# The Transactional Risk Insurance Report

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## *2009 Insurance Solutions for Distressed Sales*

Unfortunately, 2009 seems to promise an increase in bankruptcy filings and troubled companies. In such times, competitors, in particular, and equity funds, historically (but less so currently), keep an eye on troubled companies as an opportunity to acquire assets at discount. However, significant risks are associated with such acquisitions and tailored insurance products are often the ideal solution.

**Defining Troubled Companies**
Troubled companies include:

- Companies with business lines that are underperforming;
- Companies that have discontinued certain operations
- Companies that are negotiating with their lenders to amend or waive loan covenants
- Companies that are projecting reduced sales or earnings over the next fiscal period
- Companies that are insolvent or nearing insolvency

**Identifying the Risks**
Acquisitions of assets/divisions of troubled companies pose a number of risks to the buyer, including:

- ✓ The risk of successor liability as to any or all liabilities and debt obligations
- ✓ The risk that certain key assets (such as IP) has not been lawfully acquired
- ✓ The risk of fraudulent transfer claims unwinding the transaction (or increasing the purchase price)
- ✓ The risk of loss of key employees, suppliers or customers with limited or no recourse against the seller
- ✓ If the transaction is structured as a stock sale (perhaps in a restructuring designed to preserve the company's net operating losses and other tax attributes), the risk that the net operating losses will be limited or disallowed.
- ✓ Depending on the manner of sale (e.g., out-of-court sale, UCC Article 9 sale, debt acquisition, bankruptcy sale, assignment for the benefit of creditors, etc.), the risk that the sale will be challenged as either unfair or non-compliant with required procedures.

In addition, a number of tax risks may confront the seller and, depending on how the transaction is structured, the buyer. Most significantly, the parties may be concerned with the following tax issues: *(Please turn to page 2)*

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- ✓ Will there be taxable cancellation of debt (COD) income?
- ✓ Will prior interest deductions/net operating losses be challenged?
- ✓ Must tax attributes be reduced?
- ✓ Will Section 382 limitations apply?
- ✓ Can the state tax structure be repositioned?
- ✓ Are there legacy tax issues, perhaps noted in the company's financial statements pursuant to FIN 48?

**Buyer Beware: The Law Is Shifting**
The law appears to be shifting against insulating buyers. For example, successor liability has expanded for products liability by judicial findings of an implied assumption of liability or a de facto merger just because the buyer continues the operations and brand of the acquired assets. Some courts are not limiting this expansion to just product liability.

Buying assets "cleansed" by a bankruptcy proceeding will not necessarily provide a buyer with protection of "successor liability" claims. The courts have been divided over whether the "free and clear of all liens" language of 11 U.S.C. § 363(f) and/or whether a discharge of "claims" in a Chapter 11 plan applies to subsequent claims of successor liability.

In fact, a bankruptcy filing may create additional risk around technologies used by the business being purchased. A recent Ninth Circuit opinion has raised the issue of whether a bankruptcy filing in and of itself may cause the debtor to lose its rights under patents or copyrights that had been licensed to the debtor before the bankruptcy filing because such licenses can only be assigned by consent.

**Insurance Solutions**

The following chart summarizes the types of solutions that transactional risk producers may offer.

| **Particular Risk** | **Insurance Solution** | **Benefits** | **Features** |
|---|---|---|---|
| Successor Liability | Successor Liability Insurance Policy | Protects against claims made for up to six years following the acquisition | Includes fraudulent transfer theories of recovery as well as successor liability. |
| Assets Not Lawfully Acquired | Either a Buyer-Based Representations & Warranties ("R&W") Insurance Policy or a Key Asset Protection Policy | Protects against claims made challenging title to acquired assets and acquired rights. | Includes IP licenses and compliance with UCC-9 sales and/or other creditor rights proceedings. Key Asset Protection Policy also includes fraudulent transfer claims. |
| Material Adverse Change | Buyer Based R&W Insurance Policy | Protects against material adverse changes that are company specific. | Includes lender protection as a loss payee, for no extra charge. |
| COD Income, Reduction of Tax Attributes, Inability to Use Net Operating Losses, Repositioning of State Tax Structure | Tax Insurance Policy | Protects against a covered tax positions being challenged. | Includes coverage regarding ownership changes, loss corporation value, built- in gains and loss, consolidated return rules, bankruptcy exceptions, reduction by COD income, etc. |
| Legacy Tax Claims | R&W Insurance Policy, Tax Insurance Policy or FIN 48 Insurance Policy | Insures adequacy of tax representations, particular tax positions or provides a backstop to FIN 48 reserves, respectively. | Loss may include additional taxes, penalties, interest, certain defense costs and a "gross-up." |

**FIN 48 Insurance Assists CFO's**
FASB Interpretation No. 48 ("FIN 48") has dramatically changed how companies must account for uncertain tax positions under US-GAAP standards. Currently, FIN 48 applies to all public reporting companies. Beginning in 2010, FIN 48 will also apply to privately held companies. A new insurance product, FIN 48 Insurance, offers valuable protection to CFO's and their companies.

**FIN 48 Summarized**
FIN 48 lifts the veil on a company's uncertain tax positions. A company must disclose in its annual statements on their "unrecognized tax benefits" – i.e., how much would be owed to taxing authorities if they audited every tax issue, with full knowledge of all facts and law regarding each issue and without trading issues for settlement purposes. (The term "unrecognized tax benefits" is so named because it represents the portion of tax benefits taken by a company, in its filed tax returns or its decisions to not file a tax return in any jurisdiction, that will not be recognized for financial statement purposes.)

**The Implications**
For some companies, the amount of FIN 48 charges (frequently referred to as FIN 48 reserves) is staggering. Merck & Co. charged $7.4 billion as of January 1, 2007. The rules, however, require a significant degree of subjective judgment – particularly as to ultimate settlement amounts. Many companies appear to be taking the position that once a FIN 48 reserve has reached a certain level, tax positions supported by a "covered opinion" need not be reserved. (A "covered opinion" means a tax opinion that meets the qualifications of Treasury Circular 230.)

**The Risk Dilemmas**
FIN 48 confronts companies with at least two dilemmas:

1. Should the company post large FIN 48 reserves by using conservative judgments about settlement valuation, which may cause more aggressive tax audits and become self-fulfilling; or

2. Should the company post smaller reserves by using more aggressive judgments about settlement valuation, which may result in having understated FIN 48 reserves.

**FIN 48 Insurance**

FIN 48 Insurance can help solve these dilemmas.

**The Insuring Agreement.** Subject to its terms and conditions, FIN 48 Insurance promises to pay:

1.The amount by which the ultimate tax liability for covered tax positions exceed the amount reserved for such positions on a company's financial statements; and

2. The amount of ultimate tax liability for any covered tax position for which no FIN 48 reserve was established.

**Annual, Renewable & Flexible.**
FIN 48 Insurance is an annual, "renewable" and flexible policy. With respect to each succeeding annual financial statement, the company can elect to extend its limits of liability to cover additional tax positions while perhaps removing from coverage earlier tax positions that have closed (i.e., the statute of limitations period has expired or the tax year has been audited).

**Additional Features & Benefits.**
FIN 48 Insurance may allow a company to disclose in its financial statements that it has insurance backstopping its reserves in an amount and scope deemed adequate by the Company. FIN 48 Insurance may be an important factor in determining whether any change in reserves in the coming 12 months is material, requiring additional disclosure under Paragraph 21D of FIN 48.

***The Summary:***
***An Elevator Spiel to Bring it Home***

Here is a hypothetical, two minute "elevator spiel" between a producer and a CFO regarding FIN 48 Insurance.

Producer: "Mr. CFO would you benefit if an insurer were to backstop the charges taken by your company for uncertain tax positions?

CFO: What do you mean?

Producer: An insurance company will insure the adequacy of the charges/reserves taken under FIN 48 for specified uncertain tax positions and/or insure against any loss for those uncertain tax positions for which no charge/reserve was deemed necessary.

CFO: What's the cost?

Producer: The rate-on-line will vary on the insurer's assessment of the risk. A set of uncertain tax positions supported by strong should opinions may cost as little as 1.9% of the limits.

CFO: What's the benefit?

Producer: (1) Cash when needed. (2) The ability to disclose in your financial statements that your FIN 48 charges have been independently reviewed and insurance is in place to backstop their adequacy in scope and amount deemed appropriate by the Board. (3) Since FIN 48 does not apply to immaterial items, it is possible that uncertain tax positions covered by FIN 48 Insurance may be deemed immaterial for purposes of the "going forward" disclosures required under Paragraph 21D of FIN 48.

CFO: Let's set up a meeting.

**How The Stimulus Package May Stimulate Tax Insurance**

The stimulus package, known as the American Recovery and Reinvestment Act of 2009 – H.R. 1 (the "Act"), amends the Internal Revenue Code in a number of ways that could create new opportunities for tax insurance. The Act:

- Extends for "eligible small businesses" from two to five years the carry back period for net operating losses (which may cause net operating losses to be more keenly scrutinized);
- Limit the applicability of Treasury Notice 2008-83 (suspending restrictions on the offset of net operating losses and unrealized built-in losses against the taxable income of banks that acquire or merge with other entities) to periods prior to January 16, 2009.
- Allow an election to claim an investment tax credit for renewable facilities placed in service in 2009 or 2010 (which may create issues regarding when a facility is "placed in service").

**Extended Carry back Period: "Monetize Expected Refunds"**
An eligible small business (that has gross receipts not exceeding $15,000,000) that suffered net operating losses in a tax year that either ended or, at the election of the taxpayer, began in 2008 may elect to carry back such net operating losses against returns filed for periods up to 5 years prior. The election will be made pursuant to Regulations not yet promulgated as part of the return reporting the net operating losses. Presumably, amended returns for the prior year will then be filed showing the election had been made. For consolidated return filers, the election will be made by the common parent and will be binding on all members.

The carry back may entitle some companies to a significant refund, but may also subject both the return for the net operating losses and the amended past returns to additional scrutiny and the risks and delay of audit. For those companies seeking to engage in an extraordinary transaction while awaiting a tax refund from the carry back, or perhaps seeking a capital or debt infusion based, in part or in whole, on their net operating loss refunds, tax insurance may be an excellent solution.

**Banks Acquiring Loss Corporations: "Insure the Grandfather"**
This provision authorizes Internal Revenue Service Notice 2008-83, which essentially provided that the losses and deductions attributable to loans or bad debts of a bank will not be treated as built-in losses or deductions attributable to a pre-change period for purposes of the Section 382 limitation for losses following a change of ownership. The Act declares Notice 2008-83 effective with respect to any ownership change (as defined in section 382(g) of the Internal Revenue Code of 1986) occurring on or before January 16, 2009.

Grandfather clauses in tax provisions often create ambiguity, warranting tax insurance. In this instance, the Act's grandfather clause for Notice 2008-82 may create a number of ambiguities:

- When did an "ownership change" take place;
- Was a written binding contract entered into on or before January 16, 2009;
- Was a written agreement entered into and described in a public announcement before January 16, 2009.

Transactional Risk Insurance Producers with bank clients who have entered into acquisition or merger agreements (whether "binding" or just "publicly announced") as of January 16, 2009 may be interested in tax insurance.

**New Placed In Service Rules for Tax Credits Regarding Renewable Facilities: "Insuring Future Grandfathers"**
While not expected to be the next "Section 29", the Act allows an income tax credit for qualifying tangible personal or other tangible property (but not including a building or its structural components) that is an "integral part" of a "qualified facility" that is "placed in service" after December 31, 2008 but before 2012 (for wind facilities) or 2013 (for other renewable energy facilities). The investment credit is 30% of the cost of the qualified property, which includes certain fuel cell property, solar property, geothermal power production property, small wind energy property, combined heat and power system property and geothermal heat pump property.

Since the credit does not depend upon the actual production of electricity, a key issue may be when qualifying property was "placed in service." In related provisions and regulations of the IRC, the term "placed in service" has been defined to be a state of operational readiness, perhaps certified as such by an engineer, but not necessarily having begun ongoing operations for sale. If "operational readiness" becomes the litmus test for qualified investment credit facilities under the Act, tax insurance may be an appropriate means of protecting against a somewhat subjective standard.

We intend to timely alert our producer partners as new tax issues emerge.

## Recent Successful Placements

**Successor Liability Insurance for Asset Sale**

A trucking company was involved in an accident that horrifically killed two single mothers of young children and seriously injured a passenger. The company had minimal insurance limits under its fleet automobile policy and lacked any umbrella coverage. Its owners, devastated by the event, sought to put the company up for sale to raise money for the victims and their survivors. The prospective buyers, however, were concerned about the pending and threatened lawsuits. Because the purchase price was less than the potential aggregate jury awards against the company, the acquisition could be challenged as a fraudulent transfer. Also, despite structuring the transaction as an asset sale and excluding liability for the accident, recent case law had implied an assumption of liability merely because the seller agreed to indemnify the buyer for an excluded liability! A Successor Liability Insurance policy covered the risk of successor liability (whether on a traditional successor liability theory or fraudulent transfer theory) and facilitated the sale.

**Consolidated Taxpayer with COD Income & Corporate Restructurings Obtains Tax Insurance to Facilitate Sale of Subsidiary While Under IRS Audit!**

The following scenario is one that, in some respects, at least, may repeat itself many times in 2009.

The cancellation of debt is generally taxable income to the debtor. An exception exists, however, for insolvent companies to the extent of their insolvency. Insolvent companies don't need to include cancellation of debt income ("COD income") to the extent of their insolvency. However, insolvent companies that exclude COD income are required to reduce their tax attributes (such as net operating losses and basis in assets) as they exist at the end of the taxable period.

One more technical rule and then the story: If an insolvent company with COD income owns a subsidiary and both are members of a consolidated group for U.S. tax purposes, the (parent) company it is required to reduce its basis in the stock of its subsidiary and the subsidiary is required to reduce its tax attributes, such as the basis in its operating assets to the extent that the parent reduced its basis in the stock of the subsidiary (the so-called "look-through" rule). Now the common scenario: A company recapitalized its preferred shares and notes for common shares – resulting in COD income. Financial statements, supported by an appraisal, evidenced that the company was insolvent at the time of the recapitalization by an amount exceeding its COD income. The company owned a subsidiary and both filed consolidated returns. At the time of the recapitalization, the parent company had a positive basis in the stock of its subsidiary by $XXM and the subsidiary had a basis in its assets of $YYM.

Following the recapitalization, but prior to the end of the tax year, however, the company reorganized and refinanced for business (non-tax) reasons. It essentially created a new subsidiary that assumed the liability owed in connection with a new refinancing and merged its old subsidiary into the new subsidiary. The result was the holding company had a zero basis in the stock of its new subsidiary, which meant that the basis in the assets held by the new subsidiary did not have to be reduced by the cancellation of debt income.

The company was in the process of selling the new subsidiary. The company's U.S. tax return for the tax year in which the recapitalization and series of reorganizations and refinancing occurred was under IRS audit. Issues regarding IRC Sections 269 and 357(b) and a number of judicial doctrines that could recast the transactions were all evaluated and insured – allowing the sale to take place without price adjustment or escrow!

**R&W Insurance Assists a Privatization**

Not that long ago, private equity funds were "taking public companies private." There is a common snag in these types of transactions - the representations and warranties of the board and/or officers of the public company made in support of the transaction typically do not survive closing. (The rationale is that (a) money will be disbursed to public shareholders and in would be impractical to sue to recoup such funds (b) no officer or director wants to stand as a guarantor and (c) if the buyer is retaining top management, the buyer may have little interest in later suing them.)

Usually R&W Insurance is not available where the representations do not survive closing. There is an obvious "moral hazard" concern in insuring statements in which the speaker has "no skin in the game." Nonetheless, given the degree of confirmable due diligence and the existence of "walk away" rights for misrepresentations, coverage was placed for significant limits in this "privatization" deal. The private equity firm, already a "repeat" buyer of R&W Insurance plans more such deals in 2009.

Editorial: Letter from a "Hungry" Underwriter

Dear Reader:

Does it seem to you that our current economic woes are, in large part, the result of poor risk management, by otherwise astute executives? The common factors are:

- The failure to understand the potential severity of the risk.
- A lag time before any loss may be realized (making it seem remote).
- The upside of rewards based on short term results that may be short-lived (making the risk seem less significant).

For example, the purchase and trading of financial instruments (whether mortgage backed or otherwise) appears to have done with a dependence upon rating agencies and the "system" so that the potential severity of the risk was never appreciated. The impairment of such instruments seemed remote and uncertain while the short-term profits were immediate and substantial. These decisions now haunt those who made them.

The purchase or sale of a business, the taking of uncertain tax positions and the making of subjective accounting judgments all lend themselves to the same vulnerabilities. We are proud to be part of an industry that serves to mitigate and transfer such risks. There is no question that our niche industry provides a vital service.

The goals of all parties involved in transactional risk insurance are (1) gain a clear understanding of the risk, (2) accurately quantify the risk and (3) economically transfer the risk on terms that are acceptable to the insured and sustainable by the insurer.

Good insurance underwriters and experienced transactional risk insurance producers understand these concepts. Fairness, flexibility and frankness are the foundation of every successful transaction. Promptness and professionalism are the hallmarks of the quality players. Adequate, but not excessive, rates are the currency.

With these principles in mind, we truly look forward to working together with the experienced and knowledgeable producers with whom we are proud to have a relationship during these challenging times. There is no question in our mind that the producers, specialists and account executives involved in transactional risk insurance represent today's leaders of the insurance brokerage profession.

Sincerely,

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