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INDOPCO Rears Its Ugly Head, Preventing Deductions, Says Full Tax Court

by Robert W. Wood • San Francisco

The friendly vs. hostile dichotomy that was first made famous by the *National Starch* case seems never to die. As loyal readers are all aware, *National Starch and Chemical Corp. v. Commissioner*, 93 T.C. 67 (1989), made it all the way to the U.S. Supreme Court, by that point being renamed *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). The *INDOPCO* case held that expenses incurred by a target corporation during a friendly takeover were nondeductible capital expenditures.

There has been no shortage of discussion over the past few years about whether there is a bright line between friendly and hostile. (For prior *M&A Tax Report* coverage, see Schiffhouer, "Indopco, Federated and Beyond," Vol. 1, No. 1 (Aug. 1992), p. 1; Willens, "*INDOPCO*'s Reach Expanded in *Victory Markets*," Vol. 1, No. 7 (Feb. 1993), p. 7; Willens, "IRS Aggressively Expands *INDOPCO*," Vol. 1, No. 10 (May 1993), p. 5; and Wood, "Asbestos Abatement and Other *INDOPCO* Problems," Vol. 1, No. 12 (July 1993), p. 7.)

To any company that has paid out large attorneys' and/or investment banking fees, of course, the stakes can be enormous. The value of a current deduction vs. the treatment of capitalized expenditures can be monumental.

That all such issues were not resolved by *INDOPCO* seems obvious. However, only relatively rarely does the Tax Court get a case that is explicitly one of first impression. This may seem particularly odd in the *INDOPCO* genre given the supposedly bright line drawn by the Supreme Court in that case. Nonetheless, the Tax Court's recent decision in *A.E. Staley Manufacturing Co., et al v. Commissioner*, 105 T.C. No. 1 (1995), was explicitly a case of first impression.

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First Impressions are Important

The *Staley Manufacturing* case arose out of a history of acquisitions. A.E. Staley Manufacturing Co. was in the food sweetener business. By the mid-1970s, it had diversified and acquired CFS Continental, Inc. ("CFS"). In 1985, Staley reorganized, with Staley Continental, Inc. ("Staley") emerging as the parent of both A.E. Staley Manufacturing Co. and CFS. Staley thereafter acquired a number of produce and food service distributors.

Following the advice of its law firm, Staley adopted several anti-takeover devices during the 1980s, including a stockholder rights plan and management retention agreements. Staley also engaged two investment banking firms, and they also recommended actions that Staley followed.

A U.K. corporation, Tate & Lyle PLC, began purchasing Staley stock on the open market in 1987. In late 1987, in response to Tate & Lyle's expressed intent to buy up to 25% of Staley's stock, Staley strengthened its stockholder rights plan. On April 18, 1988, a subsidiary of Tate & Lyle (RP Acquisition Corp.) publicly tendered for Staley shares. The public tender offer at $32 cash per share was conditioned on the nullification of the shareholder rights plan and the inapplicability of a Delaware anti-takeover statute.

Tate & Lyle's CEO then wrote to Staley's CEO criticizing Staley's management. This letter went so far as to state that if the tender offer were successful, Tate & Lyle would sell *all* of Staley's distribution subsidiaries. Tate & Lyle and the RP subsidiary even sued Staley in both Delaware state court and U.S. District Court seeking an injunction against the shareholder rights plan and challenging the constitutionality of the anti-takeover statute. These lawsuits were ultimately unsuccessful.

Once again, Staley hired investment bankers who advised that the Staley stock was worth between $35.83 and $43.57 per share, thus confirming the inadequacy of the tender offer. Accordingly, Staley's board of directors rejected the tender offer and advised its shareholders to do likewise. Upon Staley's request, the investment bankers explored other transactions as alternatives, including a recapitalization.

Tate & Lyle increased its tender offer to $35 per share on April 29, 1988. Still, the Staley directors advised shareholders to reject the offer as not in the shareholders' best interests. In May of 1988, the investment bankers reported that there was no viable alternative to persuade shareholders to reject the cash offer. Three days after this, Staley, Tate & Lyle and RP entered into an agreement and merger plan calling for $36.50 per share to be paid in cash for the Staley shares. This the Staley directors approved as fair.

The acquisition was accomplished by RP using over $1.6 billion in funds borrowed from various Tate & Lyle entities. Staley and RP were then merged, with Staley being the survivor, succeeding to RP's debt. Tate & Lyle replaced Staley's management and fired many executives. Tate & Lyle sold CFS for approximately $665 million in cash and the assumption of $50 million of Staley debt.

Big Fees Deducted

On its short year return ended May 31, 1988, Staley claimed a $23 million deduction for fees paid to law firms, investment bankers and other vendors relating to Staley's response to the tender offer. The IRS disallowed the deduction for amounts paid to the investment bankers. Staley argued to the IRS that the takeover was hostile, therefore distinguishing this situation from the *National Starch/INDOPCO* case. *INDOPCO*, keep in mind, had held that expenses incurred by a target during a friendly takeover had to be capitalized. Was this friendly?

With a good deal of persuasive force, Staley argued

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in Tax Court that this case could hardly be compared to *National Starch.* After all, Staley had *never* wanted to be taken over by Tate & Lyle. Indeed, the takeover represented a rather clear threat to its business, given that Tate & Lyle had announced early on that it would break up the company and fire management. And it did. Staley therefore argued that its motives in incurring the expenses were significant in determining their character from a tax perspective.

Unfortunately, the Tax Court—in a reviewed decision—rejected the argument that the attitude surrounding a takeover was a significant factor. In fact, the court found that no deduction was available for expenditures made incident to a corporate reorganization, including a change in ownership, where the reorganization gave rise to a "continuing benefit." (There's that awkward concept again.) The court found that there was a continuing benefit to the transaction that was ultimately consummated between Staley Manufacturing and Tate & Lyle.

Indeed, Staley's board of directors (at least at the very last minute!) had anticipated that the acquisition would affect operations (to the good) for the indefinite future. The expenses were made in connection with this change in ownership. After Tate & Lyle had sweetened its offer, the investment bankers retained by Staley Manufacturing had advised accepting the offer. Doing so had extended future consequences for Staley's operations.

There were also benefits merely from the transaction's transformation of Staley from a separate public company into a wholly-owned subsidiary. These included reduced or eliminated shareholder relations expenses such as reporting and disclosure obligations, possible proxy fights, etc.

Victory Markets Revisited

In at least some respects, the *A.E. Staley Manufacturing* case is the logical rejoinder to the Tax Court's decision in *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648 (1992). In *Victory Markets*, the Tax Court required capitalization of acquisition expenses based on the notion that the acquisition had provided the company with long-term benefits. The Tax Court in *Victory Markets* had stated that it really did not need to decide whether the *INDOPCO* holding was limited to hostile as opposed to friendly acquisitions. The Tax Court in *Victory Markets* found that the facts in that case were not materially distinguishable from those in *INDOPCO.*

Consequently, the *Victory Markets* Tax Court did not focus on the hostile vs. friendly distinction. Rather, the Tax Court focused on whether the change in ownership could be expected to provide substantial future benefits. The court found such a long-term benefit in *Victory Markets*: the acquired company there had obtained the resources of a much larger acquiring organization, as well as the administrative benefits of being transformed from a publicly-owned corporation to a wholly-owned subsidiary. This discussion in *Victory Markets* sounds awfully like the benefits enumerated by the Tax Court in *Staley Manufacturing.* (For further discussion of *Victory Markets*, see Willens, "*INDOPCO*'s Reach Expanded in *Victory Markets*," Vol. 1, No. 7 (Feb. 1993), p. 7.)

Eleventh Hour Friendship?

What is doubtless troubling about the *A.E. Staley Manufacturing* case to many in the business world is that *Staley Manufacturing* seemed like a rather clear case of overt hostility until literally days before the parties were able to come to agreement. Could not expenses be bifurcated, with the admittedly substantial expenses leading up to the hostile-to-friendly metamorphosis being deductible, with only those thereafter being capitalized?

There were two dissenting opinions filed in the case, one by Judge Maryanne Cohen and the other by Judge David Laro. Judge Cohen found the facts of the *Staley Manufacturing* case indistinguishable from those in *INDOPCO.* Judge Cohen's dissent notes that she believes the majority opinion now expresses the rule that *any* expenses relating to a change in corporate ownership are simply not deductible. This, she insisted, was not the holding of the Supreme Court in *INDOPCO*, nor is this conclusion even supported by *INDOPCO.*

Judge Laro's dissent, on the other hand, argued that this truly was a hostile takeover. When a takeover is hostile, in his view, one should strongly suspect

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that there are no long-term benefits anticipated by the target. In such a case, the deduction of expenses is proper.

It was Judge Cohen's dissent, however, that expressly advocated a bifurcation of the expenses. There was, after all, an initial period during which the Staley board of directors resisted the takeover and sought out alternatives. Most of the expenses that were incurred related to this timeframe. Then there was the second period of time, after the investment bankers informed the board of Staley that there seemed no viable alternative to the Tate & Lyle offer.

At that point, the board had changed from, in Judge Cohen's words, "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." Although there could doubtless be factual questions about precisely when a particular acquisition target would jump from phase one (hostile) to phase two (friendly), this bifurcation of time periods, and consequent bifurcation of fees, would appear to be eminently reasonable. It also should be workable, raising few practical problems.

What, Me Worry?

It is probably unproductive for companies to lament the result in *Staley Manufacturing*, as it seems unlikely that facts better than those presented in that case would yield a different result. In any event, we have doubtless not yet heard the last word about this issue, nor for that matter, even the last word about *Staley Manufacturing*. The Tax Court's decision will most likely be appealed. One can only hope that the appellate court will hear the reason of the dissenting opinions, particularly Judge Cohen's views about bifurcation.

In the interim, it might behoove companies to adopt and attempt to follow at least one of the arguments that was voiced in *Staley Manufacturing*. Staley had argued in Tax Court that it should be entitled to a deduction under the theory expressed in *U.S. v. Federated Department Stores*, 171 Bankr. 603 (7th Dist. Ohio 1994). That case had involved the hostile takeover of Allied by Campeau Corporation. Allied had turned down the takeover proposal, and eventually ended up negotiating a merger with the DeBartolo organization.

Under that agreement, DeBartolo was entitled to a break-up fee in the event the Allied merger with DeBartolo failed to occur. Campeau maneuvered to block the DeBartolo merger and DeBartolo was consequently paid a whopping break-up fee of $116 million. After the Campeau merger occurred and the DeBartolo fee was paid, the IRS challenged the deductibility of the $116 million fee.

The Bankruptcy Court upheld the validity of the deduction on the theory that the Allied board had never believed the Campeau acquisition would yield any long-term benefits. And as we all know, Campeau itself ended up in Chapter 11, as did Allied. Thus, according to the Bankruptcy Court, no long-term benefits were expected or obtained. The Bankruptcy Court therefore allowed the deduction, saying it could be viewed as deductible under either Section 162 as a business expense or under Section 165 as a loss. The District Court affirmed the

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Bankruptcy Court's conclusion.

Staley Manufacturing argued in its case that the monies it had expended in fighting Tate & Lyle likewise could be viewed as either a Section 162 expense or as a loss under Section 165. After all, the Tate & Lyle transaction was abandoned. The Tax Court disagreed with this appealing theory because, in the Tax Court's view, there was never any abandonment of a separate and distinct proposal. In fact, the Staley Manufacturing transaction went from hostile to friendly, and the price may have increased, but it was not one transaction that was abandoned and another that was adopted.

Conclusion

Creative tax professionals may well read into this an opportunity to have a hand at structuring the transaction that is ultimately consummated as looking quite different from one that was originally proposed. This "abandoned alternative" question seems of enormous practical importance, even if the "hostile vs. friendly" dichotomy seems at the moment not to be so critical.

Of course, hand in hand with the notion that some alternatives may be abandoned should go in the clear and distinct division of fees, regardless of to whom they may be payable. This would seem to help quell the unfortunate result (at least at the Tax Court level) in a case like *Staley Manufacturing*.

Perhaps somewhat more quirky would be the notion of maintaining hostility and the assertions of "no continuing benefit" that go with it. It would not appear to require too much stretching of the imagination to suppose that some last minute hostile-to-friendly transformations may now not occur. All other factors being equal, after all, it may behoove acquired companies to continue voicing animated opposition (but perhaps somewhat less convincingly?) until whatever transpires has completely occurred. Admittedly, this fanciful notion would appear to belie the fiduciary duty that all boards owe to the corporation and its shareholders. Besides, if someone were to follow this course it would probably produce another case like *Staley Manufacturing*—of first impression. ■

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requirements. The continuity of business enterprise requirement has been most discussed of late in the context of bankruptcy reorganizations and other situations where it seems that the same business is not being conducted.

The continuity of proprietary interest requirement, on the other hand, focuses upon the results of two corporate enterprises amalgamating. Continuity of interest will be present if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation. It is insufficient to establish continuity of interest if the holders of the stock and securities of the old corporation end up merely with short-term notes in the new corporation. Reg. §1.368-1(b).

The Service has recently issued Revenue Ruling 95-69, ruling that the continuity of proprietary interest requirement will not be affected by a partnership distributing the stock it receives in a reorganization to its partners in accordance with their partnership interests. Under the facts of the ruling, a limited partnership held 100 outstanding shares of Corp 1. The partnership consisted of two individuals, one general, and one limited partner. The partnership held other assets besides the Corp 1 stock.

The other entity involved in the reorganization, Corp 2, was owned entirely by another individual. For valid business reasons, Corp 1 merged into Corp 2, with Corp 2 thereafter electing S

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corporation treatment. Pursuant to binding written agreements between all of the parties, the merger occurred with the partnership (which held the Corp 1 stock), receiving 100 shares of Corp 2 stock in exchange. Immediately thereafter, the partnership made a nonliquidating distribution of the Corp 2 stock it received in the merger so that Corp 2 could qualify as an S corporation. Thus, the Corp 2 stock was distributed to the general partner and limited partner in accordance with their respective partnership interests. Pursuant to the plan, Corp 2 elected S treatment, with the Corp 2 shareholders consenting to the election.

No Problem

The ruling concludes that before the merger, the general and limited partners of the partnership indirectly owned the Corp 1 business enterprise. Likewise, after the merger (but before the partnership distributed the stock), the partners remained indirect owners of the Corp 1 business enterprise (this time through the Corp 2 stock). The distribution by the partnership of the Corp 2 stock in accordance with the partners' interest in the partnership, therefore, resulted in no change to their underlying ownership of the business enterprise operated by Corp 1. Consequently, the ruling concludes that the distribution did not affect whether the continuity of proprietary interest requirement of the regulations was satisfied.

How Much Continuity?

The question of just how much continuity is enough has been litigated and debated. For advance ruling purposes, of course, the IRS usually requires a high standard of continuity, generally 50%. Thus, shareholders of the acquired corporation need to have a continuing interest through stock ownership in the acquiring corporation that is equal in value on the date of the reorganization to at least 50% of the value of all the acquired corporation's outstanding stock as of the same date.

Not surprisingly, the case law has been far more liberal, with 25% or 30% continuity being held sufficient. On the other hand, in some rather notable cases, continuity at approximately the 15% level has been judged insufficient. See *Yoc Heating Corp.*, 61 T.C. 161 (1973). ■