Sausage, Capital Gain, and Settlement Payments

By Robert W. Wood

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It is commonly understood that one should not watch sausage or laws being made.[1] Perhaps that well-worn admonition should be super-sized in the case of tax laws, particularly (as today) when tax laws are so often used to not only raise revenue, but to make social policy. But sometimes tax problems are not the fault of the lawmakers who make the tax laws, the IRS that enforces them, or the Tax Court that interprets them. Sometimes, we taxpayers foul it up pretty nicely ourselves.

That is at least one moral I take from *Joseph A. Freda v. Commissioner*,[2] the latest in a long line of cases of similar ilk involving the tax treatment of litigation recoveries. That opinion is by Judge Chiechi, who is no Otto von Bismarck, but is also not known among tax lawyers for being gentle. In *Freda*, she turned up her nose at what the taxpayer attempted to serve, and in the last analysis, it was the taxpayer's own cooking that spoiled the meal.

Fast Food Nation

Like so many of my favorite tax cases, *Freda* involves the tax treatment of a settlement payment. On the one hand, we have Pizza Hut, the ubiquitous vendor of pies. On the other was C&F Packing Co., owned by the Fredas and others. C&F may not be a well-known brand name, but it supplied the enormous amount of sausage that went atop the Pizza Hut merchandise.

Sausage, it turns out, may be less fungible than you think. In fact, C&F had some pretty slick sausages. In particular, C&F guarded a secret process that made garden-variety precooked sausage take on the appearance and taste of home-cooked. That sausage filled the bill for Pizza Hut.

During negotiations in 1985, Pizza Hut pushed for C&F to disclose the secret process to Pizza Hut's suppliers. C&F countered that C&F would share the secret process with other suppliers only if C&F would receive a royalty on all sausage sales made with the process. The sausage negotiations ensued, with offers and counteroffers flying like pizza dough spinning in the sky.

In 1985 the companies reached a confidential disclosure agreement, requiring C&F to disclose its confidential information to Pizza Hut, and Pizza Hut to keep it confidential and not to exploit it. Pizza Hut's suppliers also entered into third-party confidentiality agreements with C&F. Those ancillary agreements allowed the third parties to use the C&F process to beef up (and perhaps pork up) their sausage bona fides, all to the benefit of Pizza Hut's pies and customers.

But despite the execution of a raft of those agreements, there seemed something rancid afoot. Pizza Hut did not enter into a long-term supply contract with C&F as it had promised. Furthermore, Pizza Hut's weekly purchases of sausage from C&F remained a mere fraction of what Pizza Hut had promised, and a few years later, the relationship really went to pot.

By 1989 Pizza Hut had disclosed the trade secret that allowed C&F's sausage to look and taste homemade to IBP, another sausage-maker. IBP used the secret process and began selling the homemade look-alike sausage to Pizza Hut. That sausage flood caused a significant drop in Pizza Hut's purchases from C&F.

Brewing Trouble

C&F became suspicious in late 1992 or early 1993, surmising that IBP was using its secret sausage recipe. C&F received confirmation of that fact in early 1993 and filed suit against IBP for infringement. C&F informed Pizza Hut about the lawsuit, but far from being helpful, Pizza Hut immediately stopped purchasing from C&F. Twice spurned, C&F amended its complaint to add Pizza Hut as a defendant, claiming that Pizza Hut had induced the patent infringement.

Like a sizzling sausage bursting on the grill, a second amended complaint followed. In it, C&F accused the parties of fraud, breach of fiduciary duty, unfair competition, unjust enrichment, patent infringement, tortious interference, and misappropriation of trade secrets. Some of those claims were only against Pizza Hut, while some were against both Pizza Hut and IBP.

The Tax Court recited considerable procedural history of this war, with some causes of actions being immediately dismissed. Meanwhile, in early 1997 C&F redeemed all of the stock (one-third) owned by Gerald Freda. More claims in the lawsuit were dismissed, until on March 31,

[1]This remark is attributed to Otto von Bismarck, aka the Iron Chancellor.

[2]T.C. Memo. 2009-191, *Doc 2009-19173*, *2009 TNT 163-18*.

1998, the district court held that C&F's patent on its sausage-making process was invalid.

More motions were granted in favor of IBP or Pizza Hut. Finally, in December 1998 a jury trial was conducted on the misappropriation count against IBP. On December 9, 1998, the jury returned a verdict for C&F for $10,939,391 in damages based on unjust enrichment. The district court added prejudgment interest, and denied various IBP posttrial motions.

Both parties appealed the decision. IBP appealed the award of prejudgment interest and the judge's denial of its posttrial motions. C&F appealed the district court's various dismissals of its claims against Pizza Hut for fraud, breach of fiduciary duty, unfair competition, unjust enrichment, and misappropriation.

Pizza Appeal

In 2000 the Federal Circuit affirmed the district court's denial of IBP's posttrial motions, and affirmed the award of $10,939,391 in damages. The court of appeals also affirmed the district court's dismissal of most of C&F's claims against Pizza Hut. However, it reversed the district court's award of prejudgment interest to C&F, and reversed the district court's dismissal of the misappropriation count against Pizza Hut.

After reinstating the misappropriation count against Pizza Hut, the Federal Circuit remanded the case to the district court for further proceedings. Pizza Hut was still in the soup. After the Federal Circuit's opinion, the only unsettled claim in the C&F lawsuit was its claim against Pizza Hut for misappropriation, which turned out to be important.

IBP paid the $10,939,391 judgment to C&F. In turn, C&F paid $4,922,726 to its own attorneys (Niro Law Firm), and $2,055,555 to Gerald Freda, whose stock had been redeemed in 1997. C&F retained balance of $4,011,110.

In January 2002 C&F, Pizza Hut, and several current and former C&F shareholders entered into what might be viewed in the sausage world as a global settlement. Essentially, that agreement required Pizza Hut to settle all claims with C&F and its attorneys for $15.3 million. But like the ingredients in a pizza pie, the devil is in the details of a settlement agreement. Sadly, this settlement agreement was generic — not unlike a prefab frozen pizza of indeterminate origin.

The settlement agreement recited the intended compromise, calling for Pizza Hut to pay the $15.3 million jointly to C&F and the Niro Law Firm in exchange for a general release. Although the check was payable jointly, when Niro received it, the firm apparently had no trouble negotiating the check.

Niro retained $6,120,000 as legal fees, distributed $3,060,000 to the previously redeemed shareholder, and remitted the balance of $6,120,000 to C&F. C&F reported only this amount (actually, $6,112,347) on its 2002 S corporation return as long-term capital gain. It disclosed the payment on its Schedule D as a ''trade secret sale.''

C&F issued Schedules K-1 to its shareholders, passing through the long-term capital gain pro rata. The shareholders, of course, then reported the capital gain. The IRS issued notices of deficiency, determining that: (a) the settlement payment represented ordinary income and (b) the $3,060,000 Niro received (and distributed to the previously redeemed shareholder) also represented ordinary income to C&F.

Making Sausage

The underlying dispute here was about a secret sausage process. After all, who wouldn't want precooked sausage to taste homemade? Yet there was sausage being made when it came settlement time in this case, and more was made in the Tax Court.

Although the taxpayers argued that this settlement was long-term capital gain, the Tax Court (predictably) made clear that the burden of proof was on the taxpayers. That was something the taxpayers seemed destined not to carry. The taxpayers argued that their underlying case was about damage to the C&F trade secret, a capital asset in C&F's hands. This was, they argued, a sale or exchange of that trade secret to Pizza Hut.

Alternatively, they said, the monies were for C&F's rights under the Pizza Hut confidentiality agreement concerning this trade secret. The court properly characterized the trade secret argument — that this was a capital asset in C&F's hands — as the primary argument. It was the first and most important ingredient. Beyond the usual authorities on origin of the claim, the Tax Court pointed out that the parties (government and taxpayers alike) agreed that the only claim outstanding against Pizza Hut when the case settled was the misappropriation claim. Everyone also agreed that a trade secret (like C&F's trade secret) is in fact a capital asset.

The critical question, however, was whether *that* amount was paid by Pizza Hut to C&F *for* injury to or destruction of the C&F trade secret. How do you determine that? The taxpayers cited luminary cases such as *Inco Electroenergy Corp. v. Commissioner*[3] and *State Fish Corp. v. Commissioner*.[4] Yet the Tax Court pointed out that the complaint against Pizza Hut was replete with references to lost profits, lost opportunities, operating losses, and expenditures as C&F's damages. That all sounds ordinary. Ouch!

In a footnote, Judge Chiechi notes that the taxpayers argued that all their lost profits damages had already been paid by IBP (as a result of the jury verdict), and *not* by Pizza Hut. The court rejected that exclusionary notion, finding it premised on the dubious assumption that profits C&F might have lost (attributable to IBP's misappropriation of its trade secret) were the *same as* any profits C&F might have lost (attributable to Pizza Hut's misappropriation). Once again referring to the complaint's allegation that C&F suffered *lost profits*, lost opportunities, operating losses, and expenditures at the hands of Pizza Hut, the court concluded that C&F simply did not carry its burden of proof.

Surely there was a trade secret here, no question about it! Surely this lawsuit was about, among other things, that very trade secret! Yet the Tax Court found the taxpayers simply failed to carry their burden. They were unable to establish either that the damages C&F claimed in the

[3]T.C. Memo. 1987-437.
[4]48 T.C. 465 (1967).

Pizza Hut misappropriation count or that the damages C&F ultimately received via the settlement were paid for injury to (or destruction of) the C&F trade secret.

Significantly, the misappropriation count against Pizza Hut was the *only* claim outstanding against Pizza Hut when the settlement agreement was executed. Moreover, according to C&F's own complaint, Pizza Hut was paying this amount for ''lost profits, lost opportunities, operating losses and expenditures.''[5] Like the aroma of a baking pie wafting your way, the phrase ''hoist with your own petard'' should enter your mind, even if the Tax Court did not use it.

Noble Alternatives

The Tax Court then confronted the taxpayers' alternative arguments, the first being the notion that the settlement amount *must* have been a long-term capital gain because it represented gain from C&F's sale or exchange of its trade secret to Pizza Hut. There was a predictable discussion of the relevant tax authorities.

Yet in the end, it all came down to facts, which, like ingredients in a good pizza, must be *quality*. There was no sale or exchange language in the settlement agreement, and nothing in the record to show that one was intended. The Tax Court stated that the settlement agreement did not transfer *any* rights to Pizza Hut, let alone the most significant, the right to the C&F trade secret.

Next, the taxpayers argued that section 1235 itself imported capital treatment. That section, one of the oft-ignored gems of the code, provides for capital gain treatment when there is a transfer of all substantial rights to intellectual property. Nice theory, but the Tax Court found that there were no facts to support it.

Finally, and perhaps most interestingly, the Tax Court turned to the argument that the settlement money was for contract rights under section 1234A. Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation regarding property that is (or on acquisition would be) a capital asset in the hands of the taxpayer will be treated as gain or loss from the sale of a capital asset.

Here, the taxpayers argued that the confidentiality agreement gave C&F the right to require Pizza Hut to:

- keep the C&F trade secret confidential;
- refrain from using the trade secret except for purposes of evaluating the sausage product; and
- return all materials relating to the trade secret.

That was a contract, argued the taxpayers, and the settlement agreement terminated the contractual rights. To be sure, C&F could point to some provisions in the settlement agreement to support that notion. After all, there were some references to the confidentiality agreement.

However, the Tax Court was far more persuaded by the provisions in the settlement agreement that the taxpayers did *not* mention. First, the settlement agreement compromised and settled claims regarding both liability and amount, and settled all past, present, or future claims against Pizza Hut. Second, the settlement agreement terminated any claim by the C&F parties against Pizza Hut, and barred any future litigation.

But did this $15.3 million settlement payment terminate C&F's rights under the Pizza Hut confidentiality agreement concerning the C&F trade secret? The taxpayers had the burden of showing that it did; a burden the Tax Court found they did not meet.

All In a Day's Work

No one likes a Monday morning quarterback. Nevertheless, there are several lessons from *Freda* worth memorializing, even if they are of the ''shoulda-coulda-woulda'' variety. The Tax Court is right in examining the litigation documents. As tends to happen in this area, everyone may focus (a little myopically) on the complaint.

Nevertheless, it makes perfect sense for the court to do what it did. Procedural history in a case can be good or bad, depending on what you have to prove and to whom. Yet in a complex case, there may be many causes of action, motions to dismiss, or a summary judgment that knocks out most of the complaint.

Arguably, the more documents that have been penned in the inevitable march toward trial and even toward appeal, the worse off a litigant may be. As the scope of the litigation becomes narrower and narrower, it may become much more difficult to argue that a payment in question relates to something in particular. If you run out of one ingredient, you cannot use it.

Of course, the goal in a complaint, in a settlement agreement, and in a tax return should be accuracy. Yet in the gristmill of modern litigation, there may be multiple reasons a payment is made. Of course, some basic precepts must be present in the form of clearly manifested claims.

Optimally, the taxpayers in *Freda* should have been thinking about tax issues from the very commencement of their case. I recognize that's a tall order. But even if that is a mere pie-in-the-sky dream, they *surely* should have been thinking about taxes at the time the settlement agreement was negotiated and signed!

Sadly, I see no suggestions that those quality ingredients were being selected even at settlement time. Tax planning does not seem to have been considered by anyone, perhaps until the time the notices of deficiency appeared.

Some questions inevitably should come to mind. For example:

- Given the litigation history, what would the Tax Court have done with a settlement agreement that said clearly that the $15.3 million payment in question was for a purchase and cancellation of the confidentiality agreement?
- What would the Tax Court have done with a settlement agreement that clearly stated Pizza Hut was buying the trade secret itself? Could there have been gradations of these approaches?
- What if the settlement agreement had allocated some portion (say half) of the consideration to one claim or another?
- Given section 1234A's statutory clarity, just how strong would the section 1234A argument have been

[5] *See* complaint, para. 57.

assuming proper drafting, explicitly terminating all contract rights regarding the process?

Although I can't help asking those questions, there are few answers. What we do have is yet another reminder of the extraordinary need for diligence in this area of the tax law. Yet paradoxically, as I'm fond of saying, this area of the tax law isn't very complicated.

In fact, one need not be capable of understanding section 704(b) or the consolidated return regulations to do just fine in this area. Similarly, to make a pizza one need not use a fancy recipe. You just need quality ingredients and a little care and attention.

Sometimes, tax advisers to a settlement can achieve significant goals merely by using quality ingredients and careful presentation. In the *lingua franca* of this tale of Tax Court woe, one can't expect a pizza to taste (or even look) good if it receives no attention in ingredients or baking. If you want it to look and taste homemade, there's no secret formula.