Tax indemnities: lessons from recent litigation

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For the principals negotiating private M&A transactions, the key considerations around the allocation of tax risk between the parties can often be restricted to known 'big ticket' items and picking a point in time at which tax risk in the target company or companies more generally transfers from seller to buyer. Even when operating in the private equity marketplace (where the recent trend has been to utilise so-called 'synthetic' tax covenants negotiated directly between the buyer and an insurance provider, or to execute a short-form tax indemnity between the buyer and seller on which a buy-side insurance policy is then super-imposed) a series of recent cases has shown that proper advice on the drafting and implementation of clauses dealing with the practicalities of tax claims, including time limits, notification requirements, and conduct, is key if the eventual cash outcome is to match the commercial expectation.

In applying the practical lessons from these cases, we have assumed (as is common) that a seller provides a buyer with a tax indemnity in respect of the tax liabilities of a target company or companies; and that the underlying tax liability is one which is capable of being claimed for under the terms of that indemnity.

Time limits on bringing claims

Whatever the merits of a claim under a tax indemnity, it is important that the claim is brought within the appropriate time limits.

In *Takeda Pharmaceutical Company Ltd v Fougera Sweden Holding* 2 AB [2017] EWHC 1995 (Ch), the issue of whether a share purchase agreement (SPA) contained implied terms that the seller provide the purchaser with information necessary to determine the quantum of a tax liability was brought into focus by the time limit for bringing tax claims. Claims could only be made in respect of liabilities which had been 'finally determined' before the sixth anniversary of the share purchase.

Although a time limit such as that in *Takeda* has the benefit of establishing a finite end to a seller's liability, it can have a significant impact on the buyer's level of protection. In particular, sellers may be able to escape liability for long running tax disputes, or enquiries raised shortly before the time limit for bringing claims, simply because a final quantum has not been established before that time limit.

Buyers should therefore consider including drafting allowing claims to be made for tax liabilities which are contingent or otherwise not capable of being quantified; and for the seller to continue to be liable for such claims until the contingent liabilities become actual liabilities or the liabilities are capable of being quantified.

Notification of claims

As well as bringing its claim within the required time frame for doing so, a buyer must make sure that it complies with its notification obligations in respect of that claim.

Conditions precedent

Where a buyer has not complied with an obligation to give notice in a particular manner, and that obligation is drafted as a condition precedent, the entire claim will be defeated. In *Zayo Group International Ltd v Ainger* [2017] EWHC 2542, part of the reason a contractual claim failed against all of the defendants was because the claimant did not comply with the terms of a notice clause drafted as a condition precedent – it served notice on only six of the seven defendants.

By contrast, in *Heritage Oil and Gas Ltd & Anor v Tullow Uganda Ltd* [2014] EWCA Civ 1048, the Court of Appeal held that the obligation of a party to give notice of a tax claim was not a condition

precedent to its ability to claim under the tax indemnity.

In practice, each case will turn on the drafting of the relevant notification clause. Although the words 'condition precedent' do not have to be used in order to make a notification provision a condition precedent to claiming under the tax indemnity, the drafting must make such an effect the clear intention of the parties. Sellers may want to press for this in the M&A negotiations but both sides will need to be clear on what is agreed to avoid any nasty surprises down the line.

Example: condition precedent

A notification clause drafted as a condition precedent:

> 'No claim under [the tax indemnity] can be brought unless the purchaser has given notice of that claim to the seller in accordance with clause [X]…'

A notification clause not drafted as a condition precedent:

> 'The purchaser shall give notice to the seller of any claim as soon as reasonably practicable.'

Notices of claim

A buyer must also ensure that its notice of claim to the seller contains all of the information required under the terms of the indemnity. In the recent case of *Teoco UK Ltd v Aircom Jersey 4 Ltd* [2018] STC 518, an indemnified party's claim under a tax indemnity was prevented due to it failing to properly set out the grounds for its claim when giving notice.

Although each notification clause must be examined on a case by case basis, most will require the giving of some details of the grounds for the claim. Practically, that does not mean that the buyer is restricted to claiming under one particular warranty or indemnity if several are in play, but it should specify which warranties and/or indemnities it has a claim under. Preferably, this would be achieved by referring to the applicable clause/paragraph numbers (although, exceptionally, this could perhaps be achieved by setting out the facts behind the claims in such a way that the specific warranties and/or indemnities under which claims are being made is unequivocally indicated), rather than including a general reference to the tax warranties or indemnities.

Conduct

Once a tax claim has been brought by the buyer within the appropriate time limits and in compliance with applicable notice requirements, there remain challenges to resolving how much tax has to be paid and who ultimately foots the bill. These challenges are largely driven by the multiparty nature of any dispute. Commonly, there will be the target company/companies (the taxpayer), the relevant tax authorities, and then the buying and selling parties. Even in the rare circumstances that there is no dispute as to which of the buyer and seller is ultimately picking up the tax liability, the ongoing conduct of any dispute in relation to the underlying tax liability itself provides a new minefield of potential issues around who deals with the tax authority, whether and how all the parties involved have access to relevant information and the question of legal privilege.

Dealing with the tax authority

Notwithstanding that the taxpayer will be owned and controlled by the buyer, it is usual for proceedings in respect of an underlying tax liability for which a claim has been brought, including any correspondence with the applicable tax authority, to be handled at the direction of the seller. The buyer's protection for giving up conduct is commonly limited to a right to comment on any correspondence or documents sent to the tax authority, and a restriction on the circumstances in which the seller may direct that an appeal be made to the courts.

While there is a certain logic to allowing the party ultimately footing the bill to conduct proceedings,

it may surprise principals that so little protection is generally given to the buyer's broader interests; in particular, the relationship of the target(s) and/or buyer with the tax authority, or their public image. For example, a seller would usually be free to direct that a target company defend an aggressive tax avoidance scheme, through the courts, potentially to the detriment of the target company's reputation.

A buyer can take some small comfort in knowing that, where the costs (financial or otherwise) of complying with the seller's directions appear to be greater than the value of the tax liability being claimed for, it can refuse to comply, giving up on its claim but hopefully also preventing the wider costs from being incurred. However, a strong buyer may seek to include an ability, in the contractual terms of the indemnity itself, not to follow directions of the seller which would materially harm the buyer's broader interests.

Further assurances

At the time of signing an SPA, the parties cannot be aware of all of the circumstances in which a tax liability might arise in a target company or the tax compliance issues which a target company might face. The solution to this is generally to include a 'further assurances' clause, requiring that the parties take such actions as are required to give effect to some or all of the terms of the SPA.

Given the pace at which many M&A transactions progress, it can be tempting to rely on such clauses to fix deficiencies in the drafting of detailed conduct clauses or address unknown unknowns more generally. However, a further assurances clause is no substitute for a clear and focused provision. In *Takeda*, the court rejected the buyer's attempt to rely on a further assurances clause to require the seller to hand over certain information which would have enabled a target company to settle a dispute with the Danish tax authorities by a specific date. Likewise, *Astor Management AG and another v Atalaya Mining plc and others* [2017] EWHC 425 (Comm) shows the benefit of having specific information obligations.

A buyer should therefore consider including express drafting to ensure that the seller provides it with any assistance and information required to resolve relevant tax disputes as soon as reasonably practicable.

Legal privilege

Documents that are covered by legal privilege do not need to be shared with tax authorities or the other side in litigation, so buyer, seller and underlying taxpayer will all have an interest in knowing when they can claim legal privilege (and against whom). Particularly with litigation privilege, recent litigation (and commentary) provide a reminder of the care needed in practice to mitigate the risk that potentially unhelpful material has to be disclosed to a tax authority or the other side in a tax indemnity claim.

Litigation privilege

The two key issues that arise most commonly in establishing whether litigation privilege applies at all in a tax dispute are whether litigation is reasonably contemplated; and, if so, whether the documents in question were made for the dominant purpose of that litigation (see Lord Carswell in the House of Lords' decision in *Three Rivers District Council v Bank of England (No. 6)* [2005] 1 AC 610).

Whether proceedings are reasonably contemplated is usually fairly clear cut once an appeal has been made to the FTT or even a final closure notice received. However, the extent to which litigation privilege applies in the context of investigations (and so earlier stages of a tax enquiry), has been re-examined following the decision last year in *Director of the Serious Fraud Office v Eurasian Natural Resources Corp Ltd* [2017] EWHC 1017 QB. There, the fact that ENRC was not sure it would be prosecuted meant a Serious Fraud Office (SFO) investigation was not sufficiently 'adversarial' to mean litigation was reasonably in contemplation. A similarly tough line was taken by the Court of Appeal in *R v P Jukes* [2018] EWCA Crim 176, where a claim to litigation privilege failed on the basis that there was no evidence that prosecution (or

formal proceedings) was contemplated during the earlier phases of a health and safety inquiry.

This line of cases is not free from criticism, not least given the limited protection it gives organisations under SFO or other criminal investigation that have (perhaps understandably) not yet concluded that they are likely to be prosecuted, but it may well be raised by tax authorities seeking broader disclosure.

Obiter comments in *R (on the application of Glencore Energy UK Ltd) v HMRC* [2017] EWCA Civ 1716 might suggest that, similarly, litigation privilege won't be available in a tax investigation until it's clear there's no alternative but formal litigation. See, specifically, Sales LJ's point (at para 67) that the issue of diverted profit tax notices was not the final stage in the dispute, given Glencore could eventually appeal to the FTT. However, that case could be distinguished as being about the availability of judicial review not litigation privilege.

Much more helpful for taxpayers is the recent decision of *Bilta (UK) Ltd (in liquidation) and others v Royal Bank of Scotland plc and another company* [2017] EWHC 3535 (Ch). There, RBS successfully claimed litigation privilege in relation to certain interview notes that had been made as part of a broader investigation commenced by RBS following receipt of a letter from HMRC denying certain input VAT reclaims by RBS. The interviews and related notes were held to be covered by litigation privilege as a matter of fact, notwithstanding that no formal proceedings had yet begun before the FTT. The key lesson from *RBS* (and the broader line of cases) is the need to be certain about the point in time at which proceedings are first reasonably contemplated – and then have the evidence to support that position.

In a tax indemnity claim scenario, that moment in time might be different in terms of proceedings as between buyer and seller (e.g. when it's apparent there is going to be a contested claim under the tax indemnity) and as between taxpayer and tax authority (the analysis and evidence for which may be complicated by the seller having conduct of discussions with the tax authority).

The multiparty nature of tax indemnity claims makes establishing the second key limb of litigation privilege – that documents were created for the dominant purpose of the proceedings – more challenging too. For instance, documents created by the buyer or seller during the M&A process are not going to be covered by litigation privilege (though it is worth considering legal advice privilege, below). Likewise, documents prepared by the seller to help resolve the underlying tax authority enquiry may not be for the purposes of formal proceedings (even if relevant to eventual proceedings against the buyer). Each party therefore needs to take care when creating and circulating documents, to mitigate the risk that they are later used against them.

Even if documents are covered by litigation privilege, which of the parties can rely on that privilege? That was a key issue in the recent case of *Minera Las Bambas SA and another v Glencore Queensland Ltd and others* [2018] EWHC 286. One of the reasons that Moulder J refused a claim to litigation privilege by the sellers against the buyers was that the documents in question had been created for the purpose of the underlying tax dispute (about Peruvian VAT) and so if anyone was entitled to claim privilege it was the taxpayer company (now owned by the buyer) not the seller. This is a difficult decision in principle, as it potentially limits the ability of a seller exercising conduct rights to the underlying tax dispute, which has precisely the same interest as any named litigant in protecting the confidentiality of communications concerned with the preparation of its case, to assert litigation privilege in its own right, including as against the buyer in any subsequent dispute about the scope of a tax indemnity. This is a particular issue in tax disputes where accountants rather than lawyers may be retained as tax advisors, such that legal advice privilege is not available (per *R (on the application of Prudential plc and another) v Special Commissioner of Income Tax and another* [2013] UKSC 1).

With respect to the judge in *Las Bambas*, an alternative analysis (and one much easier to navigate in practice) would be to accept that the seller in these circumstances is entitled to litigation privilege in its own right but, importantly, qualify the extent to which that privilege can be asserted as against other parties with whom the privileged documents may have been shared. For instance, if the documents have been shared confidentially between seller and target company with a limited waiver of privilege, then the seller could not assert privilege against the target company but could more generally. This alternative analysis was not addressed by the judge (and permission to appeal has been refused). Practically, therefore, parties to potential tax indemnity claims should be very careful about what is said in documents that may prove relevant to multiple sets of proceedings, ideally recording which documents are prepared for which purpose.

Legal advice privilege

It is worth remembering that legal advice privilege may apply even if litigation is not in contemplation. Care needs to be taken to ensure that the legal advice is properly addressed to the client (which, for corporates, means the relevant team seeking legal advice, not everyone at the corporate). Parties should consider whether they share any legal advice with the other side of the M&A transaction and act carefully to ensure that privileged material created at the time of transactions or matters in dispute is not lost as against the tax authorities.

Conclusion

Given the various pitfalls set out above, it is important that the parties to a private M&A transaction obtain proper legal input into both the drafting of clauses dealing with the practicalities of tax claims, and what is recorded and done in the event that a tax claim appears to be in prospect. Without such input, the eventual cash outcome of the tax indemnities negotiated is unlikely to match the commercial expectations of the principals.

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