close, but the Tax MAC provision was the reason for termination in only one of those deals (Pfizer/Allergan). Nineteen different law firms (almost all Am Law 100 firms) advised on these deals, with two firms (Kirkland & Ellis LLP and Cleary Gottlieb Steen & Hamilton LLP) advising on three different deals each and four other firms advising on two deals each.

Although there are some language similarities among a few of the Tax MAC provisions, the details of these provisions vary significantly, as explained further below.

What Tax Concerns Led Parties to Include Tax MAC Provisions in Their Agreements?

The Tax MAC provisions indicated concerns about many different possible tax law changes, including changes to the tax treatment of reorganizations, inversions, qualified dividends, partnerships, renewable-electricity production, and more. Some deals included Tax MAC provisions on multiple issues. In addition, the Tax MAC clauses in most deals identified the specific tax issue of concern, but the Tax MAC provision in one deal was more general, indicating a concern about *any* change in tax law that would have a material adverse effect.

What Counts as a "Change in Tax Law"?

The agreements reflected surprising variability about what constituted a "change in tax law" for purposes of triggering the Tax MAC provisions. The parties' choices about which types of changes should be treated as "changes in tax law" presumably reflected their assessments about the ways in which the tax laws that concerned them were most likely to change and their preferences about how complete the change should be before triggering termination rights. All agreements provided that changes to the Internal Revenue Code or the Treasury Regulations could trigger the Tax MAC provision. The agreements varied, however, about whether unenacted bills, other proposed changes to the Code or regulations, enacted changes not yet effective, changes to different types of sub-regulatory guidance, or judicial decisions could constitute changes that trigger the Tax MAC provision.

Two agreements explicitly included judicial decisions in the types of changes that could trigger the Tax MAC provision. Both agreements included in the definition of "Change in Tax Law" decisions by federal courts that change the interpretation of the tax law. One specified particular federal courts. The other did not specify particular courts but did limit judicial triggers by the substantive topic of the decision. The remainder of the agreements were not explicit but still arguably included judicial decisions in the types of changes that could trigger a Tax MAC provision because the Tax MAC provisions were typically drafted using a defined term ("Law" or something similar), whose definition included such things as orders, rulings, common law, and judicial interpretations. In most agreements, nothing would undermine the conclusion that judicial decisions could be triggering changes. In one agreement, however, the high degree of specificity with which the agreement articulated the types of changes in tax law that could trigger the Tax MAC provision (and which did not include any reference to courts or case law) suggested that the parties might have intended to exclude judicial decisions despite the fact that the "Tax Law Change" provision used the defined term "Law," which did include judgments and orders. This potential ambiguity suggests that parties may want to be explicit about whether judicial decisions could trigger Tax MAC provisions, particularly if a party is concerned about an imminent judicial decision with potentially adverse tax implications.

How is the Tax MAC Provision Triggered?

The conditions under which the Tax MAC provision's termination rights would be triggered varied in three ways. First, subtle differences in how the agreements phrased the trigger led to different meanings. Because of the opportunity for these subtle phrasing differences, parties should carefully and clearly draft language that captures the precise situations when they want the termination right to be triggered. Second, the agreements varied about the requisite level of confidence that the particular adverse tax result had occurred. Many used confidence-level language commonly used in tax opinions (e.g., "will," "should," "more likely than not") to designate the requisite level of confidence, but other agreements used more ambiguous language. Third, some agreements specified procedures for determining whether the Tax MAC provision trigger had occurred. However, other agreements did not; efforts to exercise rights under these Tax MAC provisions could be contentious, especially if the phrasing of the trigger is convoluted or the level of confidence required by the trigger is ambiguous. In these situations, disagreements over whether a Tax MAC provision applies are more likely to devolve into expensive litigation.[4]

What Consequences Arise If a Change in Tax Law Causes a Tax MAC?

My study focused on Tax MAC provisions that allowed one or more parties to terminate the deal unilaterally if a material adverse tax change occurred before closing. The study also identified several agreements in which a Tax MAC triggered other consequences, including obligations to exert various levels of effort to restructure the deal to avoid the adverse tax consequences and an obligation to make gross-up or indemnification payments. Tax MAC provisions can also trigger a wide variety of other rights and obligations, including obligations to increase the amount of consideration. The variety of possible consequences triggered by the occurrence of an adverse tax law change allows for extrapolation from this Chapter's discussion of Tax MAC provisions to any additional provision that is intended to alter the terms of a contract if tax laws change.

How Does the Tax MAC Provision Overlap with a General Tax Opinion Requirement?

My study also sought to determine whether, how, and why an agreement might contain both a Tax MAC termination provision and a general tax-opinion requirement (i.e., requiring an opinion that addresses the tax consequences in general, and not solely as a

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[4] *Cf.* Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2012 (2009) (explaining that "MAC clauses have given rise to more litigation than any other provision of merger agreements").

result of *changes* in tax law). A party's inability to obtain a general opinion about the desired tax treatment can prevent closing and lead to termination. Thus, a general tax opinion required as a condition to closing implicitly provides a Tax MAC termination right on the topic of the opinion. Nevertheless, some deals with Tax MAC termination provisions also included general tax-opinion provisions. Deals involving both types of provisions usually distinguished the functions of the two provisions (e.g., they involved different tax issues, conferred rights on different parties, or spoke as of different points in time). Whether to opt for one, the other, or both likely depended on counsel's willingness to render opinions and on the risk-allocation decisions made by the parties (e.g., whether they want to be able to exit the deal if the desired tax treatment is thwarted for *any* reason, or whether they are comfortable being able to exit the deal only if the desired tax treatment is thwarted because of a change in law).

How Is the Tax MAC Provision Discussed in the Publicly Filed Disclosure Documents?

The deals' publicly filed disclosure documents (8-Ks and some proxy statements) varied considerably as to whether and how they discussed the Tax MAC provision and the related tax issues. The documents ranged from proxy statements that discussed the Tax MAC termination provision extensively and repeatedly to 8-Ks that did not mention the provision at all. The different approaches to discussing the Tax MAC termination provisions in the public filings likely reflected the parties' differing assessments about the likelihood of the possible tax changes and about how material the possible tax changes might have been to an investor's decision whether to vote for the transaction (where votes were solicited) or whether to buy, sell, or hold the stock of the disclosing corporation.

Conclusion

Uncertainty about future tax law changes can stymie desirable business transactions. The parties to the transaction can help manage that uncertainty by specifying in the contract how their rights and obligations will change if tax law changes ultimately occur. Tax MAC provisions in M&A agreements provide examples of this type of contracting. Because these provisions are carefully tailored to the specific circumstances in which they are used, they illustrate a wide range of possible approaches on key deal points. My study of the details of Tax MAC provisions offers guidance about the design, drafting, and deployment of tax-transition, risk-shifting provisions in M&A agreements and elsewhere. More generally, the study provides insights into strategies and practices for managing deal risk posed by the possibility of future tax law changes.