Feeling Sick About *Wellpoint*, Part II

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Title Fight or Just Business?

Were these three lawsuits fundamentally about title to assets, or were they about Wellpoint's business and its ability to keep operating? You might think the company had a pretty good argument that dealing with the three Attorneys General was *really* about Wellpoint's manner of conducting business. Wellpoint argued this should make the three settlement payments (along with the related legal fees) deductible.

After all, these three lawsuits never challenged title to specific items of property. According to Wellpoint, that made capitalization inappropriate. Interestingly, the Tax Court agreed that it was Wellpoint's business practices that were assaulted in these cases.

Yet the Tax Court said it believed the origin of each claim was a dispute over the equitable ownership of assets allegedly impressed with charitable trust obligations. That is understandable. Indeed, in each case, the settlement agreement called for the assets to be transferred to a Code Sec. 501(c)(3) organization conforming to the charitable purpose the state Attorney General sought to enforce.

The Tax Court applied its logic to each of the three pieces of litigation separately, although with common effect. The settlement agreements in all three states deny the existence of a charitable trust, and assert something that is undoubtedly true: that Wellpoint was making the payment to avoid the interruption of its business or loss of goodwill. Instead of arguing the facts, the Tax Court simply said it found this argument irrelevant. A taxpayer's *motive* for settling a case is not controlling in determining the deductibility of the settlement payment, said the court. For this proposition, the court cites *F.W. Woodard,* SCt, 70-1 USTC ¶9348, 397 US 372, at 578.

Strictly Business

Wellpoint found itself arguing that these settlement payments were *per se* deductible because they were necessary to defend its business. Two cases underscoring such a rule are *BHA Enterprises Inc*, 74 TC 593, Dec. 37,024 (1980), and *AE Staley Manufacturing Co. and Subsidiaries,* CA-7, 97-2 USTC ¶50,521, 119 F3d 482 (1997). *BHA* involved a taxpayer fighting to keep the FCC from revoking its broadcasting licenses, and the settlement payments were held to be deductible.

The Tax Court found *BHA* inapposite and castigated the testimony presented by Wellpoint's witnesses. *AE Staley* involved deductions for investment banking and printing costs incurred by Staley in an unsuccessful effort to defend its business against a takeover. Those costs were deductible because they produced no future benefit.

Distinguishing *AE Staley*, the court found the future benefits accruing from the defense and settlement of these *cy-pres* cases to be manifest. They arguably enabled Wellpoint to convert the assets from charitable to income-producing purposes.

Legal Expenses

Legal and professional expenses, like settlement payments, are controlled by the origin of the claim doctrine. The Tax Court summarily concluded that the legal and professional fees here arose from defending against claims that had their origin in the equitable ownership of assets. Therefore, the Tax Court found for the government or the legal expense issue too, disallowing the deductions. After all, the three cases here *were* brought seeking the imposition of a charitable trust.

Not Appealing

The Seventh Circuit is not known for being friendly to taxpayers. It is also home to one of the most fearsome intellectuals on the federal bench, Judge Richard A. Posner. Wellpoint's fate seemed sealed the moment Judge Posner put pen to paper (or laptop to cyberspace) to start his opinion.

Judge Posner discusses the origin of the claim test and considers this dispute really about the use of the assets. The $113 million the Attorneys General received (and then handed over to charitable entities), Posner notes, was not damages. Rather, it was money "in lieu of their recovering the acquired assets." As to *cy-pres*, Posner has a nice time describing its roots, but declares simply that "[t]he doctrine has no application to this case."

Facts Interrupted

What could Wellpoint have done differently? Normally, I would advocate drafting a settlement agreement to focus on tax issues. Here, that might have meant underscoring (in recitals and elsewhere) the fact that Wellpoint's manner of doing business was challenged in three states. Wellpoint might have indicated that it was making the settlement payments to be able to continue in business, for arguably, that's what the suit was about.

Yet self-serving language might not have helped here. The three states had framed their disputes as involving *title* to assets. Of course, there was no court ruling to say the states *owned* the assets and that Wellpoint did not. Instead, there were three settlement agreements each of which explicitly called for a transfer of cash to an entity at the behest of the state.

Capitalize to What?

If one concludes that capitalization is appropriate, to what would you capitalize it? With no court ruling that the assets were always owned by the state (or a charity), the assets were presently owned by Wellpoint until the time of the transfer. The transfers occurred over two years, between 1999 and 2000. If legal expenses were incurred with respect to capital assets in those two years, and the assets were disposed of in 1999 or 2000, wouldn't that disposition trigger the loss?

Clearly, that must not be the case, since this relatively small timing difference would surely have been resolved before trial. There is no discussion in the Tax Court or Seventh Circuit of how capitalization would work here. It is tempting to think that Wellpoint would be capitalizing the property it gave away. If this theory were correct, Wellpoint would presumably have agreed to capitalization followed by immediate disposition of the capitalized asset.

Instead, what the IRS and the courts seem to have in mind is that Wellpoint must capitalize the amounts with respect to its own stock. That means Wellpoint would achieve a tax benefit only on a sale or liquidation of the company. Even with all this, though, creative drafting in the three settlement agreements might have given Wellpoint some better arguments.

Conclusion

Companies of all sizes seem relatively sophisticated when it comes to capitalization issues in the context of corporate acquisitions. The issue is ever-present, and has long been on most people's radar. But in the context of resolving litigation, the parallel issues have been under-represented.

My intuition tells me that in all but the clearest of cases, most defendants simply deduct any settlement or judgment as a business expense, whether or not they should. Hopefully they go through some analysis, but it is not hyperbole to suggest that in many cases, the nature of litigation somehow convinces defendants their settlement is just a typical cost of doing business (along with the inevitable lawyer fees).

Not only is that not always true, but the documents (here the settlement agreements) do matter. I do not know whether a more cleverly drafted set of settlement documents with the three states in *Wellpoint* would have changed the result in the case. Before Judge Posner, perhaps it would not. But there are many different points at which this protracted dispute could have been resolved, from audit, to Appeals, to Tax Court and beyond. Better documents might have meant the difference.