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The Emerging Role of the Federal Tax Law in Regulating Hostile Takeover Defenses: The New Section 5881 Excise Tax on Greenmail

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THE EMERGING ROLE OF THE FEDERAL TAX LAW IN REGULATING HOSTILE CORPORATE TAKEOVER DEFENSES: THE NEW SECTION 5881 EXCISE TAX ON GREENMAIL

*Eric A. Lustig**

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> Why are they drawn to these battles . . . ? The challenge of the chess game partly. The thrill of battle. Greed, of course. Like professional mercenaries, most are for hire by either side. They fight their campaigns in an arena rampant with white knights, poison pills, springing warrants, and hostile front-end loaded bust-up tender offers. And they are in it to win.[1]

I. INTRODUCTION

The United States is in the midst of its fourth major merger and acquisition boom of the twentieth century.[2] Depictions of battles for corporate control more closely resemble guerilla warfare than the com-

1. M. JOHNSTON, TAKEOVER 1-2 (1987) (describing the takeover "warriors" of Wall Street).

2. COUNCIL OF ECONOMIC ADVISERS, THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISERS in ECONOMIC REPORT OF THE PRESIDENT TRANSMITTED TO THE CONGRESS 192 (Feb. 1985). The first three waves peaked respectively at the beginning of the twentieth century, during the five year period preceding the Great Depression of the 1930s, and during the late 1960s and early 1970s. *Id.*; *see also* D. RAVENSCRAFT & F. SCHERER, MERGERS, SELL-OFF, & ECONOMIC EFFICIENCY 21 (1987).

plicated contests actually taking place in the nation's financial markets and courtrooms. Of all the current business combinations, public attention has focused largely on "hostile takeovers," which occur when corporate management resists acquisition by outside parties.

Management of the corporation under attack in the hostile takeover attempt (the "target") often undertakes a defensive strategy to thwart the acquirer. One of the most controversial takeover defenses is the payment of "greenmail"[3] to the bidder. The target prevents the hostile takeover by repurchasing shares held by the bidder at a premium over the market price.[4]

There are three main criticisms of greenmail. First, it is unfair to the remaining shareholders whose shares are not cashed out at a premium. Second, it entrenches existing management. Finally, it is an ineffective takeover defense because the payment of greenmail to one "raider" does not ensure that a second greenmailer will not emerge.[5] Some commentators defend greenmail payments as ultimately benefitting all target shareholders by "actually improv[ing] the price shareholders receive in tender offers by facilitating an auction market for a firm's stock."[6] These defenders of greenmail further argue that payments provide "an efficient means of compensating those who supply valuable information to the market (or the firm) about the value of a firm's stock."[7]

Historically, greenmail has been subject to judicial review and more recently state legislative control.[8] Prior to the Tax Reform Act of 1986[9] and the Omnibus Budget Reconciliation Act of 1987,[10] federal tax law generally has not affected greenmail payments. In one case, however, a court allowed a corporation a full current deduction for repurchasing its own stock.[11] This general tax neutrality ended,

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3. Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13 (1985); Comment, *Greenmail: Can the Abuses be Stopped?*, 80 NW. U.L. REV. 1271, 1274 (1986).

4. Macey & McChesney, *supra* note 3, at 13 n.1; Comment, *supra* note 3, at 1275. The term greenmail originates from "its similarity to blackmail and the use of a cash payment ('green') for the shares." Comment, *supra* note 3, at 1275.

5. *See* R. FERRARA, M. BROWN, J. HALL & J. RICHMAN, TAKEOVERS ATTACK AND SURVIVAL: A STRATEGIST'S MANUAL 413 (1987) [hereinafter R. FERRARA & M. BROWN].

6. Macey & McChesney, *supra* note 3, at 15.

7. *Id.*

8. *See infra* notes 71-81 and accompanying text.

9. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 [hereinafter "the 1986 Act"].

10. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 [hereinafter "the 1987 Act"].

11. Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966). *See also infra* notes 137-40 and accompanying text (discussion of tax treatment prior to the 1986 Act).

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though, in two stages. First, section 162(l)(1), as added by the 1986 Act, disallows any deduction "for any amount paid or incurred by a corporation in connection with the redemption of its stock."[12] Second, the 1987 Act added section 5881, which levies a 50 percent excise tax on the receipt of greenmail.[13] These excursions by the tax law into the arena of hostile takeovers and greenmail payments raise policy questions as to whether federal tax law should regulate hostile takeovers by regulating certain hostile takeover defenses.

This paper does not focus on the propriety of greenmail but rather examines the role of tax law in regulating hostile takeovers, particularly greenmail. It begins with a general survey of hostile takeovers and takeover defenses, as well as the general effect of federal tax law on takeovers and defenses. It then addresses section 5881. First, it examines the statutory requirements. Then, it analyzes the underlying policy, focusing on the propriety of using the Internal Revenue Code to discourage certain economic and social behavior. The paper concludes that the use of federal tax law to discourage greenmail transactions violates tax policy goals, and such violations are not justified by this overly broad, punitive statute.

II. HOSTILE TAKEOVERS AND THE USE OF GREENMAIL

A. *Hostile Takeovers Generally*

Mergers of publicly held companies generally occur because "both buyers and sellers consider themselves to be better off from the merger transaction than without it."[14] Management of the corporations involved usually negotiate the merger transaction, and the acquired corporation's management generally recommends the merger to its shareholders for their approval.[15]

Although most mergers are voluntary, some corporate acquisitions result from the takeover process where the acquirer seeks to gain control over the target corporation by making a "tender offer" to the target's shareholders.[16] The takeover process becomes hostile if the target's management opposes the offer.[17]

12. I.R.C. § 162(l)(1) (added by § 613 of the 1986 Act). Except as otherwise noted, all cites are to the 1986 Code, as amended through 1988.

13. *Id.* § 5881(a) (added by § 10228 of the 1987 Act).

14. D. RAVENSCRAFT & F. SCHERER, *supra* note 2, at 2.

15. *Id.* at 68.

16. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 568 (1983).

17. D. RAVENSCRAFT & F. SCHERER, *supra* note 2, at 68.

1. Hostile Takeover Mechanics

A hostile takeover often begins when a potential acquirer identifies a publicly traded stock that the market is undervaluing.[18] Then, the potential acquirer generally buys up to 5 percent of the target's outstanding stock on the open market. The potential acquirer can generally accomplish a 5 percent purchase anonymously. Thus, this limited purchase does not significantly affect the market price of the stock.[19]

Once the potential acquirer reaches 5 percent ownership, section 13(d) of the Securities and Exchange Act of 1934[20] requires the filing of certain disclosures with the Securities and Exchange Commission ("SEC"). The acquirer must make required disclosures within ten days of reaching the 5 percent threshold. The disclosures must include the percentage of the filer's ownership in the corporation and any plans to liquidate, sell, merge, or otherwise change the corporate structure,[21] as well as any takeover plans. This ten day "window" before disclosure allows the acquirer to purchase additional stock anonymously before the market adjusts to the SEC filing and the public's expectation that a takeover might occur.[22] After the SEC filing, many shareholders will sell if the stock's market price rises in anticipation of a takeover. The purchasers of this stock are often "risk arbitrageurs" whose "objective is generally to earn a profit of a few points per share based on the difference between the ultimate takeover price and the market price for the stock after it is known that a takeover attempt is imminent."[23]

After reaching the 5 percent "toehold,"[24] the potential acquirer might either hold the stock, engage in a friendly advance to the target's management (affectionately known as a "bear hug strategy"[25]), or com-

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18. JOINT COMM. ON TAXATION, 99TH CONG., 1ST SESS., TAX TREATMENT OF HOSTILE TAKEOVERS: HEARINGS BEFORE THE SUBCOMM. ON TAXATION AND DEBT MGMT. 18 (Comm. Print 1985) [hereinafter TAX TREATMENT OF TAKEOVERS HEARINGS]. Undervalued is defined as "trading . . . below underlying net asset value." *Id.*

19. *Id.* at 19.

20. 15 U.S.C. § 78m(d) (1982 & Supp. 1988). This provision is part of the Williams Act, which was enacted in 1968 to "alert the marketplace to every large, rapid accumulation of securities . . . that might represent a shift in corporate control." R. FERRARA & M. BROWN, *supra* note 5, at 40-41.

21. 15 U.S.C. § 78m(d) (1982 & Supp. 1988).

22. *See* TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18, at 19.

23. *Id.* It is important to note that the risk arbitrageur is not a historic shareholder and is mainly interested in seeing that the takeover is ultimately accomplished by someone. *Id.* at 20.

24. *See* F. FERRARA & M. BROWN, *supra* note 5, at 37.

25. *Id.* at 64.

mence a "tender offer."[26] A tender offer involves a public offer to purchase all or part of the target's outstanding shares at a premium over market price.[27]

2. Takeover Defenses

Management typically opposes takeovers for several reasons. They may believe their corporation has "hidden values," or that such resistance will increase the eventual offer price. They may merely want to protect their jobs.[28] Simply defined, "[t]akeover defenses include all actions by managers to resist having their firms acquired."[29] This broad definition can be classified into two types of takeover defenses: preventative (pre-offer defenses) and reactionary (post-offer defenses).[30]

a. Preventative

Pre-offer defenses are generally used as a protective measure to make a corporation less attractive to a potential acquirer. One such defense is adoption of a "golden parachute agreement." A golden parachute is generally an agreement that "provide[s] for lucrative payments to key executives in the event of change in corporate ownership or control."[31] Because these payments increase the cost of a takeover, golden parachutes presumably discourage takeover attempts. Such arrangements also help attract and retain quality managers to an employment situation that might otherwise be precarious due to takeover risk.[32]

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26. Tender offers are generally regulated by the Williams Act, which amended the Securities and Exchange Act of 1934. *See* The Williams Act, Pub. L. No. 90-439, 82 Stat. 454, *reprinted in* 1968 U.S. CODE CONG. & ADMIN. NEWS 521.

27. R. FERRARA & M. BROWN, *supra* note 5, at 22.

28. Ruback, *An Overview of Takeover Defenses*, in MERGERS AND ACQUISITIONS (A. Auerbach ed. 1988).

29. *Id.* at 49.

30. *Id.* at 53 n.61.

31. Comment, *Golden Parachutes and Draconian Measures Aimed at Control: Is Internal Revenue Code Section 280G the Proper Regulatory Mode of Shareholder Protection?*, 54 U. CIN. L. REV. 1293 (1986).

Presumably, golden parachutes have lost some of their appeal as a result of the Deficit Reduction Act of 1984, which enacted § 280G, disallowing any deduction for excess parachute payments, and § 5999, imposing a 20% excise tax on the recipient of excess parachute payments. *See* I.R.C. §§ 280G, 4999, as added by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 67(a), (b)(1), 98 Stat. 494, 585-87 [hereinafter the "1984 Act"]. *See also infra* notes 98-118 and accompanying text (discussion of the taxation of golden parachute arrangements).

32. Comment, *supra* note 31, at 1295-96.

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Another pre-offer defense is the use of "shark repellants." These are amendments to the target's articles of incorporation and bylaws intended to discourage hostile takeovers.[33] One common amendment is a "super-majority provision,"[34] which increases the percentage of shares otherwise required to approve transactions such as mergers. Alternatively, some corporations adopt "fair price amendments,"[35] which require the bidder to pay the same price to all tendering shareholders.

The most recent, and perhaps most controversial, preventative defense is the "poison pill."[36] Although actual plans vary,[37] the basic plan requires that a corporation declare a dividend to its common shareholders. The dividend provides either a right to buy additional shares of stock of the issuing corporation or of any hostile bidder for the issuer. Stockholders may exercise the rights generally on announcement of a hostile tender offer. When the rights are issued, the exercise price is higher than the market price of the underlying stock. The "poison" is injected when the bidder seeks to complete a merger after acquiring a large portion of the target. The holders of the rights would then be entitled to exchange each right for a greater value of the target's or the bidder's common stock.[38] Accordingly, the bidder dilutes its own equity as it acquires stock subject to a poison pill.[39]

b. Reactionary

Once the takeover bid has been threatened or actually made and the target's management has decided that the offer is inadequate, management will take any of a number of post-offer defensive measures to fight off the bidder.

The payment of "greenmail" is among the most controversial reactionary defensive measures.[40] Greenmail, or "targeted stock repur-

33. Comment, *supra* note 3, at 1273 n.17.

34. *See id.*

35. These amendments are aimed at preventing "two-tier tender offers" where the first tier price is substantially higher than the second. Such a tender offer results in the bidder effectively paying a price between the tiers because most shareholders tender early as a result of the incentive of receiving the first tier price, and the bidder accepts the shares on a pro rata basis. Ruback, *supra* note 28, at 58.

36. *See id.* at 59.

37. "Poison pills come in different packages but contain essentially similar toxins." R. FERRARA & M. BROWN, *supra* note 5, at 200.

38. *Id.* at 200-01. For example, the exchange rate might be 2 to 1. *Id.* Under such terms, $100,000 worth of common stock of the target can be exchanged for $200,000 of the bidder's common stock. *See id.*

39. *Id.* at 201.

40. COUNCIL OF ECONOMIC ADVISERS, *supra* note 2, at 209; *see supra* notes 3-4 and accompanying text.

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chase,"[41] is the target's payment for the repurchase of shares held by a potential acquirer.[42] A target pays to eliminate a threatening shareholder or to avert a hostile takeover.[43] Increased use of greenmail as a takeover defense is attributed to the growing trend of "corporate raiders" gaining large "toeholds" in potential targets through open market purchases until they attain a threatening position.[44]

A "standstill agreement" is a defense closely resembling greenmail. The payment, however, is not for the repurchase of shares. Rather, it is for a contractual agreement between the potential acquirer and the target that limits the former's ownership for a specified period of time.[45] This defense also differs from greenmail because the bidder in a standstill agreement may continue the takeover attempt after the expiration of the agreement.

Another common reactionary defense is the use of a "white knight." In order to defeat the bid by a hostile bidder, the target persuades a third party to merge with it, or make a competing tender offer to the shareholders.[46] The target may prefer merger with the white knight over the hostile bidder for a variety of reasons. For example, the white knight might make a better offer or be better suited to run the business.[47]

B. *Greenmail*

1. The Greenmail Controversy

Although most commentators agree that greenmail is harmful, no consensus of opinion exists.[48] The arguments against greenmail focus on its lack of fairness and effectiveness. The concern with fairness relates to use of corporate assets to cash out the potential acquirer at a higher price than the remaining shareholders can obtain on the

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41. *See* COUNCIL OF ECONOMIC ADVISERS, *supra* note 2, at 209; *supra* text accompanying notes 3-4.

42. COUNCIL OF ECONOMIC ADVISERS, *supra* note 2, at 210; R. FERRARA & M. BROWN, *supra* note 5, at 413.

43. R. FERRARA & M. BROWN, *supra* note 5, at 413.

44. Comment, *supra* note 3, at 1275. Such purchases are used to try to avoid the stricter requirements of Williams Act. *Id. See supra* text accompanying notes 18-24 (discussion of obtaining a toehold position).

45. *See* Ruback, *supra* note 28, at 63 (analogizing a standstill agreement to a treaty); Comment, *supra* note 3, at 1274 n.18.

46. L. LOSS, *supra* note 16, at 570.

47. R. FERRARA & M. BROWN, *supra* note 5, at 461.

48. *See* Gilson, *Drafting an Effective Greenmail Prohibition*, 88 COLUM. L. REV. 329, 330 n.3 (1988).

market.[49] Commentators assert this "exploitive" behavior should not be allowed.[50] An SEC study on the effect of greenmail on target stock prices concluded that the non-participating shareholders bear the direct economic burden of the target's payment of greenmail.[51]

Another fairness concern deals with the payment of greenmail in order to "entrench" management's control and preserve their jobs.[52] Empirical evidence indicates that non-participating shareholders suffer from the use of greenmail as an entrenchment device.[53] Therefore, as with the exploitation issue, non-participating shareholders bear the economic burden of the benefits enjoyed by management.

A third criticism of greenmail relates to its effectiveness as a takeover defense. The payment of greenmail to one raider does not necessarily preclude a greenmail attempt by a second raider.[54] This

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49. *See* R. FERRARA & M. BROWN, *supra* note 5, at 413.

50. "From the perspective of the antitakeover forces, greenmailers are the worst example of exploitive, opportunistic players in the market for corporate control, threatening an acquisition that has no efficiency justification (and may impose significant costs) simply to garner short-term gains." Gilson, *supra* note 48, at 331.

51. In a study of eighty-nine cases of targeted repurchases involving publicly traded companies, the SEC found that

> [t]he evidence suggests that non-participating shareholders suffer substantial and statistically significant share price declines upon the announcement of targeted repurchases at premium above market value. The overall impact on share prices from the date the initial foothold position is established to the date the block is repurchased is also negative. The appreciation in stock prices caused by the initial foothold acquisition is more than offset by the decline in stock prices in response to events subsequent to the initial acquisition, on average.
>
> . . .
>
> We conclude that the overall impact of targeted share repurchases on the wealth of non-participating shareholders is negative.

Office of the Chief Economist of the Securities and Exchange Commission, The Impact of Targeted Share Repurchases (Greenmail) on Stock Prices, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,713, at 87,174 (Sept. 11, 1984) [hereinafter "SEC Study on Greenmail"].

52. This theory is called "the managerial welfare theory." *Id.* at 87,179.

53. The SEC also found that

> [t]he possibility that a targeted share repurchase can mutually benefit the incumbent management and the block seller while harming the other shareholders arises because the benefits of changing control flow largely to the non-participating target shareholders. The dissent blockholder benefits through his share ownership by a third-party takeover at a premium. But, the great majority of the benefits go elsewhere, to other target shareholders principally. It becomes possible, therefore, for incumbent management to offer a relatively more lucrative payment to the dissident block-holder, *even if the best interests of all shareholders are served by a change of control.*

Id. (emphasis added).

54. *See* R. FERRARA & M. BROWN, *supra* note 5, at 414 (noting a situation where a target company, after paying off two greenmailers, sought a white knight when a third greenmailer

"double-dipping" occurs because the target's stock price usually declines after the market reacts to the stock repurchase.[55] If the price declines enough, the stock may become undervalued and the entire takeover process can begin again,[56] resulting in another threatened takeover and more greenmail. When this double-dipping occurs, the payment of greenmail appears to be a waste of corporate assets rather than an effective takeover defense.

Other commentators assert, however, that greenmail is not bad and that it even benefits non-participants. The first pro-greenmail argument is that the price increase generated by the bidder's initial purchase is greater than the subsequent price decline resulting from the repurchase.[57] Another pro-greenmail argument is that it creates an "auction market" for the target's stock. Accordingly, greenmail improves the eventual price shareholders receive in a tender offer.[58]

A further justification for greenmail is that it provides market information regarding the target's value and its vulnerability to takeover.[59] Such information might lead to more takeover attempts, with the shareholders receiving the overall net gain of price increases over decreases. Under this theory, greenmail constitutes compensation to the greenmailer for providing information to the market.[60]

2. Current Regulatory Scheme

a. Federal

Presently, federal securities law regulation of greenmail and many of the other takeover defenses is limited to requiring disclosure. Among the amendments to the Securities Exchange Act of 1934 ("1934 Act") made by the Williams Act in 1968, are sections 13(d)[61] and 14(e).[62]

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threatened); Comment, *supra* note 3, at 1276 n.41 (describing an instance where a target company paid a greenmail payment of over $89 million to one greenmailer and less than two months later paid a dissident shareholder another greenmail payment of over $25 million).

55. R. FERRARA & M. BROWN, *supra* note 5, at 413.

56. *See supra* text accompanying notes 18-27 (discussion of the mechanics of a hostile takeover).

57. *See* Ruback, *supra* note 28, at 63. "Overall, the total return associated with these transactions, including the initial investment, intervening events, and targeted repurchase is 7%." *Id.*

58. Macey & McChesney, *supra* note 3, at 15.

59. *Id.*; *see* COUNCIL OF ECONOMIC ADVISERS, *supra* note 2, at 210.

60. Macey & McChesney, *supra* note 3, at 15.

61. 15 U.S.C. § 78m(d) (1982 & Supp. 1988).

62. *Id.* § 78n(e).

These sections are generally applicable to greenmail and other takeover defenses.[63] Section 13(d) requires disclosure within ten days of attaining a 5 percent ownership interest in a publicly traded corporation.[64] Section 13(d) also requires the purchaser to disclose whether it intends to acquire control or make changes in the corporate structure.[65] Consequently, a greenmailer must file this disclosure. Section 14(e) is a general anti-fraud provision aimed at preventing omissions, misstatements of material facts, or other manipulative acts in connection with a tender offer.[66] In addition to enforcing sections 13(d) and 14(e), the SEC uses other disclosure requirements to bring actions against corporations for failing to disclose payment of greenmail.[67]

The limited role of federal securities law on greenmail will increase under proposed legislation. Under some of the bills, shareholders must approve greenmail.[68] Another proposed bill prohibits greenmail entirely.[69] The passage of these and other anti-takeover proposals, however, remains doubtful at the present time.[70]

b. State

i. Judicial Relief

A shareholder may challenge management's decision to pay greenmail in a state court action. Generally, the shareholder's cause of

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63. *See* Comment, *supra* note 3, at 1295.

64. *See* 15 U.S.C. § 78m(d) (1982 & Supp. 1988).

65. *Id.* § 78m(d)(C).

66. *See id.* § 78n(e).

67. The case of *In re BF Goodrich Co.* involved an administrative hearing by the SEC against the BF Goodrich Company for alleged failure to disclose in its annual Form 10-K and proxy statement the payment of $41 million in greenmail (representing a 25% premium) to a limited partnership owned almost entirely by financier Carl Icahn. Exchange Act Release No. 22,792, [1985-1986 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 83,958, at 87,991, 87,992 (Jan. 15, 1986) [hereinafter Exchange Act Release No. 22,792]. The Form 10-K allegations involved § 13(a) of the 1934 Act. 15 U.S.C. § 78j (1982). The alleged proxy violations involved § 14(a) of the 1934 Act. *Id.* § 78n(a). In this action, BF Goodrich offered to settle without admitting or denying the allegation. The SEC accepted this offer. Exchange Act Release No. 22,792, *supra*, at 87,995.

68. *See* H.R. 2172, 100th Cong., 1st Sess. § 5, 133 CONG. REC. H1562-63 (1987); S. 1323, 100th Cong., 1st Sess. § 8, 133 CONG. REC. S7601-02 (1987).

69. S. 1324, 100th Cong., 1st Sess. § 10, 133 CONG. REC. S7666, S7669 (1987).

70. R. FERRARA & M. BROWN, *supra* note 5, at 421. Indeed, even if such legislation passes Congress, the Reagan Administration would likely be in opposition. *See* President's State of the Union Address 28, *reprinted in* TAX NOTES WEEKLY MICROFICHE, Doc. 88-906 (Jan. 25, 1988).

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action is based on a theory of breach of fiduciary duty.[71] Under the common law of most states, corporate directors and management owe a duty of loyalty and a duty of care to the corporation and its shareholders. The twin duties of loyalty and care generally require that directors and management prudently and diligently obtain adequate information for their decisions. Directors must also make the best decision for the corporation.[72] Most state courts treat the decision of whether and how to defend against a takeover as a business decision of the corporation. Accordingly, the "business judgment rule" protects management and directors from liability if they meet their fiduciary duties of loyalty and care.[73] The Supreme Court of Delaware recently articulated the business judgment rule as an

> [a]cknowledgement of the managerial prerogatives of [the target's] directors . . . . It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company . . . . Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[74]

The business judgment rule is generally applicable to the target directors' decision to pay greenmail. In the seminal case of *Cheff v. Mathes*,[75] the Supreme Court of Delaware held that the board of directors of the target corporation were not liable for their decision to repurchase, at a premium, the stock of a shareholder whom the board felt was threatening.[76] Acceptance of the business judgment rule in a greenmail context, however, is not universal. Applying a stricter standard than the traditional business judgment rule, a California court upheld a preliminary injunction prohibiting the payment of green-

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71. R. FERRARA & M. BROWN, *supra* note 5, at 274; Comment, *supra* note 3, at 1278.
72. R. FERRARA & M. BROWN, *supra* note 5, at 276; Comment, *supra* note 3, at 1278.
73. R. FERRARA & M. BROWN, *supra* note 5, at 276-77.
74. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (citations omitted).
75. 41 Del. Ch. 494, 199 A.2d 548 (1964).
76. *Id.* at 508, 199 A.2d at 556 (although the articulated standard was virtually identical to the business judgment rule, it was not labelled as such). For a more recent application of the business judgment rule to greenmail, see Heine v. The Signal Cos., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,898, at 91,311, 91,322 (S.D.N.Y. Mar. 4, 1977) (absolving directors from liability upon showing that there was no evidence that the payment was to protect the directors' position).

mail by Walt Disney Productions to financier Saul Steinberg.[77] Some commentators also criticize application of the business judgment rule to the decision to pay greenmail as being too low a standard. These critics view the rule as an ineffective means of regulating greenmail.[78]

ii. Legislation

Four states have enacted legislation regulating greenmail.[79] Of these states, Arizona, Minnesota, and Wisconsin each prohibit the redemption of stock at a premium from shareholders owning a certain percentage of the corporation unless the shareholders approve.[80] Nevada delegates the regulation of repurchases to a state commission.[81]

The controversial issue of greenmail and its use as a takeover defense is presently subject to regulation by federal securities laws, state courts enforcing fiduciary duties, and a number of state statutes. Many critics, however, view the present scheme as too lenient.

III. THE EFFECT OF FEDERAL TAX LAW ON HOSTILE TAKEOVERS AND TAKEOVER DEFENSES

The controversy surrounding hostile takeovers centers on the perception that such acquisitions are encouraged by federal tax laws.[82] Accordingly, a brief discussion of some of the tax issues involving takeovers and defenses follows.

A. *Taxation of Acquisitions in General*

The initial tax issue in a corporate acquisition is whether the transaction is a taxable or non-taxable event to the acquiring or selling corporation. Taxability largely depends on the form of the transaction, which is a departure from the pervasive doctrine of "substance over form:"[83] "The [Internal Revenue] Code distinguishes among taxable

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77. Heckmann v. Ahmanson, 168 Cal. App. 3d 119, 214 Cal. Rptr. 177 (1985).

78. *See* Gilson, *supra* note 48, at 331 n.5; Comment, *supra* note 3, at 1280.

79. Gilson, *supra* note 48, at 331 n.4. The states are Arizona, Minnesota, Nevada, and Wisconsin. *Id. See infra* notes 80-81 and accompanying text.

80. *See* ARIZ. REV. STAT. § 10-1204A (Supp. 1987) (prohibiting repurchase from over 5% shareholders holding stock for less than three years); MINN. STAT. § 302A.553, subd. 3 (Supp. 1988) (prohibiting repurchases from over 5% shareholders holding for less than six months); WIS. STAT. § 180.725(5)(a) (Supp. 1988) (prohibiting repurchases from over 3% shareholders holding for less than two years).

81. NEV. REV. STAT. §§ 463.512, .516 (Supp. 1987).

82. COUNCIL OF ECONOMIC ADVISERS, *supra* note 2, at 199.

83. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 1.05, at 1-11 (1987) (discusses general application of the substance over form doctrine to the taxation of corporations).

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purchases of common stock, taxable purchases of corporate assets, and tax-free reorganizations for income tax purposes . . . . The applicable tax rules have been criticized on the grounds that economically similar acquisition transactions have different Federal tax consequences depending on their legal form."[84]

To an extent, the Code encourages corporate acquisition via its nonrecognition reorganization provisions. In a voluntary or negotiated acquisition, the acquirer might choose to merge with the target corporation under applicable state corporate law. If a merger meets additional requirements under Treasury Regulations and case law,[85] the transaction will be a type "A" reorganization.[86] Accordingly, the target's shareholders recognize no gain or loss on the exchange of their target stock for the acquirer's stock.[87]

Alternatively, the transaction might be structured as the target shareholders exchanging their target stock for the voting stock of the acquirer. Assuming the non-statutory doctrines are again met, this stock for stock exchange will be a type "B" tax-free reorganization.[88] A typical exchange tender offer of voting stock of the bidder for voting stock of the target would be a "B" reorganization if 80 percent control[89] of the voting power of the target is attained.

A third type of acquisitive reorganization is a type "C" reorganization where the target's assets are acquired in exchange for the voting stock of the acquirer.[90] In this transaction, the target corporation recognizes no gain or loss on the exchange of its assets.[91] Upon the required liquidation of the target corporation,[92] its shareholders recognize no gain or loss on the exchange of the target stock for the voting stock of the acquirer.[93]

Regardless of the acquisition form used, the acquirer recognizes no gain or loss on the exchange of its stock.[94] The nonrecognition of

84. TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18, at 17.

85. *See* Treas. Reg. § 1.368-1 (1988) (as amended in 1980); Treas. Reg. § 1.368-2 (1988) (as amended in 1962).

86. *See* I.R.C. § 368(a)(1)(A).

87. *Id.* § 354(a)(1).

88. *See id.* § 368(a)(1)(B).

89. *Id.* § 368(c).

90. *See id.* § 368(a)(1)(C).

91. *Id.* § 361(a).

92. *Id.* § 368(a)(2)(C).

93. *Id.* § 354(a)(1).

94. *Id.* § 1032.

gain or loss in a reorganization is generally preserved in the basis of the stock received by target's shareholders[95] and in the property or stock received by the acquiring corporation.[96]

B. *Taxation of Hostile Takeovers*

Through its reorganization provisions, federal tax law influences corporate acquisitions as a whole. The Internal Revenue Code (the "Code") does not, however, directly distinguish between friendly acquisitions and hostile takeovers. Thus, to the extent that the Code encourages or subsidizes a type of acquisition, that subsidy extends to friendly as well as hostile takeovers.[97] Although the Code does not directly influence hostile takeovers by distinguishing them from friendly acquisitions, it indirectly influences hostile takeovers by its effect on certain takeover defenses.

1. Golden Parachutes

Prior to the Deficit Reduction Act of 1984,[98] corporations could deduct golden parachute payments as an ordinary and necessary business expense. The only requirement was that the payment be a "reasonable allowance for salaries or other compensation for personal services actually rendered."[99] With the 1984 Act's enactment of sections 280G and 4999, Congress took the first step in using the Code to influence hostile takeover activity. These sections disallow deduction of certain golden parachute payments and impose a 20 percent excise tax on their receipt.[100] The passage of the golden parachute provisions reflected certain congressional concerns. First, because of their use as a takeover defense, golden parachutes hindered acquisition activity and therefore were "strongly discouraged" as a policy matter.[101] A second concern was that golden parachute arrangements caused key executives to place their own interests above interests of their corporations and shareholders. Congress feared that executives would perhaps favor a proposed takeover because of lucrative golden

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95. *Id.* 358(a)(1) (exchange basis).
96. *Id.* 362(b) (transferred basis).
97. TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18, at 5.
98. *See* the 1984 Act, *supra* note 31.
99. I.R.C. § 162(a)(1).
100. *See* the 1984 Act, *supra* note 31, at § 67(a), (b)(1).
101. JOINT COMMITTEE ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 199 (Comm. Print 1984) [hereinafter GENERAL EXPLANATION OF THE 1984 ACT].

parachute payments.[102] Of final importance to Congress was the fear that managers received too great a portion of the overall takeover proceeds at the expense of the shareholders.[103]

Congress addressed these concerns by defining undesirable payments and attempting to discourage them by disallowing deduction by the payor and penalizing the recipient with an excise tax. Accordingly, the golden parachute provisions attempt to implement congressional intent with detailed, precise statutory language. Section 280G generally disallows any deduction for "excess parachute payments."[104] Furthermore, section 4999 imposes a 20 percent excise tax on the receipt of excess parachute payments.[105] An "excess parachute payment" is defined as "the excess of any parachute payment over the portion of the base amount allocated to such payment."[106] "Parachute payments" are compensatory payments paid to "disqualified individuals" under certain contingent circumstances,[107] and certain compensatory payments that are deemed parachute payments because they violate "generally enforced securities laws or regulations."[108] "Disqualified individuals" are defined as those individuals who perform personal services for the payor corporation, as either an employee or independent contractor, and who are an "officer, shareholder or highly-compen-

102. *Id.* at 199-200.

103. *Id.* at 200. Congress's intent can be summarized as follows:

> In almost any takeover situation, be it hostile or friendly, acquiring company in theory will pay a maximum amount and no more. To the extent of that amount, directly or indirectly, must be paid to executives and other key personnel of the target corporation, because of the existence of golden parachutes or similar arrangements, there is less for the shareholders of that corporation. Congress decided to discourage transactions which tended to reduce amounts which might otherwise be paid to target corporation shareholders.

Id.

104. I.R.C. § 280G(a).

105. *Id.* § 4999(a).

106. *Id.* § 280G(b)(1).

107. *Id.* § 280G(b)(2)(A).

108. *Id.* § 280G(b)(2)(B). The Tax Reform Act of 1986 added the "generally enforced" modifier to "securities laws or regulations" and also placed the burden of proof on the government to show a violation. *See* the 1986 Act, *supra* note 9, at § 1804(j). This amendment was intended to limit the applicability of such deemed parachute payments. S. REP. NO. 313, 99th Cong., 2d Sess. 921, *reprinted in* 1986-3 C.B. 921. "[T]he treatment of a securities law violation as a parachute payment does not apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders." JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., EXPLANATION OF TECHNICAL CORRECTIONS TO THE TAX REFORM ACT OF 1984 AND OTHER RECENT TAX LEGISLATION 30 (Comm. Print 1987).

sated individual" of such corporation.[109] Payments are considered parachute payments if they are contingent on a change in control of either the corporation or its assets, and if the present value of the compensatory payments exceeds three times the disqualified person's "base amount."[110] When the agreement is entered into within one year of the change of control, there is a presumption, rebuttable only by clear and convincing evidence, that the agreement is "contingent."[111] In computing parachute payments under section 280G(b)(2)(A) (but not payments deemed "golden parachutes" because they violate securities laws), the amount is reduced to the extent the recipient shows by clear and convincing evidence that the payments are reasonable compensation.[112] Thus through these complicated provisions, the statute attempts to isolate potential abusive transactions from bona-fide transactions.

The Tax Reform Act of 1986 made significant changes limiting the applicability of golden parachute provisions. The first change provided that parachute payments do not include payments to or from qualified employee plans.[113] Congress also exempted corporations that qualify as a "small business corporation" under section 1361(b) immediately before the control change. An additional exemption is provided for a corporation, whose stock is not "readily tradeable on an established securities market,"[114] as long as 75 percent of the outstanding voting power approves the payments after adequate disclosure of all material facts.[115] These amendments reflect Congress's attempts to isolate the abusive situations the provisions were intended to prevent.

The golden parachute provisions are not, however, solely applicable to hostile takeovers.[116] Rather than focusing on a hostile change in control, the provisions require only a change in control, therefore including friendly acquisitions as well as hostile takeovers. Depending on the circumstances, the golden parachute provisions may either encourage or discourage a hostile takeover. For example, if management

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109. I.R.C. § 280G(c)(2)(A). "Highly compensated" is defined as being in either the highest paid 1% of employees or the highest paid 250 employees. *Id.*

110. *Id.* § 280G(b)(2)(A). Generally, "base amount" is the disqualified individual's average salary for the five years preceding the change in control. *Id.* §§ 280G(b)(3)(A), (d)(1),(2).

111. *Id.* § 280G(b)(2)(C).

112. *Id.* § 280G(b)(4).

113. *See id.* § 280G(b)(6)(as added by § 1804(j) of the 1986 Act). The employee plans referred to are under I.R.C. §§ 401(k), 403(a), 410(a).

114. *See* GENERAL EXPLANATION OF THE 1984 ACT, *supra* note 101, at 199.

115. *Id.* § 280G(b)(5) (as added by § 1804(j) of the 1986 Act).

116. *See* GENERAL EXPLANATION OF THE 1984 ACT, *supra* note 101, at 200.

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favors an acquisition of its company because of the lucrative golden parachute payoff,[117] then acquisition becomes less favorable to the acquirer, who can no longer deduct the payment, and the managers, who must pay an additional 20 percent tax and accordingly receive a lesser amount. On the other hand, if the golden parachute plan is being considered strictly as a takeover defense,[118] then these provisions will make golden parachutes a less attractive defense. Theoretically, this favors the acquirer in a hostile takeover by reducing the target's available defenses.

2. Poison Pills

Another takeover defense influenced by the Code is the "poison pill" plan. In a poison pill plan, target shareholders have the right to purchase stock of the issuer or an acquirer at a big discount in the event of a takeover.[119] Several potential tax issues arise from the use of a poison pill plan.[120] The first issue involves the adoption of the plan, which is typically structured as a dividend to the common shareholders of the poison pill right or warrant.[121] Because the rights are highly contingent, speculative, non-transferable, and non-exercisable, an issue arises as to whether or not the rights even constitute property.[122] If the rights are considered property, then the Code treats distribution of the stock rights as a tax-free distribution by the corporation of its own stock[123] to its shareholders with respect to their stock.[124]

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117. *See supra* note 31 and accompanying text.

118. *See supra* text accompanying note 32.

119. *See supra* text accompanying notes 36-39.

120. Dionne, *IRS Ruling that Poison Pills Bar Some Tax-Free Reorganizations Stirs Controversy*, 39 TAX NOTES (TAX ANALYSTS) 679, 680 (May 9, 1988).

121. Rosen, *Selected Target Defense Strategies*, in TAX STRATEGIES FOR LEVERAGED BUYOUTS AND OTHER CORPORATE ACQUISITIONS AND FINANCINGS 237, 251-53 (1986).

122. *Id.* at 253-54. If the rights are not property, then they are treated as a new term of the outstanding common stock contingent upon the occurrence of subsequent events. *Id.* Consequently, shareholders have nonrecognition of tax as either an exchange of stock in a tax-free recapitalization, I.R.C. § 368(a)(1)(E) (1988), or as an exchange of outstanding common for new common with this contingent term. *Id.* at § 1036(a); *Rosen, supra* note 121, at 254.

123. Section 305(d)(1) provides that stock includes rights to acquire a corporation's stock. I.R.C. § 305(d)(1); *see also* Dionne, *supra* note 120, at 682 (stating corporate tax bar's belief that the rights are a new attribute of outstanding common stock); Rosen, *supra* note 121, at 254 (even if rights were treated as property, distribution of rights would be a non-taxable distribution under I.R.C. § 305).

124. I.R.C. § 305(a) generally provides for nonrecognition of a stock distribution by a corporation of its own stock to its shareholders with respect to their stock. I.R.C. § 305(a).

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Notwithstanding the issues concerning the adoption of a poison pill plan, a more severe problem arises if the pill is determined to be property. For purposes of a type "B" or "C" reorganization, the poison pill property rights might be considered "boot." Boot is property other than voting stock and therefore impermissible consideration in both type "B" and "C" reorganizations.[125] Therefore, a corporation with an outstanding poison pill plan may not be allowed to use its common stock to acquire other corporations and qualify as a type "B" or "C" reorganization.[126] For example, in a recent private letter ruling,[127] a publicly traded corporation with a poison pill plan attached to its common stock sought to acquire a target corporation through a "reverse triangular merger"[128] form of tax-free reorganization. In the reorganization, one of the acquirer's subsidiaries was merged into the target. The target shareholders received the acquirer's common stock (including the poison pill), and the acquirer received target stock from its subsidiary. The IRS held that the proposed transaction qualified as a reorganization, despite the fact that the poison pill rights were property and taxable as boot.[129] The real concern raised by this letter ruling is that treatment of poison pill rights as property other than stock will disqualify a type "B" and possibly a type "C" reorganization.[130] A type "B" reorganization would be disqualified because it requires the acquirer's voting stock be the sole consideration in ex-

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125. Rosen, *supra* note 121, at 261. Although any amount of boot will disqualify a "B" reorganization, a limited amount of boot is permitted in a "C" reorganization. I.R.C. § 368(a)(2)(B).

126. Dionne, *supra* note 120, at 679; Rosen, *supra* note 121, at 261.

127. Priv. Ltr. Rul. 88-08-081 (Dec. 3, 1987), I.R.S. Ltr. Rulings Rep. (CCH) No. 575 (Mar. 7, 1988). Although private letter rulings are only binding on the party requesting them and may not be used or cited as precedent according to I.R.C. § 6110(j)(3), such rulings are often helpful in predicting the Internal Revenue Service's interpretations on provisions and has been used by courts in such a manner. *See* M. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 3.03, at 3-45 (1981).

128. *See* I.R.C. § 368(a)(2)(E); *see also* B. BITTKER & J. EUSTICE, *supra* note 83, ¶ 14.15, at 14-62 (further discussion of reverse triangular mergers).

129. Priv. Ltr. Rul. 88-08-081 (Dec. 3, 1987), I.R.S. Ltr. Rulings Rep. (CCH) No. 575 (Mar. 7, 1988). Boot is generally a consideration that is not stock or securities and therefore does not generally qualify for non-recognition treatment. B. BITTKER & J. EUSTICE, *supra* note 83, ¶ 14.31, at 14-117. Boot is generally allowed in an otherwise qualified reorganization although the recipient of boot is taxed. I.R.C. § 356(a)(1). In the instant letter ruling, the value of the rights was so small due to the contingent nature of the plan that the gain was probably *de minimis*. Dionne, *supra* note 120, at 681.

130. Dionne, *supra* note 120, at 680; Schmedel, *Poison-Pill Rights May Add a Taint of Tax to Stock in Takeovers*, Wall St. J., Apr. 6, 1988, at 1, col. 5.

change for the target's stock.[131] For purposes of a "B" reorganization, "solely for voting stock" means solely for voting stock and stock rights; warrants are not stock.[132] Although a "C" reorganization also has a solely for voting stock requirement,[133] the statutory "boot relaxation rule"[134] allows a limited amount of consideration other than voting stock to be used in a "C" reorganization. Accordingly, a "C" reorganization is less likely than a "B" reorganization to be disqualified by the acquiring corporation's use of common stock with poison pill rights attached.

In response to pressure from corporate lawyers, the Internal Revenue Service ("IRS") announced that it would regard the adoption of a poison pill as a tax-free event. Furthermore, the IRS will not treat poison pill rights as separate property for purposes of section 368.[135]

3. Greenmail

Prior to the Tax Reform Act of 1986, there was an issue as to the deductibility of greenmail payments by a target corporation for the repurchase of its stock from a corporate raider. Although a corporation's repurchase of its own stock is generally a non-deductible capital expenditure,[136] deductions were allowed in extraordinary circumstances. In *Five Star Manufacturing Co. v. Commissioner*,[137] a corporation repurchased the shares of a 50 percent shareholder. The consideration used for the repurchase was a judgment for the corporation against the shareholder.[138] The Fifth Circuit Court of Appeals allowed the corporation a current deduction for the repurchase as an ordinary and necessary business expense.[139] In reaching its holding, the court found that had the redeemed shareholder not been removed, the corporation would have been forced into liquidation; consequently,

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131. *See* I.R.C. § 368(a)(1)(B).

132. Helvering v. Southwest Consol. Corp., 315 U.S. 194, 198-99 (1942).

133. I.R.C. § 368(a)(1)(C).

134. *Id.* § 368(a)(2)(B).

135. Sheppard, *IRS Will Allow Tax-Free Creation of Poison Pills*, 41 TAX NOTES (TAX ANALYSTS) 258 (Oct. 17, 1988); *see also* New York State Bar Association, *N.Y.S.B.A. Tax Section Considers Tax Treatment of "Poison Pills,"* 14 TAX MGMT. WASH. TAX REV. 139 (Sept. 1988).

136. JOINT COMM. ON TAXATION, 100TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 277 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION OF THE 1986 ACT].

137. 355 F.2d 724 (5th Cir. 1966).

138. *Id.* at 725.

139. *Id.* at 727.

there would have been insufficient assets for the corporation to meet its obligations.[140]

Although other courts have limited the holding of *Five Star*,[141] many target companies apparently deducted greenmail payments under the authority of *Five Star*.[142] Congress became concerned that greenmail payments were being deducted as ordinary and necessary business expenses.[143] In the 1986 Act, Congress added a new section to specifically disallow deductions for amounts paid by a corporation to redeem its own stock.[144] Congress intended this provision to be construed broadly enough to include such transactions as standstill agreements.[145] Payments discharging certain contractual obligations, such as settlement of litigation, however, are beyond the scope of the provision if the corporation can show the payments are not in consideration for the shareholder's stock or related expenses.[146] In addition to covering the payment for stock and related premiums, Congress intended the provision to apply to all related fees and expenses.[147]

As with golden parachute provisions, disallowance of redemption expenses is not just applicable to hostile takeovers. Although it is instead intended to apply to all redemptions, the provision clearly affects hostile takeovers. The economic cost to a target paying greenmail is now increased because of the loss of the possible tax savings created by the former tax deduction. Accordingly, to the extent greenmail as a takeover defense is economically less attractive, the Code adversely influences the decision to pay greenmail.

The income tax consequences to the greenmail recipient depend on the form of the transaction. If greenmail is in the form of a redemption, it will either be treated as a sale or exchange or treated as a distribution.[148] Treatment depends on how much stock is redeemed, the greenmailer's relationship with the target, and the greenmailer's relationship with the target's shareholders after redemption. Assuming all of the greenmailer's stock is redeemed, the transaction will gener-

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140. *Id.*

141. GENERAL EXPLANATION OF THE 1986 ACT, *supra* note 136, at 277 n.8.

142. *Id.* at 277; Forman, *Using the Tax Code to Fend Off Corporate Takeover 'Sharks'*, 26 TAX NOTES (TAX ANALYSTS) 1162, 1164 (Mar. 18, 1985).

143. GENERAL EXPLANATION OF THE 1986 ACT, *supra* note 136, at 277-78.

144. I.R.C. § 162(l) (added by § 613 of the 1986 Act).

145. *See supra* text accompanying note 45 (discussion of standstill agreements).

146. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-168, -169, *reprinted in* 1986-3 C.B., 168-69.

147. *See* GENERAL EXPLANATION OF THE 1986 ACT, *supra* note 136, at 278.

148. I.R.C. §§ 302(a), (d).

ally be a sale or exchange of the stock.[149] After reducing the proceeds by the greenmailer's basis in the stock,[150] the greenmailer will have a realized gain or loss.[151] Any gain is generally a capital gain,[152] which was subject to preferential tax treatment prior to 1987.[153] When the greenmail payment is treated as a distribution,[154] the payment is generally taxable to the recipient shareholder as a dividend.[155] If the greenmail payment is structured as a standstill agreement where the shareholder receives payment for refraining from purchasing additional shares for a period of time, then the payment should be gross income to the greenmailer.[156]

IV. SECTION 5881 EXCISE TAX ON GREENMAIL

A. *Prelude to the Enactment of Section 5881*

As a result of congressional concern that federal tax law was somehow influencing hostile takeovers, several takeover-related tax bills were introduced.[157] In 1985, Congress held hearings on the tax treatment of hostile takeovers.[158] The hearings, which were held prior to the passage of the Tax Reform Act of 1986, reflected the particular concern that tax law encouraged greenmail. Congress believed that the target deducted the payment and the greenmailer received preferential capital gains treatment on the receipt of greenmail.[159] This concern was reflected in proposed bills that denied deductions for green-

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149. *Id.* §§ 302(a), (b)(3).

150. Assuming the greenmailer purchased the target's stock, the basis will be the cost, or purchase price. *Id.* § 1012.

151. *Id.* § 1001.

152. *Id.* § 1222. Generally, a greenmailer treats its stock as a capital asset under I.R.C. § 1221, although there is a possible argument that the raider is in the business of greenmail, and accordingly, the stock would not be a capital asset under I.R.C. § 1221(1). Forman, *supra* note 142, at 1164.

153. I.R.C. § 1202 (1986), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514 § 301(c), 100 Stat. 2085, 2216, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 2085, 2216.

154. *See* I.R.C. § 302(d) (1988).

155. *Id.* §§ 301(c)(1), 316(a). A dividend is a distribution by a corporation to its shareholders to the extent of its earnings and profits, as determined under I.R.C. § 312. *See id.* §§ 312, 316.

156. *See id.* § 61(a)(1) (gross income includes compensation received).

157. *See* S. 420, 99th Cong., 1st Sess., 131 CONG. REC. S1151-01 (1985); S. 476, 99th Cong., 1st Sess., 131 CONG. REC. S1579 (1985); S. 632, 99th Cong., 1st Sess., 131 CONG. REC. S2789 (1985); H.R. 100, 99th Cong., 1st Sess., 131 CONG. REC. H410-09 (1985).

158. *See* TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18.

159. *Id.* at 73 (statement of Senator Boren).

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mail payments[160] and imposed an excise tax on greenmail recipients.[161] While subsequent passage of the 1986 Act resolved deductibility issues and repealed capital gain preferences, concern over greenmail remained.

More recently, the Corporate Raider Tax Act of 1987 was proposed

> in response to the spate of hostile takeovers in recent years and the devastation they bring.
>
> Wall Street's merger and acquisition shops are working overtime. These paper entrepreneurs are engaged in a "feeding frenzy." . . . Regrettably, the people who really benefit from hostile takeovers are the raiders, the investment bankers, and the merger lawyers.
>
> . . .
>
> Obviously, this legislation will not stop hostile takeovers, but it will discourage these manipulative raids. It's time that Congress acted to protect American workers, American competitiveness, and the American economy from the greed and crimes of these raiders.[162]

This bill again proposed an excise tax on greenmail to discourage corporate raiders.[163] Congress also proposed broader provisions to discourage hostile takeovers as a whole. These provisions included a mandatory election to step-up the basis of assets acquired for any hostile stock purchase[164] and a denial of deduction for any interest on indebtedness incurred in a hostile purchase of stock or assets.[165]

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160. S. 632, *supra* note 157, at § 2. The IRS had always taken the position that greenmail payments were not deductible and urged the Senate to confirm the IRS's position by statute. TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18, at 118 (testimony of Ronald A. Pearlman, Assistant Secretary (Tax Policy) Department of Treasury).

Presumably the enactment of I.R.C. § 162(l) in the 1986 Act accomplished this concern. *See supra* text accompanying notes 143-47.

161. S. 420, *supra* note 157, at § 1; S. 476, *supra* note 157, at § 1; H.R. 100, *supra* note 157, at § 1.

162. H.R. 2995, 100th Cong., 1st Sess., 133 CONG. REC. E3043 (1987) (statement of the bill's sponsor, Rep. Byron L. Dorgan).

163. *Id.* § 2, at E3044.

164. *Id.* § 3, at E3044.

165. *Id.* § 4, at E3044. The mandatory § 338 election was intended to deprive the hostile acquirer of being able to choose whether or not to increase or "step-up" its basis in the target. While there are circumstances where the election to step-up basis might be beneficial to the acquirer, there are also times when the step-up is not beneficial because of the additional tax liabilities arising from the election. TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18, at 39. Accordingly, by taking the choice away from the hostile acquirer, this provision would make the decision to acquire a corporation in a hostile purchase economically less attractive.

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The proposals made in the Corporate Raider Tax Act of 1987 were included by the House Ways and Means Committee in the Budget Reconciliation Act of 1987.[166] The House Ways and Means Committee clearly intended these provisions to discourage hostile takeovers as a whole:

> The Committee believes that corporate acquisitions that lack the consent of the acquired corporation are detrimental to the general economy as well as to the welfare of the acquired corporation's employees and community. The Committee therefore believes it is appropriate not only to remove tax incentives for corporate acquisitions, but to create tax disincentives for such acquisitions. In addition, the committee believes that taxpayers should be discouraged from realizing short-term profits by acquiring stock in a public tender offer and later being redeemed by the corporation in an effort by the corporation to avert the hostile takeover.[167]

The Senate, however, did not include the hostile takeover provisions from the House version in its version of the Budget Reconciliation Act of 1987.[168] After the Conference Committee reconciled the two versions, only the greenmail excise tax remained in the bill. President Reagan subsequently signed the bill into law.[169]

B. *The Statutory Elements*

1. What is Greenmail?

Section 5881 imposes a 50 percent excise tax on the recipient of greenmail.[170] In order for the excise tax to apply, "greenmail" must exist. The Code defines greenmail as any acquisition that is not made on the same terms to all shareholders. Additionally, the corporation

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The proposed disallowance of the interest expense addressed the concern that many takeovers are financed by "junk bonds" and other risky, highly "leveraged" instruments and that the Code subsidizes hostile takeovers by allowing a deduction for interest. *See* I.R.C. § 163(a).

166. H.R. 3545, 100th Cong., 1st Sess. §§ 10142-10144, in PRENTICE HALL FEDERAL TAXES (P-H Oct. 30, 1987) (as reported by the Ways and Means Comm. on Oct. 26, 1987).

167. H.R. REP. No. 391, 100th Cong., 1st Sess. 1086, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1, 2313-701.

168. *See* SENATE COMM. ON FINANCE, 100TH CONG., 1ST SESS., TAX PROVISIONS OF OMNIBUS BUDGET RECONCILIATION ACT OF 1987 (Comm. Print 1987), *reprinted in* PRENTICE HALL FEDERAL TAXES § 4 (P-H Dec. 10, 1987).

169. I.R.C. § 5881 (added by § 10228 of Pub. L. No. 100-203, § 10228, 101 Stat. 417-18 (1987)).

170. *Id.* § 5881(a).

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must have repurchased its stock from a shareholder who held the stock for less than two years and who made or threatened to make a tender offer.[171]

a. Acquisition

The Code defines greenmail as including "any consideration,"[172] including money and other property. The statute further requires that consideration be for the "acquisition" of the shareholder's stock.[173] Although the statute used the term "acquisition," this clearly includes "redemption" transactions.[174] Additionally, the statute anticipates the use of a related entity, such as a subsidiary of the corporation, to circumvent the acquisition requirement. The Code prevents such circumvention by including "direct and indirect acquisitions."[175]

Unlike the disallowed deduction for redemption payments,[176] the statute apparently does not apply to payments under a standstill agreement. Because such payments are not made for acquisition of the shareholder's stock, they apparently escape the definition of greenmail.[177]

b. Holding Period

The statutory definition of greenmail requires the shareholder to have held the redeemed stock for less than two years.[178] The statute does not provide for the shareholder who acquired blocks of stock over a period of time. Therefore, when the shareholder holds some shares less than two years and other shares longer than two years, the corporation could possibly redeem the stock in two steps. The first step could be a redemption, at a premium, of the older shares.

171. *Id.* § 5881(b).

172. *Id.*

173. *Id.*

174. H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess. 970-71, *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1245, 2313, 1716-17.

175. I.R.C. § 5881(b).

176. *See id.* § 162(l); *see also supra* text accompanying notes 143-46 (discussing disallowance of deductions for redemption payments and standstill agreements).

177. The Technical and Miscellaneous Revenue Act of 1988 [hereinafter "the 1988 Act"] does not appear to change this result because the Act only expands the character of the greenmail that is subject to the excise tax, i.e., the character is expanded from "gain" to "gain or other income." I.R.C. § 5881(a), as amended by Pub. L. No. 100-647, § 2004(o)(A) (1988). The definition of greenmail, however, is still defined to be a result of the acquisition by a corporation of its stock. *See infra* note 194 and text accompanying notes 193-99 for discussion of the 1988 Act.

178. I.R.C. § 5881(b)(1). The holding period is determined under I.R.C. § 1223. *Id.*

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This apparently falls outside of the holding period. The second step could be a redemption on terms available to all shareholders. Of course the IRS would likely challenge such transactions under the "step transaction doctrine."[179]

c. Tender Offer Element

Another element in the statutory definition of greenmail is that at some time during the two year period preceding the acquisition, the shareholder, or a person "related" to or acting "in concert" with the shareholder, must have made or threatened to make a "public tender offer" for the corporate stock.[180] This element apparently adds the hostile takeover taint to the provision. The Code defines "related person" as including certain relationships between persons that result in disallowed losses under the Code.[181] Although not defined in the statute, "in concert" commonly applies to situations where one person "acts with another to bring about some preconceived result."[182] Therefore, a shareholder cannot escape application of this provision by circumventing the "related" provision through use of an "unrelated" accomplice under an agreement.

A more problematic issue is defining a "public tender offer." Public tender offer is defined as "any offer to purchase or otherwise acquire stock or assets in a corporation if such offer was or would be required to be filed or registered with any Federal or State agency regulating securities."[183] The first problem with this definition is that "tender offer" is not statutorily defined under the Securities Exchange Act of 1934:

> Although the Williams Act purports to regulate the making of tender offers for public companies in the United States, *it does not define the term "tender offer."* Similarly, when the SEC issued its rules promulgated under the Williams Act, it also failed to define "tender offer." Consequently, the judiciary has played a significant role in developing a definition of the term, based upon the purposes reflected in the Act's legislative history.[184]

179. *See* B. BITTKER & J. EUSTICE, *supra* note 83, ¶ 1.05, at 1-16.

180. I.R.C. § 5881(b)(2).

181. The referenced Code sections under which the losses would be disallowed are I.R.C. §§ 267, 707(b). *Id.* § 5881(c)(2).

182. BLACK'S LAW DICTIONARY 262 (5th ed. 1979).

183. I.R.C. § 5881(c)(1).

184. R. FERRARA & M. BROWN, *supra* note 5, at 22 (emphasis added).

The federal tax law inherits the interpretation problems encountered under federal securities law. In addition, the Code's definition of "public tender offer" is much broader than the Williams Act requirements.[185] The Code's definition is broader because it encompasses any offer "required to be filed or registered with any Federal or State agency regulating securities."[186]

Compounding the problem of determining when a tender offer is actually made is the additional inclusion of "threatened" tender offer in the Code's greenmail definition.[187] The potential breadth of the term "threatened tender offer," as well as the lack of guidance under the Code, concerns those in the mergers and acquisitions field.[188] One concern involves the common practice by 5 percent owners of disclosing the possibility of increasing their ownership through a tender offer, even though the shareholder has no intention of making the offer. The purpose behind this disclosure is to ensure full disclosure. Commentators are concerned that such disclosure should not be considered a "threatened" tender offer because no actual threat has been made.[189] Indeed, if such disclosures were held to be threatened tender offers, tension would arise between the federal securities law's goal of full disclosure and this overly broad tax provision.

One suggestion offered to provide guidance is to analogize the "threat" of a tender offer to the Code's provision for involuntary conversion, where one of the triggers to nonrecognition is the "threat" of condemnation.[190] In a ruling under the involuntary conversion provision that determined whether a threatened condemnation occurred, the IRS required official notice that the government intended to condemn the taxpayer's property.[191] Thus, the greenmail statute could require formal notice from the raider to the target. This suggested analogy, however, may not be appropriate because the involuntary conversion provision is a nonrecognition provision and is accordingly

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185. Dionne, *Will the Greenmail Tax Apply to White Knights?*, 39 TAX NOTES (TAX ANALYSTS) 1145, 1148 (June 6, 1988).

186. I.R.C. § 5881(c)(1). With respect to the state registration requirement, the decision of the highest court of the state should be determinative as to state law under the doctrine of Commissioner v. Estate of Bosch, 387 U.S. 456 (1967).

187. I.R.C. § 5881(b)(2)(C).

188. Dionne, *supra* note 185, at 1148.

189. Letter from attorneys Peter I. Faber & S. Austrian to O. Donaldson Chapoton, Assistant Secretary of the Treasury for Tax Policy (Apr. 12, 1988), *reprinted in* TAX NOTES WEEKLY MICROFICHE, Doc. 88-4276 (May 9, 1988).

190. Dionne, *supra* note 185, at 1148; *see also* I.R.C. § 1033(a) (generally providing for the nonrecognition of gain from an involuntary conversion of property).

191. Rev. Rul. 58-557, 1958-2 C.B. 402, 403.

very narrowly construed. In contrast, the greenmail provision is intended for broad application. Although an official notice provision may not be effective, there should be a safe harbor provision so that some predictability exists in the mergers and acquisitions field.[192] The obvious problem in establishing a bright line rule is that once established, one could manipulate this rule to avoid the statute and thus avoid its intended broad application.

2. Imposition of Excise Tax

Once the statutory elements of greenmail are met, a 50 percent excise tax is imposed on the "gain" realized by the greenmail recipient.[193] The Technical Corrections Act of 1988 expands this to "gain or *other income realized.*"[194] The excise tax overrides any nonrecognition provision.[195] Furthermore, no income tax deduction is allowed to the recipient for payment of the greenmail excise tax.[196]

The Code imposes the greenmail excise tax in addition to income tax.[197] Therefore, assuming the recipient is in the highest marginal tax bracket for individuals (28 percent)[198] or corporations (34 percent),[199] the effective tax rate of combined income and greenmail excise tax will be as high as 78 percent and 84 percent for individuals and corporations, respectively.

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192. *See* Dionne, *supra* note 185, at 1148-49 (noting the confusion in the mergers and acquisitions field over I.R.C. § 5881).

193. I.R.C. § 5881(a).

194. H.R. 4333, 100th Cong., 2d Sess., § 204(m) (1988) (emphasis added). Dividend income is specifically included in other income. JOINT COMM. ON TAXATION, DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988, 423 (H.R. 4333 & S. 2238) (Comm. Print 1988) [hereinafter DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988]. Because the provision as enacted was applicable only to gain realized, which I.R.C. § 1001(a) generally relates to a sale or exchange, and not other types of income such as dividends, there appeared to be a way to circumvent the excise tax by structuring the acquisition of the shareholder's stock in a way that would create dividend income rather than gain from sale or exchange of property. One transaction that was structured this way to avoid the statute was to issue warrants rather than cash as the consideration for the shareholder's stock. Dionne, *Tax-Free Greenmail Scheme Foiled*, 39 TAX NOTES (TAX ANALYSTS) 1147 (June 6, 1988). The warrant holder was treated as still owning the stock under the § 318 attribution rules and taxed as a receiving dividend. I.R.C. § 302(d). This apparent loophole has been detected by the 1988 Act. *See* DESCRIPTION OF THE TECHNICAL CORRECTIONS ACT OF 1988, *supra*, at 423.

195. I.R.C. § 5881(d).

196. *Id.* § 275(a)(6), *amended by* Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10228, 101 Stat. 1330.

197. The greenmail excise tax is imposed by Chapter 54 of the Code. This is consistent with the intent underlying the excise tax as imposed by the Corporate Raider Tax Act of 1987. *See supra* text accompanying note 162.

198. I.R.C. § 1(a)-(d).

199. *Id.* § 11(b).

C. *White Knight Problem*

An amendment in the Technical and Miscellaneous Revenue Act of 1988[200] (the "1988 Act") creates a new wrinkle to existing definitional and interpretive problems under the section 5881 greenmail tax.[201] When a "white knight"[202] succeeds in acquiring control of the target through a competing tender offer, the white knight might seek to buy the initial bidder's shares at a premium to dispose of a potentially troublesome shareholder. The greenmail tax as originally enacted in the 1987 Act would not apply to this transaction because the target neither directly nor indirectly acquired the stock from its shareholder.[203] Instead, a majority shareholder has acquired the stock from a minority shareholder.

The 1988 Act expands the definition of greenmail to "any corporation (*or any person acting in concert with such corporation*)."[204] This expansion raises the question of whether a white knight, who purchases the initial bidder's stock, is acting in concert with the target corporation.[205] The legislative history of the 1988 Act provides no explanation of the scope or meaning of this change. There are two possible interpretations of the application to white knights in this expanded definition. One view is that the proposed change is intended to apply when a third party acts as a "conduit" for the acquisition and eventual return of the stock to the target corporation. Based on this view, the white knight's purchase from the greenmailer should not be treated differently from a sale on the open market because the white knight is not a conduit for the return of the stock to the target. Accordingly, the excise tax should not apply to the purchase.[206]

Under a contrary view, the expanded definition of greenmail would cover payment by a white knight to an intended bidder.[207] This view is apparently based on the "broadly drafted language" of the expanded definition to include consideration transferred by any person acting in concert with the issuing or target corporation. Under common usage of in "concert,"[208] any action by the white knight that is planned with

200. Pub. L. No. 100-647, § 2004(o)(1)(B)(i) (1988).

201. *See* Dionne, *supra* note 185, at 1147.

202. *See supra* text accompanying notes 46-47.

203. I.R.C. § 5881(b).

204. *Id.* (amended by § 2004(o)(1)(B)(i) of the 1988 Act) (emphasis added).

205. Dionne, *supra* note 185, at 1147; Willens, *Greenmail Tax Should Not Apply to White Knights*, 39 TAX NOTES (TAX ANALYSTS) 623, 623-24 (May 2, 1988) (letter to the editor).

206. Willens, *supra* note 205, at 623-24.

207. Dionne, *supra* note 185, at 1147.

208. *See supra* text accompanying note 182.

the target corporation apparently falls within the statute. Accordingly, if the white knight's purchase of the bidder's stock is pursuant to an agreement with the target, such purchase would be greenmail if all other elements are met.

Because the Internal Revenue Service has not taken a position on this issue and is only in the early stages of drafting regulations on section 5881 as originally enacted,[209] prompt resolution appears unlikely.

D. *The 1988 Act*

The 1988 Act also confers jurisdiction over the greenmail excise tax to the United States Tax Court by subjecting the tax to the Code's deficiency procedures.[210] Additionally, the Statement of Managers of the 1988 Act articulates an exception to the greenmail tax:

> [T]he conferees clarify that the greenmail tax does not apply in a situation where the stock of the taxpayer and all other shareholders is purchased at the same price, at essentially the same time and in a transaction which is substantially the same; that is, all shares are purchased with the same total present value of consideration per share, whether in the form of debt, debentures, or cash, with no additional consideration provided to any selling shareholder.[211]

This exception appears to allow some flexibility in repurchasing shares but creates many interpretation problems. For example, what is "substantially the same?" At what discount rate is the present value to be calculated? Again, guidance is needed to interpret application of the greenmail excise tax.

V. IS SECTION 5881 JUSTIFIED FROM A POLICY STANDPOINT — SHOULD THE FEDERAL TAX LAW BE USED TO REGULATE GREENMAIL AND HOSTILE TAKEOVERS?

Prior to the enactment of the greenmail excise tax in the 1987 Act, the Code did not attempt to distinguish hostile takeovers from other transactions. Nor did the Code attempt to discourage certain activity within the context of hostile takeovers. Although the golden parachute provisions were somewhat aimed at hostile takeovers, the provisions

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209. Dionne, *supra* note 185, at 1142.

210. I.R.C. § 5881(e) (added by § 2004(o)(1)(B)(i) of the 1988 Act).

211. H.R. CONF. REP. No. 1104, 100th Cong., 2d Sess. 19 (1988).

are applicable to perceived abuses in any change in control, be it hostile or friendly.[212] Although disallowance of deductions for redemption payments was partially directed at greenmail payments, the disallowance applies to all redemption payments.[213] Finally, the IRS's initial position that poison pill plans might disqualify certain types of tax-free reorganizations[214] does not seem to reflect any concern with hostile takeovers. Rather, the treatment appeared to reflect IRS's strict construction of the nonrecognition reorganization provisions.

With the new greenmail excise tax, however, the Code for the first time distinguishes hostile takeovers from other activity, and discourages certain activity associated with hostile takeovers. This section examines the propriety, from a tax policy perspective, of direct regulation of takeover defenses by the Code through the use of an excise tax to discourage greenmail.

A. *Does the Greenmail Excise Tax Comply with Tax Policy Objectives?*

From a tax policy perspective, taxes are generally viewed in terms of equity and efficiency.[215] The equity analysis is divided into vertical and horizontal equity. Vertical equity occurs when the cost of government is distributed fairly by income levels.[216] Under the principle of horizontal equity, taxpayers in approximately the same economic circumstances should share the same cost of government, i.e., the tax burden.[217] The general principle in an efficient tax system is that "the tax system should minimize the extent to which individuals alter their economic behavior so as to avoid paying tax."[218]

1. Vertical Equity

Because of the resources necessary to engage in greenmail, such activity is generally limited to high-income individuals and companies. Therefore, although the "flat" 50 percent tax may appear regressive and unfair to lower-income taxpayers, the tax really only applies to high-income groups. Accordingly, the tax is effectively progressive and does not violate the principle of vertical equity.

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212. *See supra* text accompanying notes 116-17.
213. *See supra* text accompanying notes 143-46.
214. *See supra* text accompanying notes 125-34.
215. *See* J. PECHMAN, FEDERAL TAX POLICY 5 (5th ed. 1987).
216. *Id.*
217. *Id.*
218. D. BRADFORD, BLUEPRINTS FOR BASIC TAX REFORM 46 (2d ed. 1984).

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2. Horizontal Equity

Applying the policy goal of horizontal equity is more problematic. Two shareholders with identical stockholdings and economic incomes can have their shares redeemed at a premium. If one shareholder acquired the stock within two years of the redemption and threatens or makes a tender offer, then that shareholder will be subject to the tax. Accordingly, two taxpayers in approximately the same economic circumstances are taxed differently. This violation of horizontal equity is a common criticism of excise taxes, because in keeping with the intent of the tax, only taxpayers engaging in the targeted activity are taxed.[219]

3. Efficiency

Because the purpose of the greenmail excise tax is to discourage greenmail payment, the tax is clearly intended to alter the economic behavior of taxpayers. Accordingly, the excise tax violates the principle of efficiency. Such violation always results from any tax intended to discourage or encourage economic behavior.[220]

When evaluated against the tax policy goals of vertical equity, horizontal equity, and efficiency, the greenmail excise tax only satisfies the objective of vertical equity. These goals raise the broader question of whether it is appropriate to use the Code to encourage or discourage non-tax economic and social behavior.

B. *Should the Internal Revenue Code be Used to Regulate Non-Tax Economic and Social Behavior?*

> If all proposals encouraging some worthwhile social activity through the tax system were adopted, the tax system would be left in shambles, incapable of performing its primary function of financing government equitably and with healthy economic growth. Yet the tax system now contains many provisions that have few ties with raising revenue and with measuring income.[221]

In addition to raising revenue, the Code has long been used to encourage certain economic and social conduct through exclusions from tax, deductions, credits, and preferential tax rates.[222] The Code also

219. J. PECHMAN, *supra* note 215, at 199.

220. *See* S. SURREY, PATHWAYS TO TAX REFORM 138 (1973).

221. Kurtz, *Tax Incentives: Their Use and Misuse*, 20 MAJOR TAX PLAN 1, 5 (1968).

222. 1 DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 1 (Prentice-Hall 1984) [hereinafter TREASURY I].

discourages certain economic and social behavior through the use of disallowance of deductions and the imposition of excise taxes.[223]

Provisions encouraging and discouraging certain economic and social conduct are often cited as a main cause of the Code's undue complexity.[224] In turn, commentators blame the Code's complexity for the unfairness in the present tax system:

> The resulting tax system is both unfair and needlessly complex. Moreover, it interferes with economic behavior and, thus, prevents markets from allocating economic resources to their most productive uses. Perhaps worse, the complexity and inequity of the tax system undermine[s] taxpayer morale — a valuable, yet fragile, national asset and a prerequisite for a tax system based on voluntary compliance.[225]

Despite the near universal concern over complexity, inefficiency, and unfairness resulting from use of the Code to implement social and economic behavior, such use continues, largely as a result of the underlying tax legislative process.[226] Indeed, notwithstanding the stated intent of the Tax Reform Act of 1986 to simplify the Code and remove incentives that interfere with taxpayers' economic decisions,[227] the Code is still replete with incentives and disincentives. Therefore, the threshold issue remains whether the Code should be used to regulate non-tax economic and social behavior.

Perhaps the best example of the use of the Code to encourage behavior is the investment tax credit, which was repealed in 1986. The investment tax credit allowed taxpayers who invested in certain property to obtain a credit against their tax liability for a certain prescribed percentage of the investment. *See* I.R.C. § 38 (1986), *repealed by* the 1986 Act, *supra* note 9, at § 211. Other examples of incentives include I.R.C. § 170, the deduction for charitable contributions; I.R.C. § 21, the credit for child care expenses necessary for gainful employment; I.R.C. § 42, the credit for owners of certain low-income housing. *See* I.R.C. §§ 21, 42, 170.

223. *See* S. SURREY, *supra* note 220, at 155. For example, no deduction is allowed for illegal payments such as bribes and kickbacks, nor is any deduction allowed for payment of any governmental fines resulting from a violation of law. I.R.C. § 162(c), (f). Furthermore, certain transactions involving tax exempt private foundations trigger an excise tax on persons engaging in the proscribed transaction. *Id.* §§ 4940-49. Excise taxes are also generally imposed on manufacturers and importers of tobacco products and liquor. *Id.* §§ 5001, 5701.

224. *See* TREASURY I, *supra* note 222, at 2; Ferguson, *Luncheon Address: Tax Complexity and Compliance — One View From the Department of Justice*, 30 MAJOR TAX PLAN 871 (1978); Comm. on Tax Policy (1970-1971), New York State Bar Association, Tax Section, *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325, 345 (1972).

225. TREASURY I, *supra* note 222, at 1.

226. *See* McDaniel, *Simplification Symposium — Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27, 28 (1978).

227. GENERAL EXPLANATION OF THE 1986 ACT, *supra* note 136, at 6.

1. Tax Incentives

Professor Surrey has suggested an analysis for determining whether tax incentives should be used to encourage certain activities or industries or whether the government should provide direct assistance.[228] Surrey asserted that many virtues attributed to using tax incentives do not withstand scrutiny. For example, one claimed advantage of tax incentives is that they encourage participation by the private sector in social programs. Surrey countered that the expressed need only reflects the need for assistance, not whether such assistance should be through tax incentives or direct governmental assistance.[229] Another asserted virtue of tax incentives is that they are simpler than direct assistance because incentives avoid government bureaucracy. This is an oversimplification, however, because complex requirements may be necessary to implement the tax.[230]

The real advantage to using tax incentives is apparently political. It is based upon the notion that conservatives like the perceived lessened governmental role, while liberals are happy that social programs are assisted.[231] Another political notion is that tax incentives are more likely to be passed by Congress than direct assistance programs.[232] Surrey, however, found these political justifications illusory at best.[233]

Furthermore, Surrey noted the asserted defects of using tax incentives included some taxpayers being rewarded for doing what they would otherwise do.[234] Also, tax incentives often create inequitable differences between high-income and low-income taxpayers.[235] Perhaps the biggest problem is that "[t]ax incentives distort the choices of the marketplace and produce unneutralities in the allocation of resources."[236] Thus, the issue becomes whether the distortion is justified.

Another critical weakness in using tax incentives is that administration of targeted social problems occurs through the legislative process rather than in federal agencies more knowledgeable in the area.[237]

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228. S. SURREY, *supra* note 220, at 126; Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970).

229. S. SURREY, *supra* note 220, at 131.

230. *Id.* at 131-33. Perhaps the charitable contribution requirements in I.R.C. § 170 illustrate the complexity within incentive provisions. *See* I.R.C. § 170.

231. S. SURREY, *supra* note 220, at 147.

232. *Id.*

233. *Id.*

234. *Id.* at 134.

235. *Id.* at 134-38.

236. *Id.* at 138.

237. *Id.* at 141-42.

The House Ways and Means and Senate Finance Committees are responsible for tax legislation, and both are generally unfamiliar with the areas involved in the incentives. Accordingly, the control over substantive legislation in non-tax areas becomes bifurcated. Similar confusion and conflict can arise between the agency normally responsible for administering the particular non-tax area and the Internal Revenue Service.[238]

Surrey concluded that tax incentives should only be used when there are clear advantages over direct assistance. He further noted that such clear advantages are unlikely.[239]

2. Tax Disincentives

Tax disincentives to discourage behavior are used less frequently than tax incentives.[240] These disincentives may take the form of disallowed deductions or excise taxes. Some excise taxes are intended to raise revenue in addition to regulating conduct, and accordingly, are presumed appropriate.[241] For example, excise taxes on alcohol and tobacco raise revenue because the demand for such products is inelastic, and consumers will generally continue to purchase the product despite price increases for the excise tax.[242]

Another situation warranting the use of a regulatory excise tax is when a taxpayer imposes heavy costs on society and that taxpayer should arguably bear the cost of such behavior. An example is pollution by a manufacturer.[243] Professor Surrey urged caution, however, when excise taxes are used to "shore up other substantive measures . . . ."[244] Without a revenue-raising justification, the same general concerns involving tax incentives are present.

The use of tax disincentives to discourage certain economic and social conduct appears more justified than the use of tax incentives. Congress should, however, observe caution in using the Code for such regulation. The effectiveness and integrity of the Code, where the main purpose is to raise revenue, is compromised to the extent that the Code is used to interfere with non-tax economic and social policy issues.

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238. *Id.* at 142-43.
239. *Id.* at 148.
240. *Id.* at 336 n.61.
241. *Id.*
242. *See* J. PECHMAN, *supra* note 215, at 198-99.
243. *Id.* at 195-96; S. SURREY, *supra* note 220, at 336 n.61.
244. S. SURREY, *supra* note 220, at 336 n.61.

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C. *If Regulation by the Code Is Appropriate in Some Circumstances, Is Greenmail Such a Circumstance?*

Because the greenmail tax is apparently not intended to raise revenue[245] like the alcohol and tobacco excise taxes and violates tax policy goals of horizontal equity and efficiency, the only remaining justification for the tax is its use in discouraging undesirable economic or social behavior. Assuming, *arguendo*, that it is sometimes appropriate to use the Code to regulate certain inappropriate economic and social behavior, to what extent, if any, is greenmail such inappropriate behavior?

Unfortunately, no articulated standard exists to determine when social or economic behavior is so harmful as to justify a tax disincentive. The legislative history of the greenmail provision is not particularly helpful in determining specific harms of greenmail. Rather than focusing on greenmail specifically, Congress discussed the broader issue of the appropriateness of hostile takeovers.[246] Ironically, discouraging greenmail limits its use as a takeover defense, thus theoretically favoring hostile takeovers.

Why should greenmail be singled out among all of the other possible takeover defenses as inappropriate? Persuasive evidence suggests that greenmail may be harmful to remaining shareholders of the target corporation.[247] One concern is that the greenmailer exploits the target corporation and the remaining shareholders.[248] A particularly egregious situation occurs when a "raider" buys a position in a target and, with no intention of completing a takeover, creates dissention and threatens to make a bid. The raider undertakes these actions in hopes of the target management buying out the raider at a premium. The remaining

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245. The greenmail excise tax is estimated to provide the Treasury less than $500,000 for the fiscal years 1988-90. H.R. CONF. REP. NO. 495, 100th Cong., 1st Sess., 1024 app., *reprinted in* 1987 U.S. CODE CONG. & ADMIN. NEWS 2313-1771.

Indeed, it is ironic that the tax will not raise significant revenue because it was enacted in a revenue raising act that was supposed to reconcile the national budget. *See* Letter from Joseph A. Grundfest, Chairman, Securities Exchange Comm. to Dan Rostenkowski, Chairman, House Ways & Means Comm. (Oct. 10, 1987), *reprinted in* Grundfest, *Five Reasons to Reject the Corporate Control Provisions of the House Budget Reconciliation Bill*, 37 TAX NOTES (TAX ANALYSTS) 1271 (Dec. 21, 1987) [hereinafter Grundfest Letter].

For general criticisms of the use of the budget reconciliation process to enact tax bills see Handler, *Budget Reconciliation and the Tax Law: Legislative History or Legislative Hysteria*, 37 TAX NOTES (TAX ANALYSTS) 1259 (Dec. 21, 1987).

246. *See generally* TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18 (discussing hostile takeovers in tax context).

247. *See supra* text accompanying notes 48-56.

248. *See supra* text accompanying notes 48-51.

shareholders are harmed when the threatening shareholder is redeemed at a premium unavailable to all shareholders. Deception and exploitation of remaining shareholders arguably should be discouraged as inappropriate. Another articulated concern involves management using greenmail to entrench itself at the expense of remaining shareholders.[249] Perhaps this conduct should be discouraged because management has benefitted itself at the expense of remaining shareholders.[250]

These exploitation and entrenchment concerns are somewhat consistent with the theory underlying the justification of a tax on polluters. Polluters harm society as a whole. To the extent that all stock traded on the nation's markets is subject to greenmail, the potential harm from greenmail might also affect society as a whole.

1. Is the Greenmail Tax Drafted Well Enough to Deal Specifically with Exploitation and Entrenchment Abuses of Greenmail?

Assuming further that exploitation and entrenchment issues of greenmail involve inappropriate social and economic behavior, does section 5881 adequately address these issues? Although the 1985 Senate hearings generally acknowledge the need for a carefully drafted statute,[251] the greenmail provision is not drafted with the same precision as the golden parachute provisions. In isolating its applicability to abusive situations, the golden parachute provisions provide safe-harbor relief for small corporations, reasonable payments, and pay-

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249. *See supra* text accompanying notes 52-53.

250. In addressing the potential harms of greenmail, the pro-greenmail arguments should also be considered. Some evidence suggests that remaining shareholders eventually benefit from the payment of greenmail. This benefit might result when the greenmail payment alerts the market of the target's attractiveness. Eventually a successful takeover occurs with all shareholders receiving a premium. *See supra* notes 57-60 and accompanying text.

251. This concern was articulated as follows:

> [I]t is also true that not all hostile mergers are bad . . . . Sometimes an ineffective management team needs to be replaced. Sometimes the interests of the shareholders are not being adequately represented.
>
> So therefore, while there are problems with corporate mergers that need our attention, we must be careful in crafting a remedy to target the abuses while not preventing the legitimate economic activity to which I have referred.
>
> I also believe that we should attempt to interfere with the free market as little as possible in crafting any remedy.
>
> . . .
>
> So I think we must be very careful, take a rifle-shot approach in any legislative remedy that we craft.

TAX TREATMENT OF TAKEOVERS HEARINGS, *supra* note 18; at 73 (statement of Sen. David L. Boren).

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ments made with shareholder approval.[252] Without safe-harbor provisions, the greenmail provision effectively provides that any greenmail-type payment is *per se* inappropriate, despite a lack of exploitation or entrenchment. For example, assume a bidder buys a position in the target intending to take over the target in a tender offer. Further assume that subsequent to completion of the tender offer, the bidder must abandon the takeover due to circumstances beyond the bidder's control. If the bidder chooses to sell, it will not be entitled to any premium for the large block of stock even though neither exploitation nor entrenchment exists. By not allowing for approval by the shareholders, whom the statute intended to protect, the Code effectively decides the shareholders' best interests. It effectively takes any decision away from the shareholders. For example, even if the shareholders agree that good business reasons exist for paying greenmail, such transactions will unlikely occur because the recipient will not agree to greenmail due to the punitive nature of the tax.

Uncertainty over the treatment in the white knight scenario[253] also reflects the over-inclusiveness of this broad provision. Although the white knight scenario possibly includes an entrenchment issue, it generally does not include an exploitation issue. Clearly, not all white knight takeovers are abusive. Despite the lack of abusive situations, the greenmail tax may apply if the white knight buys out the initial bidder at a premium.

Although the greenmail tax appears to be intended for broad application, it apparently does not include payments under standstill agreements.[254] Standstill agreements are very similar to greenmail payments,[255] except that there is no redemption of shares and the bidder retains the shares. However, virtually the same exploitation and entrenchment abuses are possible in standstill agreements as with greenmail payments.[256]

2. Should the Code be Used to Regulate Greenmail When Means of Regulation Exist Outside the Code?

Aside from regulation by the Code, the payment of greenmail is also subject to regulation by state courts, the Securities and Exchange

252. In addition to the structural differences, the rate differences between the 20% for golden parachute payments and 50% for the greenmail are not explained. Perhaps there is an implicit decision that greenmail is more inappropriate than golden parachutes. Perhaps the difference is merely an oversight or drafting inconsistency.

253. *See supra* text accompanying notes 201-07.

254. *See supra* text accompanying notes 176-77.

255. *See supra* text accompanying note 45.

256. Indeed, the disallowance of deductions for redemption payments includes standstill agreements as well as greenmail payments. *See supra* text accompanying note 145.

Commission, and a small number of state statutes.[257] Critics are concerned about duplication of regulatory effort.[258] Indeed, the greenmail tax and other proposed hostile takeover provisions evoked concern from a member of the Securities and Exchange Commission about the potential intrusion of federal tax law into the nation's securities markets.[259]

The greenmail tax also effectively abrogates decisions made by a corporation's directors and management. Traditionally, state laws reserved these decisions to corporate directors and management under the business judgment rule.[260] Furthermore, the greenmail tax encroaches on those states that have decided to allow payment of greenmail to the shareholder on shareholder approval.[261]

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257. *See supra* text accompanying notes 61-81.

258. *See supra* text accompanying notes 237-38.

259. *See* Grundfest Letter, *supra* note 245, at 1271. Although Commissioner Grundfest qualified his views as being his own and not necessarily those of the SEC, his involvement in the opposition to the tax legislation is significant by itself.

> The Securities and Exchange Commission, and individual commissioners, have traditionally refrained from commenting on matters that do not arise directly under the Federal securities laws. These are not, however, traditional times. [The 1987 Act] is also not a traditional tax act.
>
> If the Act becomes law, it will dramatically alter the process by which the nation's securities markets influence corporate governance and allocate capital in the private sector.
>
> . . .
>
> Accordingly, I trust you will appreciate the unusual circumstances that lead me to comment on the Act and recommend that its corporate control provisions be excluded from the . . . revenue package currently being considered by Congress.

Id.

260. *See supra* text accompanying notes 71-78.

261. *See supra* note 80 and accompanying text. Additionally, the Treasury opposes the greenmail tax on a policy standpoint. *See* TAX TREATMENT OF HOSTILE TAKEOVERS HEARINGS, *supra* note 18, at 117 (testimony of Ronald A. Pearlman, Assistant Secretary (Tax Policy) Department of Treasury).

> I don't think [the Treasury] want[s] to be in a position of making economic judgments about whether particular acquisitions, whether they be hostile or friendly, are good or bad for the economy, if for no other reason than that we probably don't know.
>
> One thing we think we know, based on some history with the tax law, is that the more we get the tax law into making those decisions, the more we confuse the law, and perhaps the more we distort economic behavior.
>
> So what we suggest here in opposition to these [anti-takeover tax] bills is that as a matter of tax policy we think it is undesirable to try to draw lines that say that in hostile acquisitions there should be one kind of tax treatment, and in friendly acquisitions another . . . .

Id.

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VI. Conclusion

The current controversy over hostile takeovers and the payment of greenmail arises from a complicated arena balanced with competing offensive and defensive strategies. Several defensive strategies, including golden parachutes and poison pills, have already been indirectly affected by the Code.

Through the new section 5881 excise tax, Congress takes its first step in using the Code to regulate hostile takeovers. Because this punitive tax does not isolate potentially abusive from non-abusive situations, the statute is overly broad. Additionally, further guidance is needed for some statutory definitions, such as the meaning of "threatened tender offer." Furthermore, the issue of the tax's application to the white knight situation must be resolved.

Moreover, the use of this tax to discourage greenmail is not justified from a tax policy perspective. The tax violates the policy goals of horizontal equity and efficiency. Even if these violations are justified by the harm caused by greenmail, the statute is not drafted specifically enough to isolate harmful from harmless transactions. Indeed, the statute apparently does not include the equally abusive standstill agreement defense. This provision apparently upsets the balance in the delicate area of hostile takeovers by discouraging the defensive use of greenmail.

This provision needlessly muddles an already complicated Internal Revenue Code. Unless use of the Code to further non-tax economic and social policy goals is carefully guarded, the Code will never be simple, fair, and effective.

https://scholarship.law.ufl.edu/flr/vol40/iss4/5