Pushing the Rescission Envelope in M&A

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"Rescission" is a legal term that most lay people understand. On some level, we all know it means going back to square one. We undo something, just as if it never happened. We pay the money back, we deed the property back, we go back to the way it was. In the business world, this occurs more frequently than many realize, though perhaps in most cases it occurs on a small scale.

When we talk of transactions of significant size, the same idea is possible, although there may obviously be enormous practical and legal impediments. That is certainly one reason why the well-planned transaction is never undone. Rather it is thoroughly thought out before the transaction is consummated.

Sometimes, though, we all make mistakes. The mistakes may be of a fundamental "what was I thinking" variety, or may be more of the mechanics and routing we prefer. Who among us has not thought, "I should have taken city streets?" Some of us may even have thought, "I should have done a forward triangular merger, not a taxable asset sale."

In that sense, it is interesting to contemplate whether rescission can allow us to take a different path. If we could go back to the city streets instead of the freeway, or undo a taxable sale and do a merger instead, we might like that very much. Some things, however, cannot be undone.

Constructive Receipt?

Constructive receipt is one of the bedrock principles of our federal income tax law. Under the constructive-receipt doctrine, a taxpayer cannot turn his back on income. Unlike some other fundamental tax doctrines (such as discharge of indebtedness), lay people tend to understand constructive receipt. You can't turn down a paycheck, at least not without tax consequences.

This over-arching doctrine is solely a creature of the cash method of accounting. Under the accrual method, there is no need for constructive receipt. After all, the accrual method assumes that income is taxed when the *right* to the income matures, even if payment is made much later. The constructive receipt doctrine imports one of the fundamental precepts of accrual accounting to cash method taxpayers.

For individuals and other taxpayers on the cash method of accounting, there are limits. Some may try to *manipulate* the cash method in inappropriate ways. They face being put on the *accrual* method for some purposes. One of the classic examples of constructive receipt involves a taxpayer invoicing a buyer or employer but then telling the payor not to remit payment after all.

"Please pay me in January," the taxpayer asks. We know this manipulation of income is not allowed for tax purposes. The taxpayer is treated as receiving income when the right to the income has matured, even if he is not paid until much later.

The Litigation Model

The constructive receipt doctrine is commonly encountered when dealing with litigation recoveries. However, it can certainly arise in other contexts. In litigation, plaintiffs may want to structure their recoveries over time.

Similarly, plaintiff's attorneys may want to structure their legal fees. Constructive receipt will be monitored to ensure that the structures can be implemented. For example, if a plaintiff's lawyer has already received funds in his trust account, it will no longer be possible for the client to structure the recovery or for the lawyer to structure his fees.

There is *actual* receipt in this example, not merely constructive receipt. Once you have cash, it is too late to agree to be paid over time. The lawyer is considered the agent of his client, so both the lawyer and his client have receipt of the money. In the same way, if you sell your house for cash, it is too late to say you want to be paid in 10 annual installments.

Right to Payment?

However, suppose we take a step back in time from this situation. Assume that a settlement agreement for *cash* has been signed but the money has not yet been *paid*. Shortly after signing, the plaintiff decides he wishes to structure the settlement so he will receive a stream of periodic payments.

This situation does not involve *actual* receipt, since the money has not yet been paid. But with a signed settlement agreement, it sounds more like constructive receipt. Is it too late? Most tax advisors, structured settlement brokers and life insurance companies would say that it is.

Even though there has been no *actual* receipt of the funds, all of the events necessary to receive the money—including the plaintiff signing the settlement agreement and releasing his legal rights—have occurred. Since the settlement agreement calling for all cash has been signed, the plaintiff has the right to the money in cash. Hence, the plaintiff can no longer sign structured settlement documents and know that the periodic payments under the structure arrangement will be taxed only when and as the payments are received.

Structured Settlements

Plainly, the structured settlement divisions of life insurance companies compete aggressively for structured annuity business. Even so, I do not believe any life insurance company would write a structure on these facts. Constructive receipt has already attached.

Against such a fact pattern, though, could the plaintiff and defendant agree to *rescind* the settlement agreement and sign a new one a few days later calling for periodic payments? Many tax advisors, litigation lawyers and structured settlement professionals may still answer that it is too late. After all, constructive receipt is a threshold doctrine. In that sense, it may seem to be a one-way street.

Once you have constructive receipt, we have been led to assume, the taint *never* goes away. However, on closer examination, I find this to be flawed logic. Indeed, if one can cure *actual* receipt of money in hand *via* rescission, shouldn't one be able to cure *constructive* receipt in the same way? Surely, constructive receipt can be no worse than actual receipt.

Rev. Rul. 80-58

The primary IRS authority dealing with rescission is Rev. Rul. 80-58, 1980-1 CB 181, in which the IRS enunciated its position on rescission and its tax consequences. Rescission can undo the tax effects of a transaction provided that two requirements are met:

- The initial transaction and the rescission must occur in the same tax year.
- As a result of the rescission, both parties to the original transaction must be returned to the same positions they occupied prior to the original transaction, *i.e.*, they must be returned to the *status quo ante*.

Defined Terms

The IRS defines "rescission" as the "abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made." The rescission may be achieved:

- by the parties' mutual agreement;
- by one party declaring a rescission without the other's content, but with sufficient grounds to make such a declaration; or
- by applying to the court for a decree of rescission.

The revenue ruling considered two situations. In Situation 1, all events occurred during one tax year. In Situation 2, the transaction occurred in one year, but the rescission occurred in the next. In the former case, the transaction and its rescission are essentially treated as tax nothings, so no gain or loss is recognized.

In the latter case, even though the money was repaid and the transaction was unwound, the IRS refused to abrogate the accrual accounting concept. Thus, the original seller in the transaction had to report the sale in year 1, even though he reacquired the property in year 2. He would take a new cost basis in the property in year 2 equal to the price paid.

Case Law

Rev. Rul. 80-58 relied heavily on a Fourth Circuit case from 1940, *S.E. Penn, Exrx.*, CA-4, 40-2 USTC ¶9707, 115 F2d 167 (1940). The Fourth Circuit explained that with cash basis accounting, the taxpayer receives income for tax purposes when he actually or constructively receives an amount that is definitely ascertainable

and that is subject to his unrestricted control. Of course, federal income taxation requires annual returns and accounting.

As such, the Fourth Circuit ruled income should be determined at the end of each tax year without regard to subsequent events. Thus, the IRS has a rigid view of rescission with a focus on a single year. By and large, the courts agree.

For example, in *K. Hope*, 55 TC 1020, Dec. 30,685 (1971), *aff'd*, CA-3, 73-1 USTC ¶9168, 471 F2d 738 (1973), the Tax Court rejected a seller's attempt to postpone the recognition of gain even though he had sued to rescind the transaction in the year of the sale. In 1960, Hope sold his shares in a local corporation at a substantially undervalued purchase price. Later that year, Hope sued the buyers to rescind the transaction.

The case was settled in 1961. Hope argued that he should not be required to recognize gain from the sale in 1960 because he had sued for rescission in the same year. The Tax Court, however, characterized Hope's lawsuit as a mere *request* for rescission.

Hope had still received the purchase price in 1960. Moreover, he had an unrestricted right to use the money as he pleased despite the filing of the lawsuit. The filing of Hope's lawsuit, albeit in the same tax year, was insufficient to rescind the sale for tax purposes.

Rulings and More

Moreover, in *R.L. Hutcheson*, 71 TCM 2425, Dec. 51,234(M), TC Memo. 1996-127 (1996), the Tax Court refused to give effect to an attempted rescission that the taxpayer argued satisfied the requirements of Rev. Rul. 80-58. The parties were not returned to exactly the same positions they occupied prior to the original transaction, ruled the Tax Court. That meant the requirements of the revenue ruling were not met.

Hutcheson and his wife opened a cash management account with Merrill Lynch in 1983 that contained only shares of WalMart. He was advised to his debt so he sold shares of WalMart stock. In December 1989, Hutcheson borrowed funds from his father and purchased WalMart stock, albeit not the *same* shares of stock he had purchased in January 1989.

Hutcheson tried to characterize the December 1989 transaction as a rescission of shares erroneously sold in January 1989. Hutcheson likened his situation to Situation 1 in Rev. Rul. 80-58, since everything had occurred in the same tax year. However, the Tax Court concluded that for an attempted rescission to be effective, buyer and seller—the *same* buyer and seller—must *both* be put back in their *original* positions. The buyers in the January 1989 transaction were not put back into the same positions.

After all, in the December 1989 transaction, there was a different buyer, Merrill Lynch. Merrill Lynch had merely acted as an agent, not as a buyer, in the January 1989 transaction. Furthermore, prior to the January 1989 transaction, Hutcheson did not owe $1.35 million to his father, but he did as a consequence of the December 1989 transaction.

These were material differences, said the court. Quite literally, the buyers and sellers were not returned to their original positions. That meant the December 1989 transaction could not be viewed as a rescission for tax purposes.

Early Rescission

Not all cases are as rigid as Rev. Rul. 80-58. One of the best examples is *P. Guffey*, CA-9, 65-1 USTC ¶9144, 339 F2d 759, 760–61 (1964), a case pre-dating Rev. Rul. 80-58. Mr. and Mrs. Guffey sold their residence in 1951. In 1952, the buyers sued the Guffeys to rescind the transaction.

In 1954, the parties settled and the buyers reconveyed the residence back to the Guffeys. The Guffeys immediately sold the residence to a new purchaser. In determining the tax consequences emanating from these transactions, the Ninth Circuit ultimately concluded that the initial sale in 1951 was a nullity for tax purposes.

The court's ruling suggests that rescissions occurring after the tax year of the original transaction may sometimes be given effect. However, case law extending the rescission doctrine beyond the limits of Rev. Rul. 80-58 is rare. Most of the interesting questions surrounding rescission are about the outer limits of time. When can one go beyond one year? Concerning the circumstances, does absolutely everything need to go back to the *status quo ante*?

Unwinding Legal Settlements

What do these fact patterns and authorities say about constructive receipt and rescission,

whether of legal settlements in litigation or corporate transactions? Perhaps not much. The litigation settlement fact patterns generally do not involve the most interesting fact patterns and questions surrounding rescission.

Yet a review of nontax case law shows that sometimes settlement agreements are actually unwound. Sometimes a plaintiff and defendant sign a settlement agreement, and they may amend or rescind it before any money is paid. Sometimes a plaintiff and defendant sign a settlement agreement, the defendant pays the money, and then they unwind the deal.

Agreeing to Disagree

This may be most likely to happen when both parties are unhappy with the deal they struck. In *Cooper v. Cooper*, 35 A.2d 921 (D.C. 1944), for example, an ex-husband contracted to pay $60 in monthly alimony. The ex-husband paid the alimony for years until both he and his ex-wife decided to abandon their prior written agreement. She wanted more; he wanted to pay nothing.

This dispute led to a rescission of their written agreement. Of course, this dispute was contested, rescission arising out of—really constituting—a new legal battle. But the effects should be the same whether the rescission comes about by court order or by an agreement executed consensually by the parties.

Although legal settlement agreements are signed every day, I believe rescission of legal settlements (consensually or by court order) is rare. When it occurs and gives rise to case law, we can probably assume one party doesn't like it. If a plaintiff is trying to abrogate a settlement agreement (and presumably to return all the settlement money) the defendant will object. The defendant wants the case resolved, signed an agreement to do so, and is unlikely to want to reopen it.

Court Orders and Otherwise

But consensual rescission is possible and courts have been willing to grant mutual rescission requests in connection with settlement agreements. For example, in *IDT Telecom, Inc. v. CVT Prepaid Solutions, Inc.*, 2008 WL 2117149 (D. N.J. 2008), the federal district court granted a joint rescission request based on, among other things, the parties' mutual misunderstanding over material language in their settlement agreement. In addition, to return to my premise, consider the following example:

> The plaintiff and the defendant have been litigating an auto accident case. They eventually resolve to settle it at a late-night mediation session shortly before trial. At the mediation, they sign a handwritten (or preprinted) term sheet saying they agree on $500,000, and that's it's a binding settlement. The next morning the plaintiff hears that it's now too late to structure her recovery as she had hoped to do over her remaining life expectancy. Can she still do it?

I see no reason why not, provided that the defendant cooperates. After all, the term sheet may have contemplated that there would be a more comprehensive settlement agreement. Even if it did not—and even if a comprehensive and typewritten settlement agreement has been signed—where's the harm?

The first term sheet (or full blown settlement agreement) could presumably be rescinded. A new one calling for periodic payments can be signed. Under the doctrine of rescission, a contract for services or goods, a merger agreement or virtually any other document or agreement can be rescinded.

That is fundamental. The parties must be put back in the positions they were in before. To fit within IRS guidelines, both events must occur within the same tax year.

With these limitations in mind, is there any reason why this plaintiff and this defendant cannot rescind their all cash settlement agreement and sign one calling for periodic payments? Not that I can find and not that I can imagine. If cash can be handed back via rescission (*actual* receipt), then mere *constructive* receipt can be cured in the same way.

Conclusion

Rescission is not for everyone, and the IRS guidelines are strict. Both parties (or all parties in some cases) must be fully restored to their prior positions. To comply with the IRS position, the transaction that went awry and the rescission must both occur in the same tax year. The documentation should be clear. Yet in some limited cases, rescission can offer a way out.