Analysis

Insuring M&A tax risk

Speed read

One of the most striking recent trends in private M&A is the increasing use of warranty and indemnity (W&I) insurance. Many of the terms of an insurance policy are negotiable and this article outlines some of the provisions that advisers may wish to focus on. Although useful, insurance raises a number of practical and technical issues and may weaken the overall level of protection obtained by the buyer. The role of the tax covenant needs to be re-evaluated, and it becomes more important to ensure that identified issues are factored into the purchase price.

David Wilson
Davis Polk
David Wilson is counsel at Davis Polk. He advises corporate and investment banking clients on a broad range of UK and cross-border tax matters. Email: david.wilson@davispolk.com; tel: 020 7418 1024.

Tax insurance for M&A deals has been around for a while, but is now becoming broader in scope, and much more common.

For over a decade, insurance has been used to deal with specific tax issues identified on transactions. Risks covered in this way include uncertainty around the substantial shareholdings exemption, debt for equity exchanges and trading or residence status.

A more recent development is for general tax risk (not just specific identified matters, but rather general exposure under tax warranties and the tax covenant) to be covered by a warranty and indemnity (W&I) insurance policy. Although W&I policies have been seen for many years, until lately coverage was usually limited to non-tax matters.

Another development has been the growth in the capacity of the insurance market. Previously, W&I insurance seemed to be used mainly on small or mid-size private equity deals, but the market is now large enough to provide cover appropriate for transactions with a value of up to £2bn. Premiums have fallen too: a W&I policy now tends to cost between 0.75% and 1.5% of the sum insured (compared with between 3% and 6% for a typical specific issue policy).

This article outlines the structure of W&I insurance and examines the key terms of the policy – in particular, the all-important exclusions. Many of the provisions should be open for negotiation (although there will be areas where insurers will be unwilling or unable to move, for example due to re-insurance constraints). With this in mind, this article seeks to assist practitioners in reviewing a policy, as well as offering some broader thoughts on how W&I insurance impacts on the position under the tax covenant.

The structure of W&I insurance

Most W&I insurance today is through ‘buy side’ policies, and these are the focus of this article. An share purchase agreement (SPA) backed by ‘buy side’ insurance will normally contain a fairly typical set of warranties and tax covenant – but, crucially, will provide for the seller's liability to be subject to a low cap, which may be as little as £1 (although this cap is likely not to apply in circumstances such as fraud by the seller). At the same time, the buyer enters into an insurance policy (although the cost may be borne by the seller). In broad terms, the policy provides for the insurer to pay to the buyer an amount equal to that which the buyer could have claimed from the seller under the warranties and tax covenant, absent the liability cap under the SPA.

Sometimes, it may be the management of the target (rather than the seller), that provides warranties and a tax covenant, through a ‘management warranty deed’. This, again, will be subject to a low liability cap, and the insurance policy will operate by reference to the amount the buyer could have claimed from management, absent the cap.

Another variation is for the target companies to be parties to the policy.

Under a ‘sell side’ policy, the seller's liability under the SPA is not capped in this way. The seller remains fully liable under the terms of the SPA, but obtains insurance to cover its liability. The seller however remains exposed to the extent that exclusions in the insurance policy are wider than those under the SPA.

The choice of structure may impact on matters such as the jurisdiction in which any insurance premium tax is payable, and the tax treatment of payouts under the policy (see panel opposite).

An overview of key terms

The main operative provision is the ‘insuring clause’, which provides for the insurer to indemnify the insured for an amount as described above.

This is typically subject to an excess, often referred to as the ‘attachment point’. The interaction with the de minimis provisions in the SPA needs to be reviewed carefully. Insurers would ideally like to see a reasonable excess (since this keeps parties' interests aligned) but, in a competitive market, excesses are falling and ‘nil attachment point’ policies are now frequently seen.

The policy will contain various general exclusions (discussed in more detail below). There may also be a series of transaction-specific exclusions, covering, for example, matters identified by the insurer on reviewing due diligence materials. The breadth of drafting here may be the subject of negotiation.

Some individual warranties and terms of the tax covenant are likely to be excluded from cover, and others may be deemed to be modified for the purposes of policy. These exclusions and modifications tend to duplicate the work of some of the general exclusions referred to below, and different underwriters tend to reach a different balance between the two approaches (with some relying more heavily on general exclusions, and others preferring deemed changes to the SPA). There is sometimes debate as to whether it would be simpler to make actual changes to the SPA. For the buyer, leaving the SPA unamended has the marginal benefit of giving more scope to recover from the seller in the event of fraud.

Insurers are generally happy with a six or seven year limitation period for tax claims. A one-off premium at the outset covers the duration of the policy.

General exclusions

Disclosure

A W&I policy will not cover matters that have been disclosed by the seller. This is non-negotiable, and results in a fundamental weakening of the protection under a tax covenant.

Given the importance of disclosure, it is worth focusing on what, precisely, it means for something to be 'disclosed'. This will depend on the definition used in the policy, which will often follow the wording in the SPA. *New Hearts Ltd v Cosmopolitan Investments Ltd* [1997] 2 BCLC 249 and *Infiniteland Ltd v Artisan Contracting Ltd* [2005] EWCA Civ 758 are instructive as to how these provisions may be interpreted, and results may be surprising where, for example, a tax issue is discussed in general terms, but the detailed consequences are not spelt out.

Where a matter has been disclosed, or is otherwise discovered by the buyer (so as to be excluded under a general W&I policy), it may be possible to obtain cover under a bolt-on specific issue policy, for an additional premium.

Buyer's knowledge

A W&I policy will not normally cover matters which the buyer knows about.

The wording of the 'knowledge' exclusion requires close attention. Does it cover constructive, as well as actual, knowledge? Whose knowledge counts? What triggers the exclusion: knowledge of an event, or knowledge also that such event could give rise to tax which may be covered by the policy? Consider also including wording to limit the harsh effects of the *uberrimae fides* rule: is it appropriate that (potentially inadvertent) non-disclosure of *any* matter by the insured to the insurer could make the *whole* policy voidable? (Although when the Insurance Act 2015 comes into force on 12 August, the position here will change somewhat.)

Coverage for matters which come to light between signing and completion may be a contentious issue.

The knowledge exclusion can lead to a divergence of interests. In particular, advisers need to appreciate that excessively cautious references in due diligence reports might weaken the position of the buyer under the W&I policy. Insurers understand the broader hazards in this area. To deal with this, and encourage detailed due diligence, they may, on the one hand, offer bolt-on specific issue insurance (not subject to the same knowledge exclusion) or potentially, in limited circumstances, agree to disregard certain knowledge. On the other hand, insurers are likely to require their own access to data rooms, and may retain their own advisers, in particular to confirm that the coverage of due diligence reports is appropriate.

Transfer pricing

A W&I policy will not cover transfer pricing (and specific issue insurance is unlikely to be available either). This exclusion may extend to the diverted profits tax (including the avoided PE side of this tax).

Secondary liabilities

Coverage may be excluded, although practice seems to vary.

Reliefs

A W&I policy will not underwrite the post-completion availability of reliefs. Check, though, that this exclusion does not overreach. It should not catch any clawing back of historically claimed reliefs which might be triggered by the transaction.

Avoidance schemes

An exclusion may be worded to cover schemes notifiable under DOTAS. If so, beware the breadth of the new 'financial products' hallmark. Whilst there is generally a good case for taking a realistic, purposive approach in interpreting these rules (see 'The new DOTAS financial products hallmark' (Stephen Pevsner) *Tax Journal*, 8 April 2016), the broad wording of the legislation could potentially

Points to consider

Insurance premium tax

- The premium for a W&I policy is likely to be subject to insurance premium tax (IPT). On a cross-border transaction, it needs to be determined where, and at what rate, IPT is payable.
- Liability to IPT is sometimes thought of as depending on where the policyholder is resident. This, however, is an over-simplification.
- Pending Brexit, the territorial scope of IPT is based on EU law. IPT is levied in accordance with article 401 of Council Directive 2006/112/EC. Council Directives 88/357/EEC and 92/49/EEC (which apply throughout the EEA, not just the EU) allocate taxing rights by identifying 'the member state where the risk is situated'.
- Where insurance does not relate to buildings or vehicles, these state that risk is located where 'the policyholder's establishment is situated'. The CJEU has, however, held that where risk relates to subsidiaries of a policyholder, the place of establishment of those subsidiaries is also relevant (*Kvaerner plc v Staatssecretaris van Financien* (Case C-191/99)). This is reflected in HMRC guidance.
- Liability to IPT may, strictly, need to be apportioned between jurisdictions. Furthermore, there may be a technical question around the implementation of directives into the UK IPT legislation, since SI 2001/2635 was largely repealed by SI 2009/3075.
- Any resulting uncertainty should not, however, normally cause difficulties for the policyholder. Liability for UK IPT falls solely on the insurer (provided the insurer is established in the EU), and the policy will normally state that a specified amount is payable by the policyholder in respect of IPT.
- Bear in mind that IPT rates vary significantly between jurisdictions. The UK's main 9.5% rate will rise to 10% from October. In the Netherlands, the rate is 21%, whereas in Luxembourg it is just 4%. Some jurisdictions do not levy any equivalent of IPT. On larger transactions, these differences may be relevant in determining the location of the acquisition vehicle, and whether the policy is written in favour of the buyer, the seller, or the target.

Tax on payouts

- The tax treatment of payouts under a W&I policy is not straightforward and may depend on whether payments are made to the buyer, seller or target.
- Not being made from seller to buyer, proceeds are unlikely to be treated as adjustments to consideration.
- Payments might be taxable as income, particularly if made to the target – either under general principles (for example, if compensation for lost profits), or pursuant to CTA 2009 ss 103 and 210 (which can deem insurance payouts to be trading or property income, even where not of a revenue nature).
- More likely, payments could be regarded as capital sums derived from an asset. But which asset: shares in the target (with high base cost) or a chose in action comprising rights under the W&I policy (with little base cost)? Can *Zim Properties Ltd v Proctor* [1985] STC 90 be distinguished? To what extent does TCGA 1992 s 23 help?
- Unhelpfully, HMRC has rejected the extension of ESC D33 to payments under a W&I policy.
- Some other tax systems have similar difficulties characterising insurance proceeds. On larger transactions, using an offshore acquisition vehicle might provide an alternative to paying for a gross-up in the W&I policy.

lead to a lack of insurance cover in unexpected situations.

High-risk jurisdictions

It may be difficult to obtain cover for tax in jurisdictions such as China or India, unless operations in these jurisdictions form just a small part of a group's overall business.

Fines and penalties

There will be an exclusion for criminal and civil fines and penalties. Clearly, this is highly significant to tax. This exclusion is frequently described as based on public policy, but it is useful to understand the distinction between what cannot be covered, as a matter of law, and what an insurer may be choosing not to cover. Case law derives from the maxim *ex turpi causa non oritur actio*, that a man cannot claim in respect of his own wrongdoing. One consequence of this background is that the extent of potential coverage may depend on whether a policy is written in favour of the target, the seller or the buyer.

Other terms

Conduct and notification

The policy will contain its own conduct and notification provisions (rather than following any in the SPA), allowing the insurer control over disputes with a tax authority. These provisions will differ somewhat from those typically seen in a tax covenant, although insurers should be willing to accept some familiar safeguards, such as a mechanism to prevent appeals which are unlikely to succeed.

Insurers do not normally seek control over pre-completion tax returns. Under the policy, buyers will, however, be subject to a general duty to mitigate loss – including, significantly, on matters covered by the tax covenant.

Subrogation rights

After a claim has been paid, subrogation rights give the insurer broad powers to step into the shoes of the insured in seeking recovery from third parties. Although arising automatically in equity, these rights can be limited through the terms of the policy. As a matter of principle, it is difficult to see why limitations which insurers may accept in relation to the conduct provisions of a policy should not apply also to subrogation rights.

Confidentiality

An obligation not to disclose the existence of the policy can potentially cause complications.

Gross-up

The tax treatment of insurance payments is not straightforward (see panel on previous page). The practical response is to ensure that payments are grossed up. Not all insurers offer a gross-up as standard; sometimes an additional premium is charged. This is something for clients to focus on when weighing up quotes from different underwriters.

Impact on tax covenant

There is a contradiction around whether insurance should have any impact on the terms of the tax covenant. Insurers expect a normal, fully negotiated tax covenant, and will ask to see an exchange of mark-ups between the buyer and seller. However, whilst the broad terms of the tax covenant will typically be unaffected, it is perhaps unrealistic to expect a seller whose liability is capped at £1 to fight on every point of detail.

Also, logic demands alterations to various parts of the tax covenant.

Control over tax returns is one such area. With little or no financial exposure, it would seem inappropriate for the seller to be given control or input rights – except, perhaps, to the extent that seller and target entities are covered by a consolidated tax return, or post-completion filings could adversely affect seller retained group entities.

An 'overprovisions' clause may also be inappropriate. If the seller is not bearing risk, there is a strong argument that it should not benefit from any pass back of unexpected benefits. A related question is whether 'windfall' benefits (that is, pre-transaction reliefs not valued in the relevant accounts) should be available for the benefit of the insurer to soak up liability under the tax covenant. The author's experience is that insurers may be willing to accept that this is not the case – putting the buyer in a better position, on this point, than might be the case under a typical tax covenant.

Summing up

W&I insurance is a useful tool, particularly where a seller (such as a fund) requires a clean exit, or if the solvency of the seller is in question (although the financial strength of the insurer should be considered – remember monoline insurance?). W&I policies are, however, also used in more traditional private M&A situations.

In certain respects, covering tax risk through insurance may offer advantages for the buyer. As noted above, the buyer may benefit from greater control over tax returns, and obtain a better position on overprovisions and windfall reliefs. The process of negotiating the SPA might be easier, and it is possible that any subsequent claims may be handled more smoothly and dispassionately.

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However, in many ways, insurance substantially weakens the level of protection. Disclosure against the tax covenant, a duty to mitigate, and exclusions for known matters and a broad range of other issues each represent a radical departure from the high standard of tax protection that buyers have come to expect under a traditional English law SPA. The role of the tax covenant changes, and it becomes more important to ensure that identified issues are factored into the purchase price.

It is essential that the impact of these changes is properly understood – but important, also, that the practical commercial significance is not overstated. Stepping back, the overall effect of exclusions for disclosed and known matters is not dissimilar to that under an 'anti-sandbagging' provision, common in the US, under which a buyer warrants that it is not aware of any potential claim. This was brought home by the response the author received on explaining the impact of insurance to a client with limited experience of English law M&A: 'so you're telling me that it's normal to let the buyer sue the seller for things that the seller has disclosed to the buyer?'

If nothing else, W&I insurance may be preferable to another current trend in M&A, of limiting recovery for tax to a small escrow fund, held for a short period. ■