Successful Debt Restructuring (Part I of II)

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Each year, the Internal Revenue Code seems to get longer and more complex. Since 1986 alone, there have been over 14,000 amendments to the Code. 2005 was no exception to that trend with Congress passing 14 separate tax bills. Although 2006 will likely not exceed 2005 in the Hank Aaron versus Barry Bonds–like tax hit parade, the volume of legislation has been steady.

Indeed, over the past decade, Congress has passed a batting average of nine tax bills every year. Betting odds are that Congress will continue to tinker with the Code for the foreseeable future, extending its frequent annual changes far beyond my professional career.

With the enactment of so many new Code sections and subsections, paragraphs and subparagraphs, it's no wonder that tax practitioners need to spend so much time in the dugout and batter's box learning these new rules. Still, digesting new rules is only a part of Code landscape that we must examine and understand. We must also obtain a fluency in the existing Code, and at times, that is not easy either.

Old Friends, New Friends

Take, for example, Code Sec. 166, a relatively benign section that all M&A TAX REPORT readers know allows taxpayers to claim a deduction for bad debt. Section 166 was enacted as part of the 1954 Code, and while over the years Congress has amended it some, overall it remains true to its original form. Despite being relatively static, for some taxpayers claiming a Code Sec. 166 deduction is no more certain today than it was in the Eisenhower era.

Just ask ABC Beverage Corporation ("ABC"), one of the largest independent beverage bottlers in America. ABC has battled the IRS for the past 11 years over a $10 million bad debt deduction claimed on its 1995 tax return. Eventually, the question had to be resolved by the Tax Court. [*See ABC Beverage Corporation*, 92 TCM 268, Dec. 56,620(M), TC Memo. 2006-195.]

Before delving into the Code Sec. 166 issue, it is necessary to explain the bottling industry, which helps explain why the IRS took issue with ABC. Back in 1986, the soft drink bottling business consisted of the "big three." There were two well-known titans, Coke and Pepsi, and a third quasi-independent network encompassing all others.

Independent beverage labels at that time included Dr. Pepper, 7-Up and Squirt, to name a few. The independent bottling network was two-tiered: independent concentrate makers and independent bottling facilities, each usually owned separately yet completely dependent upon one another.

Economic Landscape

The bottling industry began to realign fundamentally as Coke and Pepsi vertically integrated their bottling businesses by buying their bottling facilities. The two titans could then produce, bottle and distribute their own beverages without independent bottlers. This was a significant departure from the bottling business prior to 1986, when bottling facilities could contract with Coke or Pepsi to exclusively bottle and distribute drinks in a given geographic region.

1986 was also the heyday of the leveraged buyout ("LBO") in which investors scoured the country for high cashflow industries. The bottling industry, with its fairly high and steady cashflows, was ripe for LBO investors. One such opportunity in the bottling industry arose when

Philip Morris exited bottling. The management group of the Philip Morris bottling business saw an opportunity to buy the business they had been managing in an LBO, and so assembled its financing and purchased the company, Mid-Continent Bottlers, Inc. ("Bottlers").

Bottlers was an independent bottling business, bottling mainly for Cadbury. In fact, Cadbury represented about 90 percent of Bottlers' business, maintaining considerable control over Bottlers' ability to transfer its franchise agreements to bottle for Cadbury to other parties. These franchise agreements were key to Bottlers' business and among its most valuable assets.

The management group used an LBO to finance the purchase of Bottlers. Once the LBO was completed, the management group, consisting of seven executives, owned less than 40 percent of Bottlers. The remaining 60 plus percent were passive investors, with no one person or entity owning even a substantial portion of this 60-percent stake, so the management group had effective control. Some of the LBO financing was on unfavorable terms. Since the management group was anxious to acquire Bottlers, they were under a tight timetable to complete their financing before competing bidders.

Escalators

The LBO financing included a capital contribution and an asset financing from Corporate Property Associates 7 ("CPA7"). CPA7 agreed to purchase seven bottling locations in three states, and then lease them back to Bottlers on terms quite favorable to CPA7. The favorable terms included significant rent escalators over the 25 year lease, eventually allowing CPA7 to receive premium rent above-market rates when the rent escalators kicked in.

Given the onerous lease provisions, management knew Bottlers would have to renegotiate or buy out the lease. Six years after the LBO, the management group was considering buying the bottling facilities from CPA7 to avoid further rent escalators, but the prospect of Bottlers owning the bottling facilities posed three problems.

First, the management group wanted Bottlers to be salable to Coke or Pepsi. Neither Coke nor Pepsi would buy Bottlers if it actually owned bottling facilities. Second, Cadbury had the contractual right to disapprove any sale of Bottlers' franchise rights. Cadbury insisted the franchise rights be sold only to Coke or Pepsi so that Cadbury products could be placed in Coke or Pepsi vending machines.

Third, buying the bottling facilities would have caused friction with Bottlers' limited partners. Around 1989, Bottlers replaced some of its original LBO financing by selling equity interests in a limited partnership to approximately 50 independent investors. The limited partners and the management group had different views on how to run Bottlers. The limited partners wanted short-term returns, while the management group emphasized long-term growth. These divergent views led to many heated communications, threats and a proxy fight.

Given these internal and external business reasons, the management group decided it was best to lease the facilities rather than own them. Hence, the management group ideally wanted a third party to buy the bottling facilities from CPA7, assume the lease and then renegotiate the lease to remove the rent escalators.

The White Knight

Bottlers identified G&K Properties, Inc. ("G&K"), an unrelated real estate development company, as a potential buyer that would lease the facilities to Bottlers on renegotiated (and more favorable) terms. While G&K was obtaining financing, the management group attempted to avoid the rent escalators in the CPA7 lease. It approached CPA7 regarding a sale, and the parties eventually agreed on a $17.8 million price. To lock in the price, the management group created a third party to own the assets temporarily until G&K's financing came through.

Neither Bottlers nor CPA7 appraised the underlying facilities during their negotiations. Instead, the price reflected the present value of the future stream of payments, including a premium over fair market value given the unfavorable lease terms. Still, the management group had to act quickly to avoid further rent escalations.

The Purchase

In 1994, the management group formed Mid-Con Properties, Inc. ("Properties"). The

management group wholly owned Properties, but management only owned 40 percent of Bottlers. To fund the purchase, Bottlers obtained a loan from Prudential, one of its original LBO investors (the "Prudential loan").

Bottlers then lent the funds to Properties (the "Properties loan") on the same terms. Properties bought the bottling facilities from CPA7 and assumed the problematic lease. The bottling facilities collateralized the Properties loan.

Immediately thereafter, Properties and Bottlers amended the lease to remove the rent escalators. Now in parity, Bottlers' rent payments equaled Properties' loan payments. This zero net cashflow was an essential part of the deal to satisfy Prudential that the payments Bottlers made to Properties (of rent) would return to Bottlers when Properties made loan payments. Furthermore, under the terms of the loan, Properties could not divert any cash to other uses.

Great Expectations

According to the Tax Court, the management group had a reasonable expectation that G&K would purchase the bottling facilities so Bottlers could satisfy the Prudential loan, or that the Prudential loan would be repaid through rental income. Once the transaction with G&K closed and G&K paid the $18 million purchase price to Properties, the management group expected Properties to pay off Bottlers, and Bottlers would pay off Prudential. Indeed, the parties intended that Properties would be liquidated once G&K bought the facilities.

By the end of 1994, when the first full payment of principal and interest on the Properties loan was due, G&K still had not obtained its financing. As Properties was intended as a short-term solution, Bottlers paid only enough rent to enable Properties to pay interest (not principal) on the Properties loan.

Given the unanticipated delay in financing, the management group decided not to pay the full rent for two reasons. First, they were concerned that having Bottlers pay the portion of the rent corresponding to principal would enable Properties to build equity in the bottling facilities. Second, the important net zero cashflow (required by Prudential) would otherwise be upset. Properties would have an interest deduction for the portion of the rent corresponding to interest but no deduction for the portion of the rent corresponding to principal that would give Properties net income and a tax liability.

G&K's Financing Collapses

Unexpectedly, G&K's purchase of the bottling facilities fell through in early 1995. Bottlers began searching fruitlessly for alternate buyers. Shortly thereafter, Brooks Beverage ("Brooks") approached Bottlers about combining with Bottlers to consolidate its position as a large independent bottler. Unbeknownst to Bottlers, Cadbury had already approved Brooks' proposed combination with Bottlers.

Combining the companies made logistical sense because Bottlers served a different geographic region than Brooks. Bottlers was the third largest independent bottling company in the country, and Brooks was the second. When combined, the two companies would offer synergies and economies of scale. Bottlers hastily agreed to the deal.

Brooks acquired all the stock of Bottlers for $48.5 million in 1995. The resulting company was Beverage America, Inc. ("BevAm") (now ABC Beverage Corporation). The management group received stock in BevAm and accepted executive positions with BevAm in the transaction.

Post-Combination

After the entities combined, the bottling facilities were appraised for approximately $8 million based on their fee-simple (not lease-fee) value. BevAm's accounting firm advised BevAm that it had a potential worthless debt because the collateral securing the debt was worth less than the debt. Plus, Properties had not been making full loan payments to Bottlers (because Bottlers had not been making full rent payments to Properties), putting Properties in default.

This default gave BevAm the right to take the bottling facility from Properties, which was attractive for three reasons. Ownership gave BevAm the flexibility to make changes to the facilities. Second, it did not want equity in only certain members of its management group. Third, the rationale for not owning the bottling facilities (*i.e.,* keeping Bottlers salable to Coke or Pepsi) no longer existed.

Thus, BevAm declared Properties in default and seized the bottling facilities and some cash in exchange for releasing Properties from the loan. BevAm deducted the difference between the value of the assets ($8 million) and the unpaid principal on the Properties loan ($18 million) on its consolidated 1995 return. The IRS issued BevAm a deficiency notice denying the bad debt deduction, and BevAm went to Tax Court.