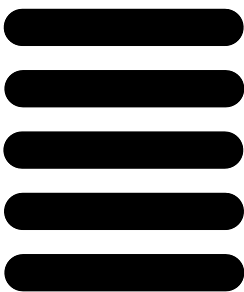

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Those Were the Days: *Times-Mirror* and How to Make a Sandwich (Part I of II)

By Robert W. Wood and Richard C. Morris • Robert W. Wood, P.C. • San Francisco

Those of us old enough to remember Archie Bunker probably also remember its wistful theme song, sung by Archie and Edith at the start of every episode. Those not old enough to remember it may not have seen it even in reruns, since Archie Bunker doesn't translate well to the digital generation. Television executives must know this, as my 140 cable channels suggest that ALL IN THE FAMILY is more extinct than the dinosaurs. Not even *Nick at Night* will touch it. Extinct or not, taxpayers in the recent tax court decision, *Tribune* [125 TC 8 (2005)] may be similarly singing *Those Were the Days*, wistfully remembering the glory days long past when at least some practitioners and taxpayers thought tax liabilities were mere inconveniences to be brushed aside.

In *Tribune*, commonly referred to as *Times-Mirror* (since Tribune took over Times-Mirror after the transaction at issue), the Tax Court held that a 1998 merger did not meet the requirements of a tax-free reorganization. The court found that the merger plan devised by PriceWaterhouseCoopers ("PwC") amounted to a $1.375 billion sale. Oops. In the transaction, which was structured at its most basic level as a state law merger, Times-Mirror "divested" itself of its legal publishing unit, Matthew Bender ("Bender"). Since Bender publishes a lot of tax books, maybe someone involved in the deal should have opened a few.

Times-Mirror's legal publishing division included a 50-percent interest in Sheppard's too. As part of the divestiture of its legal publishing division, Times-Mirror simultaneously sold Sheppard's for $275 million. Presumably, Times-Mirror sold Sheppard's rather than incorporating it into the merger because it had a relatively high basis in Sheppard's. Although no mention is made in the decision of Times-Mirror's basis in Sheppard's, the court does mention that Times-Mirror had acquired Sheppards just two years prior to this transaction.

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The buyer was Reed Elsevier ("Reed"), a British Dutch conglomerate that won a bidding war for Bender, Sheppard's and Times-Mirror's scientific publishing unit, Mosby. The divestiture of both Bender ($1.375 billion) and Mosby ($415 million) was accomplished through identical PwC–generated merger transactions. Consequently, the court found it necessary only to discuss Bender, and we'll do that here too.

Ultimately, the court did not respect the tax-free status of the transaction and found Times-Mirror's 1998 tax liability short by almost $1 billion. That has to hurt. The court noted that the "right to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the IRS and the courts will play along." [*Tribune*, 125 TC, at 133, quoting *E.J. Saviano*, CA-7, 85-2 USTC ¶9475, 765 F2d 643, 654 (1985), *aff'g*, 80 TC 955, Dec. 40,124 (1983).] That may become as quotable as Learned Hand in the future.

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Sandwich Ingredients

In 1998, Times-Mirror made the strategic decision that industry consolidation required it to exit the legal publishing business. Although Times-Mirror's investment banker, Goldman Sachs, presented tax advantaged divestiture ideas, Times-Mirror chose not to rely on its investment banker, nor its accountant, Ernst & Young, nor its legal counsel, Gibson Dunn & Crutcher, for structuring ideas. Instead, it turned to PwC's proprietary structure called the Domestic Sandwich, which was supposed to allow Times-Mirror to divest itself of Bender in a tax-free reorganization, while simultaneously allowing Times-Mirror access to cash sales proceeds. Times-Mirror required Reed (and all other bidders) to agree to use the Domestic Sandwich structure as part of the bidding process.

Alas, this seems to be yet another dot com era tax idea licensed by an accounting firm that doesn't look so red-hot in the sober sunlight. Interestingly, the decision does not mention fees paid to PwC, though it does state that all of Times-Mirror's advisors supported the structure. [*Tribune*, at 33 and 111.] The key to the Domestic Sandwich was the separation of ownership and control under the guise of a state law merger. Reed received control of the Bender stock, which it consolidated for financial accounting purposes. Times-Mirror received control of $1.375 billion cash that Reed had placed into a single-member LLC, and that Times-Mirror consolidated for financial accounting purposes.

Under the Domestic Sandwich, Times-Mirror and Reed essentially agreed to be married to each other for 20 years. At the same time, this marriage was highly conditioned, with a complicated set of puts and calls that enabled the two to accelerate divorce proceedings in certain situations. However, once the smoke had cleared and the mirrors were put away, the court held that the merger did not qualify for tax-free reorganization treatment.

Hold the Mayo?

The Domestic Sandwich structure required the participants to follow a complicated plan, and the court's description of it is not easy to follow. The opinion is 135 pages, and even PwC might tire of reading its nuances (though it shouldn't). In this article, we've tried to clarify and simplify the descriptions of the Sandwich while maintaining its essential ingredients.

For the first step in Sandwich making, Reed created a new subsidiary, Merger Sub, and capitalized it with $1.375 billion. (Reed actually used two companies as the acquirer, Reed US and Reed Netherlands, but for simplicity, we'll refer to them collectively as "Reed.") Merger Sub issued common stock, voting preferred stock and nonvoting preferred stock to Reed. The voting preferred stock provided for 80 percent of the vote and the power to elect 80 percent of the board. The common stock provided for 20 percent of the vote and power to elect 20 percent of the board.

Reed created a second subsidiary, MB Parent. MB Parent in turn created a single member LLC, Liberty Bell I LLC ("Liberty"). Reed contributed its voting and nonvoting preferred stock of Merger Sub to MB Parent in return for all of MB Parent's voting preferred stock. The MB Parent voting preferred stock provided Reed the ability to control 80 percent of the vote and the power to elect 80 percent of the board of MB Parent.

Merger Sub then contributed $1.375 billion to MB Parent in return for all of MB Parent's common stock. The MB Parent common stock provided for 20 percent of the vote and the power to elect 20 percent of the board. MB Parent contributed the $1.375 billion to Liberty. At this point, the complexities of interlocking ownership and control of the Domestic Sandwich structure begin to emerge. This was not a simple BLT.

Next, Merger Sub merged into Bender under New York law, with Bender surviving. In the merger, Bender's capital structure was changed to mirror Merger Sub's capital structure immediately prior to the merger. Thus, even though TMD was the shareholder of the surviving corporation, TMD actually relinquished all of its shares of Bender. In return, it received all of the common stock of MB Parent from Merger Sub.

Unquestionably, the end structure plausibly resembled a real world joint venture. Reed and TMD owned MB Parent. Reed and MB Parent owned Bender and Liberty. If only the reality were so clear. Underneath the polished exterior lay a web of unconventional voting and power mechanisms. For example, TMD owned all of the common stock of MB Parent, but only had 20 percent of the vote. Reed controlled MB Parent through its preferred stock, which had 80 percent of the vote.

Similarly, Reed owned the common stock of Bender, but it only had 20 percent of the vote. MB Parent controlled Bender through its preferred stock, which had 80 percent of the vote. While it may seem that this structure allowed Reed to control Bender indirectly through MB Parent, in fact MB Parent could not make any material decisions without unanimous board consent. In effect, Times-Mirror had veto power.

Further *sub rosa* mechanisms included unwinding rights galore. TMD had a call option to buy all of the voting preferred stock owned by Reed. Similarly, Reed had a put option to sell all of its voting preferred stock to TMD. These were exercisable upon certain stock dispositions and other events which would disrupt the equilibrium. In any event, both puts and calls would be automatically exercised in 2018 (*i.e.*, this was a 20-year marriage at best). MB Parent could redeem the preferred stock at any time, but redemption required unanimous shareholder consent. Analogous provisions existed for Bender's voting and nonvoting preferred, which was owned by MB Parent, except that the puts and calls were not exercisable until after 2018. Yikes.

The $1.375 billion cash was surrounded by similar complexity. MB Parent contributed it to Liberty, and Times-Mirror was appointed sole manager of Liberty. Liberty's bylaws gave its manager absolute power to manage the company and its cash. MB Parent, in its capacity as the owner of Liberty, did not have the power to remove Times-Mirror as manager, even for cause. Moreover, MB Parent had virtually no rights over Liberty's actions or its billion dollars of cash. Liberty's bylaws specifically provided that its manager (*i.e.*, Times-Mirror) owed no fiduciary duty to its members (*i.e.*, MB Parent), and only owed a fiduciary duty to the owner of the common stock of its member (*i.e.*, Times-Mirror).

Perhaps aware that this fiduciary duty provision was unusual and possibly contrary to law, the participants engaged the law firm of Richards, Layton & Finger to prepare an opinion that provided that a court "would" uphold this arrangement. [*Tribune*, at 76.] As most readers know, this level of confidence is almost unheard of in a tax opinion. Perhaps corporate lawyers can issue "would" level opinions with more ease than tax lawyers.

Of course, whether a court would actually embrace this arrangement was not the issue in this case. Nevertheless, the court did note *in dicta* that the effect of the fiduciary duty

language was uncertain. [*Id.,* at 125.] Although only *dicta,* this hardly sounds like language describing a "would" opinion.

Confusion?

This might be a good time to take a break, stretch your legs and get a cup of coffee. Readers may want to review those last few paragraphs again. Take courage that you're not the only one who was initially confused by the Domestic Sandwich. Even Times-Mirror's investment advisor, Goldman Sachs, couldn't digest the entire sandwich at first. Goldman Sachs presented a Fairness Package which contained a reference to the parties making a Code Sec. 338(h)(10) election for Sheppard's, even though only 50 percent of the stock of Sheppard's was sold. [*Tribune,* at 34.] Not only does it seem that Goldman Sachs missed this basic point, the court seems to have missed it too.

The extreme complexity also led recent commentators to miss details, or completely punt on discussing them. Surprisingly, even Lee Sheppard, one of the tax world's most astute commentators, got tripped up. In her recent summary of the decision, she noted that Times-Mirror was the "controlling shareholder" of MB Parent. [Lee A. Sheppard, *News Analysis: Corporate Planning and Tax Shelters*, 2005 TNT 195-7 (Oct. 10, 2005).] Yet, while Times-Mirror owned all of MB Parent's common stock (indirectly through TMD), it only had 20 percent of the vote, which hardly makes it the controlling shareholder. Other commentators have altogether punted on attempting to convey the details. [*See* RIA's *Federal Taxes Weekly Alert,* Oct. 6, 2005, at 473.]

What the Participants Said

The court found it telling how the participants internally described the transaction. In fact, it repeated long stretches of deal memos, noting that it could not improve on their descriptions. For example, Ernst & Young contemporaneously recorded the following:

> Times Mirror has entered into an agreement with Reed for the sale of Bender for $1.375 billion … The sale of Bender is structured as a reorganization in which the $1.375 billion proceeds from the sale will end up in an LLC … Through the various shareholder agreements, certificates of incorporation and the LLC management agreement, Times Mirror has total control over the assets and operations of the LLC and Reed has total control over the assets and operations of Bender. The structure is designed to result in no tax due by Times Mirror on the profit from the sale of Bender.
>
> Times Mirror controls the assets of the LLC through the management agreement, which specifically states that Times Mirror has no fiduciary duty to [its member] and may use its discretion as to the use of the assets. Times Mirror may have the LLC buy its own debt instruments or Times Mirror stock, make business acquisitions or any other transaction to the benefit of Times Mirror. The only limitation is that Times Mirror may not upstream LLC assets to itself.
>
> Times Mirror has the ability to ensure that the Board of Directors of MB Parent may not do anything that may affect the control or viability of the LLC. Certain board actions require the unanimous vote of the Board. These include:
>
> 1. the incurrence of indebtedness or guarantees of indebtedness of MB Parent
> 2. the sale, transfer or other disposition, pledge or assignment of any portion or all of its LLC interest
> 3. the issuance of any other securities of MB Parent
>
> All of these factors indicate that Times Mirror not only controls the assets of the LLC, but also is the beneficiary of all of the ownership risks and rewards of the LLC. [*Tribune,* at 114.]

PwC gave the Times-Mirror board the same message but with an additional statement about future separation:

> At some later date and upon mutual agreement, the Bender and MB Parent preferred stock can be redeemed at face value and the nonvoting common [*sic*—this was later changed to be nonvoting preferred due to fiduciary duty concerns that could surround common stock] can be redeemed at a formula price, which would leave [Reed] as the sole owner of Bender and Times Mirror as the sole, and controlling owner of MB Parent, with the ability to liquidate MB Parent and the LLC without a tax cost. [*Tribune,* at 113.]

The second part of this article, in the January 2006 issue of the M&A TAX REPORT, will discuss the IRS audit of Times-Mirror and the subsequent litigation.