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Greenmail Held Not Deductible

by Robert W. Wood • San Francisco

The question whether a payment of so-called "greenmail" can be deductible has not come up too many times in the courts. However, it did recently in a District Court case in North Carolina, *Wrangler Apparel Corp. v. United States*, No. 2:94CV00481 (M.D. N. Carolina July

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22, 1996). In that case, the U.S. District Court found that the greenmail pay was not a deductible business expense under Section 162. In fact, the court granted summary judgment to the government on the question of deductibility (saying it simply was not deductible). But, the court said a trial was necessary to determine if amortization was

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appropriate. Thus, the court left open the possibility of amortization.

The case arose out of the Bass family's purchase of 23% of the stock of Blue Bell, Inc. Blue Bell was worried about a hostile takeover, and consequently negotiated with the Bass Group to repurchase its stock. An agreement was negotiated that contained a standstill provision barring the Bass Group from purchasing Blue Bell stock for ten years. Blue Bell repurchased all of the stock from the Bass Group, paying a net purchase price that exceeded the publicly traded price by more than \$36 million.

Blue Bell ended up being merged with Wrangler Apparel Corp., and Wrangler Apparel as the successor was faced with arguing that the \$36 million premium paid to the Bass Group represented "greenmail." Wrangler Apparel argued that the \$36 million premium was paid not to acquire stock held by the corporate raider, but rather to eliminate the threat of the raider to the company's business. Not persuaded, the District Court just said no on the availability of a Section 162 deduction.

Motive Irrelevant

The court found that Blue Bell's motivation in this matter was irrelevant. The District Court relied in large measure on the decision in *Stokely-Van Camp, Inc. v. United States*, 974 F.2d 1319 (Fed. Cir.

1992). The Federal Circuit in *Stokely-Van Camp* had found that the premium was paid in connection with the purchase of the corporation's stock, which was a capital asset.

Interestingly, the District Court in *Wrangler Apparel* noted that although the stock purchase agreement between Blue Bell and the Bass Group did not specifically allocate any portion of the purchase price to the ten year standstill provision, a trial was necessary to determine the *intent* of the contracting parties. (It sure sounds like motive is relevant, doesn't it?) The court found that Wrangler Apparel had shown some evidence that the parties had ascribed value to that standstill provision. In the District Court's eye, this was sufficient to raise an issue as to whether the parties intended to allocate a portion of the purchase price to the ten year standstill covenant.

Greenmail Rules

Under current law, of course, Section 5881 (added in 1987) imposes a special excise tax on greenmail payments. Imposed at a whopping 50%, the excise tax applies on any gains realized as a result of greenmail payments, and is nondeductible for income tax purposes. Greenmail that is subject to the tax is defined as any amount a corporation (or any person acting in concert with a corporation) pays to a shareholder, directly or indirectly, to acquire its stock if:

- the shareholder held the stock for less than two years at the time of the acquisition;
- at some time during those two years, the shareholder, any person acting in concert with the shareholder, or a related person, made or threatened to make a public tender offer for the stock of the corporation; and
- the acquisition is pursuant to an offer that was not made on the same terms to all shareholders. I.R.C. §5881.

This statute was designed to discourage the practice of buying stock in a potential target to thereafter induce the target to buy back the stock at a substantial premium so as to prevent the unwanted prospective acquiring corporation from gaining control.

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Example:

Ron Raider makes a public tender offer for the stock of Targetco, a company that is likely to be the target of an acquisition attempt to buy Babyco. After acquiring substantial stock and holding it for a few months, Raider goes to Targetco and offers to sell his Targetco stock for a substantial premium. Targetco may well want to make this purchase to prevent the stock from getting into Bigco's hands. Unless Targetco makes the same purchase offer to other Targetco shareholders besides Raider, any gain realized by Raider on such a transaction is a greenmail gain.

Severe Tax

The tax on greenmail payments is imposed whether or not the greenmail gain is recognized. I.R.C. §5881(d). Accordingly, the receipt of stock is an otherwise tax-free reorganization could qualify as a greenmail payment, thus triggering the 50% excise tax.

Example:

Trying to avoid the greenmail tax rule, Ron Raider, in the above example, asks Targetco to structure a reorganization exchange, in which he will exchange his Targetco shares for stock in another company that is a party to the reorganization. Nevertheless, the value of the shares Raider receives would be subject to the greenmail gain tax.

Note:

Notwithstanding the scope of the greenmail tax, it does not apply if the offer to shareholders is made on the same terms to *all* shareholders. I.R.C. §5881(b)(3). Thus, in the above example, if Targetco is willing to make the offer to purchase at a premium not only to Ron Raider but also to all other Targetco shareholders, the greenmail tax will not apply.

Finally, to prevent disguised payments that are really intended to have the effect of premium payments for stock, the statute covers payments made in connection with or related to the redemption, and treats them as greenmail payments

as well. I.R.C. §5881(b). The scope of the greenmail tax also applies to other income received by reason of greenmail. Dividend income, for example, may constitute greenmail. ■

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