

## IRS Guidance on Deductibility of Transaction Success Fees and Seventh Circuit Stock Drop Case Involving Private Company Stock

By: Stephen P. Magowan, Steiker, Fischer, Edwards & Greenapple, P.C., Burlington, VT; with editing assistance from Susan Lenczewski, Gray Plant Mooty, Minneapolis, MN

### REGULATORY DEVELOPMENTS

In April, the IRS issued Revenue Procedure 2011-29, in which it has set forth a safe harbor that allows a taxpayer to make an irrevocable election to treat seventy percent (70%) of a mergers and acquisition success-based fee to be, in effect, currently deductible without the need to provide the documentation envisioned by Treasury regulations under Code § 263. This is an important development that may be beneficial to companies contemplating a transaction involving their ESOP. Success-based fees are typically paid to investment bankers and other advisors upon the closing of a transaction and based on the size of the transaction. Prior to the issuance of the Revenue Procedure, all such fees are capitalized.

This safe harbor will be available as long as the taxpayer (i) capitalizes the remaining thirty percent (30%) amount; and (ii) attaches a statement to its original federal income tax return for the taxable year in which the success-based fee is paid or incurred, which states that the taxpayer is electing the safe harbor, identifies the transaction, and specifies the success-based fee amounts that are deducted and capitalized.

The safe harbor presented in this Revenue Procedure is in lieu of attempting to document what costs are paid to facilitate a transaction and whether all or a portion of a success fee was paid to facilitate the transaction or for some other, deductible, purpose. If the safe harbor is elected, the Service will not challenge a taxpayer's allocation of a success based fee. This Revenue Procedure should be consulted by companies contemplating an ESOP transaction and their advisors as it may help clarify questions of deductibility of transaction costs.

### CASE LAW DEVELOPMENTS

In an interesting opinion by the Seventh Circuit Court of Appeals, the Court affirmed the district court's decision, in favor of a participant in an eligible individual account plan, that the fiduciaries had breached their duty of prudence when they failed to divest the participant's account of its stock in a closely-held company after the company sustained a significant drop in value, but remanded for a re-determination of damages. In *Peabody v. Davis*, 2011 U.S. App. LEXIS 7449 (7<sup>th</sup> Cir. April 12, 2011), John F. Peabody, an employee of Rock Island Corporation ("RIC"), a closely-held securities firm based in Chicago, agreed to rollover his external IRA into the RIC Savings Plan ("Plan") and have the rollover funds invested in RIC

stock. The Plan was an eligible individual account plan ("EIAP") sponsored by RIC's subsidiary, Rock Island Securities ("RIS"). As a result of this investment, Peabody's account was 98% invested in company stock. RIC went out of business, and Peabody lost the value in his account.

Peabody filed suit and made the following claims:

- against the Plan fiduciaries, on behalf of the Plan, to make good the loss to the Plan arising from their breach of the fiduciary duty of prudence;
- against the Plan, as a participant, to receive his benefits under the Plan; and
- against the third-party insurance defendants, for other equitable relief.

The Seventh Circuit agreed with the district court that defendants RIS and Plan trustees Davis and Kole, who were also co-founders and officers of RIC, violated their fiduciary duty to Peabody under ERISA § 404(a)(1)(B) and (C) by allowing Peabody's account to remain invested 98% in company stock throughout the company's decline. The Court ruled that a prudent investor would not have remained so heavily invested in the company's stock as the company's fortunes declined precipitously over a five-year period for reasons that foretold further and continuing declines. Further, the Court found that Peabody's agreement to invest his IRA rollover into the Plan in company stock at the outset did not mean that he had waived his breach of fiduciary claims with respect to the company stock investment nor did it free the defendants from the exercise of their fiduciary duty.

Peabody joined RIC in 1998. In 1999, Peabody rolled over approximately \$168,000 into the Plan, most of which was invested in RIC stock. He did so because making the investment allowed him to receive his 1999 bonus, as he desired, in cash instead of stock. Specifically, Peabody and the RIC management agreed that if he rolled over his IRA into the Plan, he could receive a cash bonus instead of receiving RIC stock, as had been the company's ordinary practice.

RIC and RIS were securities trading firms that made profits on the spread in buy and sell prices primarily on NASDAQ. Changes in SEC regulations derailed the companies' method of making money and led to rapid decline in the companies' fortunes. In particular, testimony indicated that changes in SEC regulations "crushed" RIC's profit margins, such that by 2003 or 2004 profit margins had declined by 70-80%. The Court observed that a widely-known and permanent

change in the regulatory environment had undermined the core business model, and consequently, the company stock became an imprudent investment. Sometime in 2005, RIC went out of business.

The facts in the court's opinion indicate that the valuation of RIC stock was performed periodically, at times by insiders, and resulted in values ranging from \$2,000 per share at the time of Peabody's investment in 1999 to \$550 per share in 2004. When Peabody left RIC in January 2004, he requested distribution of his benefits and eventually reached agreement with RIC that RIC would redeem all the shares at \$350 per share in exchange for an interest-bearing note in the amount of approximately \$292,000, payable in a year. RIC was not able to make the payment at the end of the year. The district court ruled that the defendants violated their fiduciary duty of prudence by maintaining the investment in company stock throughout its decline, failing to distribute Peabody's plan benefit and engaging in a prohibited transaction by offering a loan in payment for the stock. In affirming the district court, the Seventh Circuit observed that the ERISA plan at issue was an EIAP within the meaning of ERISA § 407(d)(3), as are all ESOPs, and consequently exempted by statute from the § 404(a)(1)(C) diversification duty with respect to employer securities. See §404(a)(2). The Court then stated that the "exemption from the duty to diversify reflects a congressional judgment that the benefits of broadening employee ownership outweigh the greatly increased risks of an undiversified investment." The Court followed this fairly innocuous and reassuring (at least to ESOP companies, fiduciaries and practitioners) statement with the following alarming comment: "[T]hat calculation may have been more plausible at the time ERISA was enacted than it is today, because in 1974 the prevailing form of retirement plan was the defined benefit pension for which the duty to diversify is fully applicable, while today defined contribution plans (which enjoy the employer stock exemption from the duty to diversify) predominate."

The Court next grappled with the question of whether the *Moench* presumption of prudence should apply to the fiduciaries of an EIAP, which does not affirmatively require or encourage investment in employer securities, presenting a lower barrier to divestment compared to ESOPs, which "exist for the express purpose of investing in company stock." Ultimately the court did not answer the question because it determined that even if the *Moench* presumption of prudence applied, Davis and Kole breached their duty of prudence as to the plaintiff, Peabody. RIC's marked decline, with little expectation of recovery, and Davis' and Kole's insider status lead the Court to the conclusion:

"These facts are consistent with circumstances under which sister courts would find it imprudent to continue an investment in company stock....[quoting

language from the Ninth Circuit opinion in *Quan*]....In short, a widely-known and permanent change in the regulatory environment has undermined RIC's core business model, and consequently the company stock became an imprudent investment."

It is perhaps of some comfort to fiduciaries that the Court in a footnote emphasized that its decision was narrow, because "[m]ost business failures are not so foreseeable, and a severe decline in company stock value does not, without considerably more, create a duty to divest from company stock."

Turning to the question of whether Peabody had waived his right to make a claim when he elected to make the rollover investment in stock, the Court recited the district court's finding that Peabody had "arguably waived" his claim that the defendants had breached their fiduciary duty by agreeing to the RIC stock investment initially and by *never* requesting that the fiduciaries reduce this investment. Since this assumes some element of participant control, however, the Court treated this defense as essentially a request by the fiduciaries for protection similar to that offered under ERISA § 404(c). Noting that fiduciaries bear the burden of the § 404(c) defense, the Court explained that when a plan is noncompliant with § 404(c), as was the case with the Plan, the fiduciaries are denied the statutory safe harbor.

The Court also reviewed the loan for stock exchange, finding that a prohibited transaction had indeed occurred but that Peabody had showed no loss or damages arising from the prohibited transaction, which, the Court characterized as an exchange of worthless stock for a worthless loan. While the Court found for the plaintiff with regard to liability, the Court remanded the case to the district court on the issue of damages, finding that the district court's method, which resulted in an award of approximately \$507,000, comprised of \$417,500 for the value of his stock and about \$90,000 in pre-judgment interest, was erroneous. The Court directed the district court to start with the original investment and determine what Peabody would have had left had the fiduciaries engaged in an orderly divestment over the period of decline in RIC's business.

*Mr. Magowan is a member of The ESOP Association's Advisory Committee on Legislative and Regulatory Issues. The author reviewed this article with Committee Chair, Susan D. Lenczewski, Gray, Plant, Mooty, Mooty & Bennett, P.A., Minneapolis, MN.*