

5th Circuit Decision Highlights Tax Loss Carryforwards' Effect on M&A Deals

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The Fifth Circuit in *Marathon EG Holding Limited v. CMS Enterprises Co.*, No. 09-20034 (5th Cir. Feb. 10, 2010), *aff'g*, No. H-07-2990 (S.D. Tex. July 30, 2008), denied a claim for indemnity by a buyer of target stock for taxes arising in target's post-closing tax year that were not sheltered by target's net operating loss (NOL) carryforwards arising in a pre-closing tax year because those NOL carryforwards were reduced after the closing as a result of an audit of target's pre-closing tax years.

In 2002, Marathon EG Holding Limited (buyer) bought from CMS Enterprises Co. (seller) the stock of three Cayman Island corporations (collectively, target) that conducted oil and gas operations in Equatorial Guinea. Seller represented that target had, as of December 31, 2000, approximately \$22 million of NOL carryforwards, valued at \$5.5 million. After the closing, Equatorial Guinea audited the pre-closing target tax returns, settling tax years 1997-2001 in exchange for the disallowance of \$11 million of NOL carryforwards. The settlement agreement recited that the reduced NOL carryforwards from 1997-2001 would result in a tax payment by target of \$2.7 million in respect of target's 2005 taxable income. Buyer made an indemnity claim that was rejected by seller. The dispute was whether seller had indemnified buyer against the tax imposed on target's 2005 income arising out of the disallowance of the NOL carryforwards from 1997-2001. The Fifth Circuit affirmed the district court's grant of the seller's summary judgment motion and held that the buyer was not entitled to an indemnity.

Under the sale contract, seller indemnified buyer for taxes "attributable to" pre-closing tax years. The appellate court found that "attributable to" identified the year in which the taxed income was earned, 2005, which was obviously not a pre-closing year. Buyer had argued for a "but for" reading that embraced first causes. Since the 1997-2001 years were settled in part through the payment of \$2.7 million, it reasoned, that amount was "attributable to" those years.

For its part, the buyer first argued that the course of negotiations supported its indemnity claim. The appellate court had an easy time rejecting that logic since seller had rejected buyer's draft contract language that would have required seller to indemnify buyer for a reduction in the NOL carryforwards and for a breach

of seller's representation as to the amount of the NOL carryforwards. Next, buyer argued that seller had orally promised a "full tax indemnity," which the appellate court also rejected because it couldn't figure out what that meant.

As for the meaning of "attributable to," the appellate court embraced the district court's reliance on the explanation of seller's tax expert that the term "attributable to" was a well-known term of art and meant the tax year in which taxable income is earned. Ironically, the district court had originally denied seller's motion for summary judgment based on standard dictionary definitions of "attributable."

M&A tax lawyers won't suffer from a reminder that hard fought and carefully drafted tax indemnity provisions are ultimately construed under standard state law rules of construction. More to the facts of this case, the value of target NOL carryforwards can be an important element in deal pricing, especially in the current economy. Negotiators and drafters should bear in mind that NOL carryforwards are highly susceptible to impairment and, should they become recognized as an asset whose loss is subject to indemnity, seller and buyer must carefully consider how and when a loss from reduction in NOL carryforwards occurs and the value of that indemnifiable loss.

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