IN THE SUPREME COURT OF THE STATE OF DELAWARE

TEXTRON INC., Plaintiff-Below/ Appellant, v. ACUMENT GLOBAL TECHNOLOGIES, INC., Defendant-Below/ Appellee.	No. 204, 2014 Appeal from the March 25, 2014 Decision After Trial Verdict For Defendant of the Superior Court of the State of Delaware in and for New Castle County in C.A. No. N10C-07-103 JRJ CCLD **REDACTED PUBLIC VERSION** **DATED: AUGUST 18, 2014**

APPELLANT'S REPLY BRIEF

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PRELIMINARY STATEMENT

Textron's[1] Opening Brief established that, in construing the PSA, the Superior Court ignored applicable federal tax law in the course of its analysis and that, had the Superior Court properly applied those tax principles, Textron would have prevailed below. Textron also established that the Superior Court's *sua sponte* construction of the term "reduction" was inconsistent with the parties' agreement and improper.

In response, Acument primarily argues that Textron's argument that the Court below ignored applicable tax law is in fact merely a challenge to the Superior Court's contract interpretation analysis. That is incorrect. The Superior Court's construction of the application of the central contractual clause, the Tax Benefit Reduction provision, necessarily turns upon Acument's right to a Tax Benefit. Had the Superior Court considered applicable tax law, it would have concluded that, at a minimum, the increase in Acument's tax basis resulting from an indemnified loss constitutes a Tax Benefit and therefore requires a reduction in Textron's indemnity payments under the PSA.

Acument's argument in the alternative that the Superior Court did in fact consider, analyze, and apply relevant federal tax law in reaching its determination is simply unsustainable. The Opinion contains no tax analysis whatsoever.

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[1] Defined terms in Textron's Opening Brief shall have the same meanings herein.

Acument also defends the Superior Court's *sua sponte* determination to construe the term "reduction" to mean the more narrow "deduction" on the grounds that the Court correctly regarded the terms as interchangeable. Yet the plain language of the Opinion does not permit such a conclusion. To the contrary, the Court expressly rejected the term "reduction"—the term used in the PSA—and opted to replace it with the term "deduction," even though there was no dispute on this point.

Finally, Acument's fallback argument that any error by the Superior Court was harmless is similarly without merit for two reasons: (a) the parties quantified the harm as approximately [redacted] as of March 31, 2013, *see* AR004-AR007 (Damages Stipulation); and (b) the Court's restrictive construction denies Textron the prospective relief to which it is entitled under the PSA.

For the reasons set forth in the Opening Brief and this Reply, this Court should reverse the decision below and find for Textron. In the alternative, this Court should reverse the decision and remand the matter with direction that the Superior Court properly consider and apply controlling tax law.

ARGUMENT

I. THE SUPERIOR COURT ERRED IN FAILING TO APPLY FEDERAL TAX LAW TO DETERMINE WHETHER ACUMENT IS ENTITLED TO A TAX SAVINGS TRIGGERING A "TAX BENEFIT REDUCTION" TO TEXTRON.

A. The Superior Court's Construction Explicitly Requires the Application of Tax Law.

The Superior Court found the Tax Benefit Reduction[2] provision to apply when tax law entitles Acument to a tax savings. Op. 48-49 ("[T]he Court concludes that the Tax Benefit Offset applies only if Acument is entitled to a 'deduction' upon the making of an indemnification payment."). Textron does not challenge the Superior Court's conclusion that Acument must receive a Tax Benefit in order to trigger a Tax Benefit Reduction. Rather, it challenges the Superior Court's conspicuous failure to look in furtherance of that analysis to applicable tax law to determine whether Acument is entitled to a Tax Benefit. Such an analysis requires the conclusion that Acument is entitled to a Tax Benefit under the applicable facts.

B. The Superior Court Did Not Address, Analyze, or Apply Tax Law.

Textron and Acument each presented a tax expert at trial to inform the Superior Court in the proper application of tax law in determining whether Acument received a Tax Benefit. They did so because the meaning of the

[2] The parties and the Court have used the terms "Tax Benefit Reduction" and "Tax Benefit Offset" interchangeably.

provision at issue turns importantly on the application of relevant tax law principles. Textron's expert for its part asserted that the applicable tax analysis is the "separate treatment tax analysis," which instructs that when a seller indemnifies a buyer for a contingent liability: (a) the buyer's tax basis increases upon the fixing of a contingent liability, creating immediate tax implications with respect to the Loss; and (b) the buyer's tax basis thereafter decreases upon the buyer's receipt of an indemnity payment for such Loss, creating separate and discrete tax implications that must be independently considered. *See* Section I.C.1, *infra*. Acument's tax expert, Robert Wellen ("Wellen"), could not deny the accuracy of this analysis, though he disputed its application to these facts. A227 (Trial Tr. Day IV 106:8-16 (Wellen)). Yet there is no reference to either of these approaches in the Superior Court's Opinion. The failure to consider this analysis constituted an error of law that this Court should review *de novo*. *See* Op. Br. at 19-20.

In its Answering Brief, Acument maintains that the assertion that the Superior Court eschewed all examination of the relevant tax considerations is wrong and that, in fact, the trial court: (i) considered the distinct tax arguments advanced by Textron and Acument; (ii) selected Textron's proffered tax analysis; (iii) applied the separate treatment tax analysis; and (iv) concluded that Acument was not eligible to receive a Tax Benefit under federal tax law. Yet Acument can

offer not one substantive reference to the Opinion to support any part of this wishful theory. The only supportable conclusion upon review of the Opinion as a whole is that the Court simply did not conduct *any* tax analysis of any kind. This is why the Opinion includes no reference to either party's expert report, or to any tax law, tax cases, or tax regulations. Despite the fact that the central question below was whether Acument was entitled to a Tax Benefit for purposes of the PSA, the Superior Court simply opted to forgo any examination of the relevant tax law central to the answer.

The Court's failure to apply tax law constituted plain legal error, and resulted in substantial economic harm to Textron. The Opinion below therefore should be reversed.

C. Tax Law Compels the Conclusion that Textron Is Entitled to the Tax Benefit Reduction Under the Separate Treatment Tax Analysis.

Acument is entitled to a reduction in its taxes upon the fixing of a pre-closing contingent liability. As explained by Textron's expert, Stephen Gertzman ("Gertzman"), basic and fundamental concepts of tax law demand this result. A193-A198 (Trial Tr. Day II 185:1-197:19, 203:2-205:15 (Gertzman's tax examples)); A173-A179; *Pacific Transport Co. v. Comm'r*, 483 F.2d 209, 214 (9th Cir. 1973) (finding that contingent liabilities should be added to the tax basis as a payment of the purchase price), *cert. denied*, 415 U.S. 948 (1974); *David R. Webb*

Co. v. Comm'r, 77 T.C. 1134, 1137 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 2004) (finding the payment of a contingent liability is a "capital expenditure which becomes part of the cost basis of the acquired property"); *Illinois Tool Works, Inc. v. Comm'r*, 355 F.3d 997, 1001 (7th Cir. 2004); *see also, e.g.*, Martin D. Ginsburg & Jack S. Levin, MERGERS, ACQUISITIONS, AND BUYOUTS, ¶¶ 304.2, 304.5 (2009); Op. Br. at 20-24.

1. Textron Demonstrated that Acument Is Entitled to a Reduction in Its Taxes When Tax Law Is Applied.

Gertzman established that when a seller (like Textron) indemnifies a buyer (like Acument) for a contingent liability, the appropriate tax analysis comprises two steps: (1) the buyer's tax basis increases as a consequence of the loss, and the resulting tax implications must be considered at this first step; and (2) a buyer will thereafter experience a decrease in its basis in the amount of the indemnification payment for that loss, at which point the resulting tax implications of that decrease in basis are independently considered. A199 (Trial Tr. Day II 212:17-23); A230 (Trial Tr. Day IV 117:6-118:3 (Acument's expert Wellen agreeing)). Gertzman further established that *any increase* to a taxpayer's (Acument) basis entitles it to tax savings in the form of deductions or other reductions that may be realized either immediately, over time, or in the future upon the sale of the assets.

Applying Gertzman's expert analysis here, Acument's tax basis increases, and Acument is entitled to tax savings (a "Tax Benefit"), whenever Acument

incurs an indemnifiable Loss. Tax law requires that the tax implications of this tax basis increase be evaluated separately and independently from any subsequent decrease due to indemnification or otherwise. The tax implications of a later tax basis decrease resulting from a subsequent indemnity payment are not ignored, as Acument states. Indeed, when Acument receives that indemnity payment, its basis decreases by the amount of that payment. Nonetheless, this subsequent decrease in basis does not and cannot negate the increase in basis and the resultant Tax Benefit it triggers. As Gertzman testified, federal tax law requires this result whether Textron pays the indemnity directly to the third party or Acument pays in the first instance and Textron reimburses Acument.[3] A199 (Trial Tr. Day II 210:4-12 (Gertzman)).

2. Acument Mischaracterizes Textron's Argument and the Testimony of Textron's Expert.

Acument's Answering Brief does not advocate for a different interpretation of the tax law, because it cannot. Instead, Acument selectively quotes Textron's expert in an attempt to re-litigate issues not presented for appeal here. Acument's

[3] Under the parties' 2007 Letter Agreement, whether Textron or Acument pays the third party for the liability depends upon the circumstances. The PSA requires Textron, as seller, to indemnify Acument for certain Losses but does not specify whether Textron or Acument should pay the liability and invoice the other for its share. The parties' payment practices were inconsistent prior to the signing of the Letter Agreement in October 2007, at which point the parties agreed that: (i) for any environmental loss payments, Textron would pay the liability directly and invoice Acument for the Tax Benefit; (ii) for non-environmental liabilities less than $100,000, Acument would pay the liability directly and invoice Textron less the offset for the hypothetical tax benefit; and (iii) for non-environmental liabilities greater than $100,000, Textron would pay the indemnity less the Tax Benefit to Acument and Acument would then pay the liability. AR001-AR003 (Letter Agreement).

selective quotes not only miss the mark but also mischaracterize both Textron's position and the applicable tax law.

Gertzman testified that, under the separate treatment tax analysis, a contingent liability that fixes *always creates an increase in tax basis which always gives rise to the right to deductions that will be realized either immediately or over time, or upon the sale of the assets.* A199 (Trial Tr. Day II 212:19-23) (Gertzman)). Despite this, Acument contends that "Textron has long agreed with [Acument's net-zero] analysis," quoting Gertzman's testimony in support of that proposition. Ans. Br. at 10. Textron does *not* agree with the "net-zero" analysis, nor has it ever so agreed; indeed, while Gertzman's opinion is well-supported by case law and tax authorities, there is no countervailing support for such an analysis other than Wellen's *ipse dixit.* As explained in Section I.C.4, below, Acument's critical assumption that the basis increase will always equal the basis decrease in an indemnity context is plainly incorrect.

In support of its claim that Gertzman in fact supports its "net-zero" analysis, Acument references only his agreement, when Acument presented Gertzman with *hypothetical* fact situations that did not involve a Tax Benefit Reduction provision, that a taxpayer who receives an increase in basis and *an equal decrease in basis in the same taxable year* will cancel the amounts when calculating liability *at the end of the year*. Ans. Br. at 22 (quoting only Gertzman's deposition testimony read at

trial by Acument, without including, recognizing or discussing Gertzman's full explanation). In fact, Gertzman consistently testified that the tax effects are determined on a case-by-case basis, and "you have to go to the separate steps." A202-A203 (Trial Tr. Day II at 224:9-226:15). Gertzman further testified specifically with respect to indemnity obligations that, like the PSA, do involve a Tax Benefit Reduction provision, testimony that Acument opts not to reference in its Answering Brief, despite its obvious relevance. Gertzman repeatedly confirmed that, when the taxpayer incurs a liability to a third party, that event gives rise to a tax consequence entitling the taxpayer to deductions.[4] A199 (Trial Tr. Day II 212:19-23(Gertzman)). Any *subsequent* tax basis decrease resulting from the indemnification of that liability is calculated separately.

3. The PSA Confirms that the Separate Treatment Tax Analysis Controls.

The PSA, even as construed by the Superior Court, further demonstrates the applicability of the separate treatment tax analysis. Read in light of the Opinion, the PSA entitles Textron to a Tax Benefit Reduction whenever a Loss accrues,

[4] Acument's reliance on the IRS Field Service Advice ("FSA") confirms the application of the separate treatment tax analysis. The FSA demonstrates that when a seller of assets indemnifies the purchaser from contingent liabilities, the purchaser treats the payment for tax purposes in a two-step process: first, the basis increases by the amount of the liability; second, the basis decreases by the amount of indemnification. Ans. Br. Ex. A at 10. Moreover, the FSA supports that when a contingent liability fixes and the purchaser's tax basis increases, the purchaser is entitled to tax savings. Ans. Br. Ex. A at 6 ("Taxpayer does benefit. General tax principles hold that the Purchaser . . . treats an assumed fixed liability as a cost of the acquired property and therefore includes such amount in its tax basis."). It is *only after* the basis has decreased (during the same year, and in the same amount as the earlier increase) that the taxpayer cannot take a deduction *at the end of the year*.

causing Acument's tax basis to increase, *before Textron makes the indemnity payment*. Under the PSA, Textron's indemnity payments "shall be reduced by . . . any Tax Benefit of the Indemnified Party . . . attributable to such Loss."[5] A123 (PSA § 6.1(d)(iii)(C)). Of utmost importance to this analysis, Acument's Tax Benefit must be calculated "*without regard to any other* losses, *deductions*, refunds, credits, *reductions*, or other *Tax items* available to such party," such as any decrease in basis that may occur in a separate step as a result of an indemnity payment, deduction, or other tax reduction. A142 (defining "Tax Benefit") (emphasis added).

Taken together, the Tax Benefit Reduction contemplated by the PSA occurs in two distinct steps, which mirror the separate treatment tax analysis. *First*, Acument incurs a Loss, which triggers a basis increase. The Tax Benefit attributable to that Loss is calculated. *Second*, Textron makes an indemnity payment in the amount of the Loss minus the Tax Benefit. The indemnity payment triggers a basis decrease.[6] The PSA requires that, *before* Textron makes an indemnity payment and *before* Acument's basis decreases due to Textron's indemnity payment, the parties must calculate the Tax Benefit and apply it to

[5] The PSA defines "Losses" as "any and all actual losses, liabilities, costs and expenses (including reasonable attorneys' fees and cost of investigation) of such Person." A137.

[6] This is distinct from an automatic partial indemnity. This reading of the PSA is compelled by the federal tax treatment of capitalized assets and contingent liabilities.

reduce Textron's payment. It is this procedural requirement that Acument's analysis ignores.

In practice, if an Acument contingent liability were fixed in the amount of $10, then Acument's basis would increase by $10. The mechanics of the PSA then would require the parties to calculate the Tax Benefit *before* Textron makes any indemnity payment. As illustrated by Gertzman, Acument's increased basis of $10 entitles Acument to tax deductions of $4 (assuming a hypothetical 40% tax rate), either immediately or in the future. Textron's indemnity payment, then, is reduced to $6.[7] A193-A198 (Trial Tr. Day II 185:1-197:19, 203:2-205:15) (Gertzman's tax examples)); *see also* B65-66 (Gertzman's tax illustration).

Applying the separate treatment tax analysis as described here, Acument would be entitled to tax deductions, because Acument's basis increases more than the subsequent decrease. A199 (Trial Tr. Day II 212:17-23) (Gertzman)); A230 (Trial Tr. Day IV 117:6-118:3 (Wellen)).

4. Acument's Argument Is Premised Entirely on the False Assumption that the Decrease in Basis Always Equals the Increase.

The "net-zero" argument rests on the flawed assumption that any decrease in basis will always equal the increase in basis. This assumption is wrong. The

[7] Textron is not attempting to relitigate the "automatic" or "partial" indemnity issues here, but, rather, is pointing out how the PSA would work had the trial court properly considered and applied the tax law.

increase in basis upon the fixing of the contingent liability will not always equal the decrease in basis upon the indemnity payment, and thus, the two payments will not always "net out." As shown in sections I.C.2 and I.C.3, *supra*, this assumption is erroneous both with respect to tax law and the language of the PSA.

II. THE SUPERIOR COURT PLAINLY DIFFERENTIATED BETWEEN "DEDUCTION" AND "REDUCTION," AND OPTED TO APPLY THE NARROWER "DEDUCTION."

The Superior Court found that "the Tax Benefit applies only if Acument is entitled to a '**de**duction' upon the making of an indemnification payment." Op. at 48-49 (emphasis added). In doing so, the Superior Court ignored the fact that both Textron and Acument *agreed* that a right to a **re**duction in Acument's taxes was the controlling concept—not the more narrow "deduction"—and, contrary to Acument's present assertion, expressly rejected the notion that the terms were interchangeable. Moreover, Acument's argument notwithstanding, the Superior Court's error in this regard results in real and quantifiable harm to Textron.

A. "Reduction" and "Deduction" Are Not Interchangeable Under the Superior Court's Construction.

The Opinion acknowledges that "the PSA does not 'use the term 'deduction,'' rather the PSA utilizes the *broader term*, 'reduction.'" Op. at 48 (emphasis added). The Superior Court further ignored the parties' unequivocal agreement that "reduction" (and not "deduction") is the controlling term, choosing instead to construe the Tax Benefit Reduction to apply only if "Acument is entitled to a 'deduction' upon the making of an indemnification payment." *Id.* at 48-49. Despite this, Acument maintains on this appeal that the Superior Court discerned no difference between the two terms and simply used them interchangeably.

Indeed, the best evidence that the Superior Court fully understood the difference between the two terms can be found in its (erroneous) refusal to recognize an increase in Acument's basis. The Court held: "[T]here is no express language within the PSA to support Textron's position that an increase in basis is what the PSA drafters intended to satisfy the Tax Benefit Offset." Op. at 49-50. The drafters, however, did include express language when they intentionally chose "reduction," a broader term that encompasses reductions in tax payments upon the sale of the assets, over the narrower term "deduction."

Nevertheless, the Superior Court adopted a construction that effectively removed "reduction" from the PSA, and inserted "deduction" instead: "The Court *intentionally* uses the term '*de*duction'...." Op. at 49 (emphasis added); *see also* Op. at 49 n.249 ("Despite Textron's argument that the PSA utilizes the *broader term* of 'reduction,' as will be discussed, the parties tacitly agreed reduction meant deduction.") (emphasis added). As explained in Textron's Opening Brief, this reading requires a re-drafting of the relevant section of the PSA that renders "reduction" meaningless and "deduction" superfluous. *See* Op. Br. at 30-32.

In an attempt to support its conclusion that the Superior Court's adoption of the term "deduction" was merely a judicial slip of the pen, Acument argues that the Court "provided examples of reductions that might suffice that are not produced by deductions, specifically a tax 'credit and/or refund.'" Ans. Br. at 8. At best, this is

a profound misconstruction of the Opinion. The portion of the Opinion on which Acument relies, footnote 248, does not provide examples of reductions; rather, the Court was referring to the language of the PSA and clarifying that it was not construing or attempting to rewrite the terms "credit" and "refund" that immediately precede "reduction" in the Tax Benefit definition of the PSA. A142 ("'Tax Benefit' shall mean the present value of any refund, credit or reduction in otherwise required Tax payments . . . .").

Anticipating the need for retreat, Acument contends that "Textron has never argued that Acument is entitled to any 'reduction' other than a 'deduction.'" Ans. Br. at 9; *see also* Ans. Br. at 34 ("Textron has never suggested, even on this appeal, that Acument is entitled to any type of reduction other than what it describes as a 'deduction.'"). This is plainly wrong. Textron has consistently argued that any increase in basis will yield tax reductions, *which includes not only deductions but also a decrease in taxable gain on a sale of the assets*. Op. Br. at 20-27; *see also* Op. at 49 (the Court recognizing Textron's argument that the increase in basis confers a reduction in tax payments); A242-A244 (Textron's Op. Post-trial Br. at 5-7); A320 (Textron's Post-trial Reply Br. at 17).

B. The Superior Court's Error Causes Real Harm to Textron.

By construing the Tax Benefit Reduction to apply only to deductions, instead of more broadly to deductions and other forms of reductions in tax payments, the Superior Court caused real and quantifiable harm to Textron, both retroactively and prospectively.

The Superior Court's construction materially altered and narrowed the terms of the agreement between Textron and Acument in at least two key respects. First, in holding that only a deduction is sufficient to trigger the Tax Benefit Reduction provision, the Opinion denies Textron's right under the PSA to collect the Tax Benefit Reduction when Acument's taxable basis increases.[8] Because the Superior Court erroneously denied Textron the Tax Benefit Reduction on the reductions to which Acument is entitled (*see supra*, Section I), the Court's narrow construction has foreclosed Textron from collecting the amount it is owed.[9]

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[8] The amount of the harm to Textron has previously been stipulated to by the parties: [redacted] as of March 31, 2013. AR005-AR008 (Damages Stipulation).

[9] Textron has long argued, and the Opinion confirmed, that Platinum Equity, the venture capital firm that owned Acument, intended to "flip" the Acument assets. Textron has requested that the Court take judicial notice of the recently-announced sale, by PE, of the Acument assets for an undisclosed amount. Assuming the transaction is a sale of the Acument assets, in accordance with Gertzman's tax analysis, upon the sale Acument's increased basis yields a reduction in its otherwise required tax payments—a Tax Benefit. As a result of the Superior Court's construction of the term "reduction" as the more narrow "deduction," Textron will be deprived of the benefit of its bargain and will be foreclosed from recovering the amount of the Tax Benefit Reduction to which it otherwise would be entitled as a result of the sale. Even if the transaction were structured as a stock sale, Acument would retain any increased basis (due to contingent liabilities or otherwise), and at some point would receive the tax savings associated with the increased basis upon the sale of its assets.

Second, the Court restricted Textron's right to collect reductions prospectively. The Court's Opinion will serve as a roadmap for the parties to resolve Tax Benefit disputes going forward. For any instance where the Tax Code grants Acument a *deduction* that is not a refund, credit, or other *deduction* (rather than the broader *reduction*), the Superior Court's narrow construction bars Textron from collecting under the Tax Benefit Reduction. This harm is real, foreseeable and significant. Acument's claim that the Court's erroneous construction constitutes nothing more than harmless error is meritless.

CONCLUSION

For the foregoing reasons, Textron submits the decision below should be reversed and judgment for Acument on its counterclaims vacated, with the Superior Court directed to enter judgment in Textron's favor on its claims seeking enforcement of the Tax Benefit Reduction provision. In the alternative, and at a minimum, the case should be remanded for consideration of Textron's analysis under the federal tax law regarding the issue of whether Acument received a Tax Benefit.

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