***Tribune Co. v. Commissioner of Internal Revenue,* 2005 U.S. Tax Ct. LEXIS 28; 135 T.C. No. 8 (Sept. 27, 2005)**

The U.S. Tax Court takes nearly 70 pages to establish the facts of this complicated corporate transaction—but disposes of the primary issue (and the multiple expert reports that went along with it) in fewer than three. The Court even admitted that it was reviewing the expert evidence "for completeness" sake, as all the complicated valuation theories simply couldn't stand up to "commonsense."

Tribune Co. tries for a "reverse triangular merger"

In 1998, the Times Mirror Company, the predecessor in interest to the Tribune Company, wanted to divest itself of a subsidiary, Matthew Bender & Co., Inc., a legal publisher. It found a willing buyer in Reed Elsevier, a publishing powerhouse which had just merged with Wolters Kluwer, NV. To avoid the enormous taxable gains that would result from an outright sale of its holdings, Times Mirror, on the advice of its Price Waterhouse accountants, intended the Bender transaction to qualify as a tax-free "reverse triangular merger" under Section 368 and related provisions of the Internal Revenue Code (concerning corporate reorganizations).

To simplify what sounds like a difficult gymnastic maneuver, a reverse triangular merger involves the buyer and seller creating a special purpose corporation (in this case, the MB Parent), which controls a merger subsidiary (Merger Sub), which in turn merges with and into the target corporation (Bender). As a result of Bender's merger into the acquisition subsidiary, Times Mirror would own all of the common stock and 20% voting power of MB Parent, while Reed would own nonparticipating preferred stock with 80% control.

Although Times mirror would not control the parent, it would hold a nonvoting interest in a single-member LLC, created to hold the cash payment for Bender. In layman's terms—and as Times Mirror reported to its Board of Directors, "the Price Waterhouse structure separates ownership and control, so that the acquiring company [Reed] controls Matthew Bender and Times Mirror controls an amount of cash equivalent to Mathew Bender's value, but without having paid a tax for the shift in control."

Or so they hoped: The amount of cash for the "shift in control" totaled $1.375 *billion.* The total tax deficiency, which the IRS later asserted against Tribune Co. and its successor, claiming that the transaction failed to qualify as a tax-free reorganization, totaled $551,510,819.

The value of management control uncoupled from common stock

Specifically, the IRS argued that under §368, the gain on the transaction was taxable unless the fair market value of its qualifying consideration, the MB Parent common stock, was at least equal in value to a "controlled block" (80%) of Bender stock. The parties agreed that this meant the MB Parent Common stock must have had a value of $1.1 billion for the transaction to qualify as a reverse triangular merger.

“Not surprisingly,” the Court noted, “the parties differ significantly in their descriptions of the Bender transaction” and their valuations of the MB Parent common stock. Tribune Co. argued that the transaction documents “conclusively” provided that the stock was worth $1.375 billion. But that was merely a recital consistent with the intended tax effect, the Court said, and instead, it would consider all governing documents as well as the contractual realities to determine whether the MB Parent common stock had the requisite value for purposes of §368.

The facts clearly “compelled” the conclusion that Times Mirror considered the MB common stock far less valuable than its management authority over the cash in the LLC, which represented the bulk of the consideration. “Nevertheless,” the Court said, it would examine the proffered expert testimony just to round out its ruling.

Both parties try net asset approach

Of the several experts who testified for Tribune Co., the Court highlighted that of Professor Michael Bradley (Duke University), who used a net asset value approach to determine that MB Parent's common stock was worth $1.375 billion. Using an “avoided costs approach,” Bradley determined that the management authority might have a fair market value ranging from $9.2 million to $44.1 million. Bradley did not consider, however, the contractual aspects of the Bender transaction, and assumed—“contrary to any reasonable expectation or contractual possibility,” according to the Court, the immediate dissolution of the MB Parent, Bender, and the LLC as of the transaction date. Bradley also asserted that the management authority had *no* value when uncoupled from economic ownership of the MB Parent common stock.

The IRS experts, however, had each valued the management authority uncoupled from the MB Parent common stock. The first, Professor Alan C. Shapiro (USC), also used a net asset approach to value the separate elements at the time of the merger. He examined the corporate governing documents and contractual arrangements, and substantially discounted the value of MB Parent's commons stock for lack of control over the assets. Using various assumptions, such as net value of MB Parent's assets after liabilities and scope of fiduciary responsibilities by the manager, Shapiro concluded that the fair market value of the MB Parent Stock ranged from a negative number, through worthless, to a maximum of $337 million.

The IRS also presented a “game theory” analysis by Professor William R. Zame (UCLA), who admitted this approach did not produce a value equal to fair market value. However, he did recognize that:

[because] the common stock of MB parent represents a derivative claim to the resources of [the LLC], by analyzing the nature of that derivative claim it is possible to dermine the amount a rational, well-informed investor might be willing to pay for this claim, keeping in mind that there are other competing claims to the resources of [the LLC]. It is value in this sense that this report estimates.

Zame applied probabilities to various assumptions and determined that the most plausible estimates of the value of the MB Parent stock was as a fraction of the LLC's asset values. His conclusion: the “upper bounds of the stand-alone value” of the MB Parent common stock ranged from .595 to .800 of the value of the LLC.

Finally, the last reported IRS expert, Professor Michael J. Barclay (Univ. of Rochester), addressed the value of the management authority from a financial standpoint. Barclay also considered alternative assumptions about fiduciary duty and concluded that, with out such a duty from the manager to the LLC, the MB Parent, or the MP Parent stockholder, that the management authority would have a value approaching $1.375 billion. Assuming a fiduciary duty, Barclay stated that the management authority would be worth 40% of the $1.375 billion.

In response, Tribune Co. argued that the IRS experts assumed rights that did not exist, primarily a hostile, unrelated manager with unrestrained authority over the common stock. Management authority was “an uncompensated obligation,” it said, and not an asset, which Times Mirror held as the “residual claimholder” of the $1.375 billion in the LLC.

Court says both sides ignore facts

“It is indeed unlikely that the authority of Times Mirror under the management agreement would be separated from…ownership of the MB Parent common stock in the real world,” the Court observed. However, “Times Mirror and its advisers created the scenario that makes it necessary to value the MB Parent Common stock at least as a portion of the total consideration” underlying the Bender transaction. To support its argument, Tribune Co. was asking the Court to effect a “fictional separation” of the MB Parent stock and the management authority. It also criticized the IRS experts for precisely what it asked of its own—that is, to overlook relevant facts concerning the property they valued.

In the end, “we need not determine actual value of the MB Parent Stock,” the Court said, “only proportionate value; i.e., whether the stock represents 80% of the total consideration paid by Reed.” Although it would be possible to engage in “interminable” arguments over the various expert analyses, “to do so would serve no useful purpose, because it would not affect the commonsense conclusions that (1) the MB Parent common stock cannot be isolated and treated as the sole consideration…and (2) the common stock of MB Parent, objectively, had a value less than $1.1 billion and less than 80% of the $1.375 billion paid by Reed.”

But you can't blame the parties for trying—not when more than $550 million was at stake, and when overall excellent expert testimony does make the record of this complicated transaction complete.