

RESURRECTING THE *GENERAL UTILITIES* DOCTRINE

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INTRODUCTION

The *General Utilities* doctrine was once described as one of the seven fundamental principles of our corporate tax system.¹ Always controversial, it was repealed by the Tax Reform Act of 1986. Its repeal was one of numerous tax law changes—made during the merger mania of the 1980s—designed to limit the role of the tax system in promoting what was perceived to be a dangerously high level of takeover activity.

Prominent tax scholars have long criticized the *General Utilities* doctrine, and its repeal was generally hailed as sound tax policy. Nonetheless, some scholars have questioned whether *General Utilities*' repeal was wise. The more sophisticated analyses compare the various tax non-neutralities created by the doctrine with the tax non-neutralities created by its repeal.² But even this handful of thoughtful scholars pays little attention to the existence of *non-tax* non-neutralities—namely, those arising from the separation of management and shareholders in a corporation—that may justify the introduction of tax non-neutralities.³ This Article attempts to bridge the discontinuity between the tax literature and the finance literature on takeovers by developing a broader framework that incorporates both.

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¹ Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 96, 130 (1977).

² See Glenn E. Covey, *Taxing Corporate Acquisitions: A Proposal for Mandatory Uniform Rules*, 44 TAX L. REV. 145 (1989); Paul B. Stephan III, *Disaggregation and Subchapter C: Rethinking Corporate Tax Reform*, 76 VA. L. REV. 655 (1990); Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839 (1988).

³ Professor James Repetti has argued that corporate tax policy analysis ought to take into account non-tax non-neutralities arising from the separation of management and shareholders in a corporation. See James R. Repetti, *Corporate Governance and Stockholder Abdication: Missing*

This Article examines the finance literature exploring the causes and consequences of takeovers and concludes that the policies underlying *General Utilities*' repeal were misguided. This Article finds that repeal of the *General Utilities* doctrine has made inefficient acquisitions more attractive while making efficient ones less attractive. Furthermore, repeal of the *General Utilities* doctrine has reduced the attractiveness of the most efficient means by which managers can divest themselves of the product of their past acquisitiveness. This Article concludes that certain aspects of the doctrine should be reinstated.

I. THE *GENERAL UTILITIES* DOCTRINE AND ITS REPEAL

Named after the 1935 case *General Utilities & Operating Co. v. Helvering*,⁴ the *General Utilities* doctrine appeared to begin as a straightforward exception to our classical system of corporate taxation, under which two levels of tax—corporate and shareholder—are imposed on a corporation's income. The doctrine permitted a corporation to distribute appreciated assets to its shareholders without recognizing gain. (In contrast, a corporation that sold, rather than distributed, appreciated assets, recognized gain.) As codified by the Internal Revenue Code of 1954, the doctrine excused the corporate level tax on all distributions of property by a corporation to its shareholders, whether the distribution took the form of a dividend, redemption or liquidating distribution.⁵

The simplicity of the *General Utilities* doctrine, however, was deceptive. The doctrine created tensions and tax planning incentives that the courts and Congress struggled with for fifty years.⁶ The tensions were finally resolved when the doctrine was completely repealed in 1986.⁷ In the years since then, *General Utilities*' repeal has come to stand for the broad proposition that a corporation ought to incur the cor-

Factors in Tax Policy Analysis, 67 NOTRE DAME L. REV. 971 (1992); James R. Repetti, *Management Incentives, Needless Tax Complexity, and Capital Gains*, 75 TAX NOTES 981 (1997). This Article adopts an approach similar to Professor Repetti's.

⁴ 296 U.S. 200 (1935).

⁵ I.R.C. §§ 311, 337 (1954).

⁶ For a detailed history of the *General Utilities* doctrine and its erosion, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 7.20-.22 at 7-45 to 7-60, 11.45-46 at 11-53 to 11-66 (5th ed. 1987). See also Cheryl D. Block, *Liquidations Before and After Repeal of General Utilities*, 21 HARV. J. ON LEGIS. 307, 310-24 (1984); David Shores, *Repeal of General Utilities and the Triple Taxation of Corporate Income*, 46 TAX LAW. 177, 177-80 (1992); Eric S. Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of General Utilities*, 12 J. CORP. TAX'N 3, 4-37 (1985); David Scott Sloan & John M. Loalbo, *The Ultimate Disposition of General Utilities: Analysis of the General Utilities Doctrine from Inception to Repeal*, 6 B.U. J. TAX LAW 177 (1988).

⁷ Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269 (1986).

porate level tax if it divests appreciated property, whether by selling it, distributing it or otherwise relinquishing ownership of it.

This Part will describe the tensions created by the doctrine and the ways in which these tensions shaped the doctrine. It will then summarize the policies underlying the demise of the doctrine and describe the world of *General Utilities'* repeal as it now exists.

A. Tensions Created by the Doctrine

1. Disguised Sales of Appreciated Property

The *General Utilities* doctrine created an incentive for corporations to disguise sales of appreciated property as distributions. If a corporation sold appreciated property and distributed the sale proceeds to its shareholders, it would recognize gain on the sale. If, however, the corporation instead distributed the property to its shareholders and let the shareholders sell the property themselves, it would recognize no gain under the doctrine, despite the fact that this achieved the identical economic result. This strategy succeeded in *United States v. Cumberland Pub. Serv. Co.*⁸ Yet, in *Commissioner v. Court Holding Co.*,⁹ the government prevailed in its argument that a corporate liquidation followed by a shareholder asset sale was, in reality, a corporate asset sale followed by liquidation, thereby resulting in corporate gain recognition.

In 1954, Congress codified the result of *Cumberland* by extending nonrecognition treatment to a corporation selling its assets, provided that the sale proceeds were distributed to shareholders in complete liquidation of the selling corporation.¹⁰ In this way, Congress broadened the scope of the *General Utilities* doctrine to provide nonrecognition for liquidating sales, as well as distributions, of appreciated property.

Several years later, a similarly disguised sale strategy arose in the non-liquidation context. A corporation wishing to divest an appreciated asset could avoid the corporate level tax by first having the prospective purchaser acquire shares in the selling corporation. The corporation could then distribute the targeted asset to its new shareholder in redemption of the newly acquired shares. The most well-known of

⁸ 338 U.S. 451 (1950) (corporate liquidation followed by shareholder asset sale held tax-free to liquidating corporation).

⁹ 324 U.S. 331 (1945).

¹⁰ See I.R.C. § 337 (1954) (no gain or loss recognized by corporation upon sale or exchange of assets, provided sale or exchange is pursuant to a plan of liquidation completed within 12 months).

these transactions involved Mobil's acquisition of a subsidiary of Esmark. Mobil purchased fifty-four percent of the stock of Esmark in a tender offer. Mobil then immediately redeemed its newly acquired Esmark stock for all of the stock of Vickers, an appreciated oil and gas subsidiary of Esmark. At the time the transaction took place, the corporate level tax was excused.¹¹ Therefore, Esmark reported no gain on the distribution of Vickers to Mobil. The government unsuccessfully challenged Esmark's position, arguing that the transaction was, in fact, a cash sale by Esmark of Vickers to Mobil followed by the distribution of sale proceeds to Esmark shareholders in redemption of their shares.¹²

As it had done for *liquidating* asset sales by codifying *Cumberland* in 1954, Congress could have again broadened the scope of the *General Utilities* doctrine by extending nonrecognition treatment to *non-liquidating* sales of appreciated assets, provided the sale proceeds were then distributed to shareholders. Congress, however, declined to do this and instead narrowed the scope of the doctrine by requiring corporations to recognize gain upon non-liquidating distributions of appreciated assets.¹³ This resulted in a somewhat schizophrenic state of affairs in which both liquidating distributions and sales were tax-free, whereas non-liquidating distributions and sales were both taxable. The treatment of liquidating and non-liquidating distributions was harmonized in 1986 by the repeal of the *General Utilities* doctrine in its entirety, pursuant to which liquidating distributions were also made taxable.

2. Section 338

Just as the *General Utilities* doctrine exerted pressure on the distinction between sales and distributions of appreciated property, it also exerted pressure on the distinction between stock and asset purchases.

¹¹ See I.R.C. § 311(d)(2)(B) (1969).

¹² See *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd per curiam*, 886 F.2d 1318 (7th Cir. 1989). The government lost the case, but in the meantime Congress acted to cut off this perceived abuse of the *General Utilities* doctrine. See I.R.C. § 311(d)(2)(C) (1982) (imposing new restriction on tax-free distribution of subsidiary). See generally BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ¶ 7.21 at 7-50 to 7-59, 9.64 at 9-77 to 9-81 (4th ed. 1979) (describing 1969 version of 311(d)); Lawrence M. Axelrod, *Esmark's Tax-Free Disposition of a Subsidiary: Too Good to Be True?*, 9 J. CORP. TAX'N 232 (1982) (describing potential government challenges); Martin D. Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 177, 218-23 (1983) (describing transaction and government position); Lee A. Sheppard, *Esmark v. Commissioner: Of Form and Substance and Aesthetics*, 38 TAX NOTES 1165 (1988) (describing Mobil-Esmark transaction).

¹³ See I.R.C. § 311(d)(2)(C) (1982) (imposing new restriction on tax-free distribution of subsidiary).

A corporation that purchased the stock of a target corporation and then liquidated the target arguably could be viewed as having purchased the target assets directly (while the target could then be deemed to have liquidated and distributed the sale proceeds to its shareholders). Whether the transaction was treated as a stock acquisition followed by an independent liquidation of the target, or recharacterized as a deemed acquisition of the target assets, the tax consequences to the selling target shareholders and to the target corporation would have been the same: gain recognition for the shareholders with respect to their shares and nonrecognition to the target corporation with respect to its assets.¹⁴ The consequences to the acquiring corporation, however, would differ. If the transaction were respected as a stock acquisition and an independent, subsequent liquidation of the target, the acquiring corporation would take the historic basis in the target assets.¹⁵ If instead the transaction were recharacterized as a deemed acquisition of the target assets, the acquiring corporation would take a cost basis in the target assets.

Faced with choosing between these alternate characterizations, the Tax Court in *Kimball-Diamond Milling Co. v. Commissioner*¹⁶ found taxpayer intent to be the determinative factor. This, in effect, gave an acquirer the ability to step up¹⁷ to fair market value basis in a target corporation's assets without paying any corporate tax on the appreciation. In 1954, Congress codified an objective version of the *Kimball-Diamond* rule, under which a corporation acquiring target stock could elect a tax-free step-up in the target assets by liquidating the target within twelve months of the acquisition. Section 338, enacted in 1982, was the successor of this election. It permitted the purchaser of a target

¹⁴ If the transaction were treated by the target shareholders as a sale of their stock followed by the liquidation of the target, the target shareholders would recognize gain or loss with respect to their shares. The target, as a wholly-owned subsidiary of the acquiring corporation, would recognize no gain or loss upon liquidation. See I.R.C. § 332 (1994).

If the transaction were treated by the target as a sale of its assets followed by a liquidating distribution of the sale proceeds to the target shareholders, the target shareholders would recognize gain or loss with respect to their shares. See I.R.C. § 331 (1994). The target would recognize no gain or loss upon the sale of its assets under the *General Utilities* doctrine. See I.R.C. § 337 (1954).

¹⁵ See I.R.C. § 334(b) (1954).

¹⁶ 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951).

¹⁷ In using the term "step up," I assume that in most instances assets will have a fair market value in excess of their historic basis. *Kimball-Diamond* involved the opposite situation: the target's historic basis in its assets was higher than the fair market value of the assets at the time of the acquisition and the acquiring corporation wanted to preserve the higher historic basis by purchasing target stock rather than assets. See *id.*

corporation's stock to elect a tax-free step-up of the target's basis in its assets without going through the mechanics of an actual liquidation.¹⁸

Section 338 gave new owners of a corporation certain advantages over historic owners. By making a § 338 election, new owners could step up to fair market value the basis of the corporation's assets without subjecting themselves to corporate level tax. One of the principal benefits of a § 338 election was that it permitted the new owners to "bust up" the corporation—that is, divest some or all of its assets—without recognizing corporate gain.¹⁹ Historic owners of corporations were not extended the same benefits as new owners.²⁰ The 1986 repeal of

¹⁸ Both the history and operation of this election are quite complex. The 1954 Code permitted a corporation acquiring the stock of a target corporation to be treated as if it had purchased target assets instead (provided that the acquiring corporation actually liquidated the target corporation within a 12-month period after the acquisition). I.R.C. § 334(b)(2) (1954) (as amended by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982)). The acquiring corporation was, in effect, deemed to have purchased the assets of the target corporation rather than its stock. This deemed asset purchase implicitly relied on the *General Utilities* doctrine to protect the target corporation from gain recognition. If the target corporation in fact sold its assets and distributed the proceeds to the target shareholders, any gain at the target level would have gone unrecognized under the doctrine. Only the target shareholders would incur tax on the liquidating distribution. Section 338 was enacted in 1982 as the successor to old § 334(b)(2). Section 338 also permitted the purchaser of a target corporation's stock to elect to step up the target's assets and explicitly relied upon the *General Utilities* doctrine to arrive at that treatment. Under § 338, a fictional "old" target corporation was deemed to have sold its assets to a "new" target corporation and then liquidated, distributing the sale proceeds to its shareholders. The asset sale and liquidating distribution were tax-free to the "old" target corporation by reason of the *General Utilities* doctrine. See I.R.C. § 338(a) (1982) (as amended by Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986)).

¹⁹ The other major benefit was the increase in depreciation deductions attributable to stepped-up basis.

²⁰ They attempted to step up asset basis through a "liquidation-reincorporation," in which a corporation would liquidate, distributing its assets to its shareholders, and then be reincorporated by its shareholders. The transaction obtained the same results for historic owners as the § 338 election did for new owners: stepped-up corporate asset basis at a cost of only the shareholder level tax. See generally BITTKER & EUSTICE, *supra* note 6, ¶ 11.05 at 11-16 to 11-17, ¶ 14.54 at 14-202 to 14-212 (explaining stakes in liquidation-reincorporations and various ways in which liquidation-reincorporations were challenged).

Although the results for new owners were blessed congressionally by the enactment of § 338, the liquidation-reincorporation transaction was continually challenged, sometimes successfully, by the government. Using the step transaction doctrine, the courts and the Internal Revenue Service linked together the liquidation and subsequent reincorporation and recharacterized them in ways that denied the sought-after tax benefits. See, e.g., *Telephone Answering Serv. Co. v. Commissioner*, 63 T.C. 423 (1974), *aff'd per curiam*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977) (failure to liquidate completely by reason of subsequent reincorporation results in gain recognition to corporation on sale of assets); Rev. Rul. 61-156, 1961-2 C.B. 62 (liquidation-reincorporation is in substance a tax-free reorganization with cash boot taxable as dividend income). Furthermore, Congress amended the reorganization provisions in 1984 to facilitate challenges to liquidation-reincorporation transactions. See I.R.C. § 368(a)(2)(H) (1986) (expanding the definition to "control" required for type "D" reorganization, thereby making it

the *General Utilities* doctrine and amendment of § 338 equalized the treatment of new and historic owners of corporations by eliminating the ability of new owners to step up asset basis without triggering corporate level tax.²¹

B. Policies Underlying General Utilities' Repeal

The tensions described above led many prominent corporate tax scholars to advocate repeal of the *General Utilities* doctrine.²² They asserted that the schizophrenic state of affairs described above—in which *liquidating* distributions and sales were both tax-free, but *non-liquidating* distributions and sales were both taxable—irrationally fa-

easier to recharacterize liquidation-reincorporation as reincorporation with boot). Historic owners were similarly foreclosed from employing other techniques that relied on the *General Utilities* doctrine to divest assets with no corporate level tax. See *supra* notes 11–13 and accompanying text.

In addition to producing stepped-up asset basis for the corporation, the liquidation-reincorporation transaction also allowed shareholders to “bail out” earnings, that is, to remove accumulated earnings as capital gains rather than as ordinary dividend income. See BRTTKER & EUSTICE, *supra* note 6, ¶ 14.54 at 14–202 to 14–203. Exactly the same sort of bail-out, however, occurred in the case of a stock sale followed by a § 338 election, since the selling target corporation shareholders would receive capital gains treatment with respect to their stock, thereby avoiding dividend treatment with respect to any accumulated earnings in the target corporation.

²¹ Section 338 remains in the Code. An election to step up asset basis under § 338, however, now comes at the cost of recognizing all gain at the target corporation level. Because the target shareholders also recognize gain with respect to their stock, a § 338 election now results in two levels of tax. An exception to this two-level tax treatment applies to elections made under § 338(h)(10). Under this provision, a sale of target corporation stock is deemed to be the sale of target assets—thereby providing the acquirer with a stepped-up basis in target assets—and no gain or loss is recognized with respect to the target corporation stock. The § 338(h)(10) election is available only when the target corporation is a member of a selling affiliated group, and exists because the selling group can achieve the same result by liquidating the target and then selling its assets. The liquidation of the target is tax-free. See I.R.C. §§ 332, 337 (1994). The selling group takes a carryover basis in the target assets received in the liquidation; therefore, a sale of those assets triggers any gain accrued during the target's ownership of the assets. See I.R.C. § 334(b) (1994).

²² See James B. Lewis, *A Proposed New Treatment for Corporate Distributions and Sales in Liquidation*, HOUSE COMM. ON WAYS AND MEANS, 3 COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE 1643 (1959); A.L.I. FEDERAL INCOME TAX PROJECT, SUBCHAPTER C, PROPOSALS OF THE AMERICAN LAW INSTITUTE ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 102–19 (1982); Clark, *supra* note 1, at 152; Bernard Wolfman, *Corporate Distributions of Appreciated Property: The Case for Repeal of the General Utilities Doctrine*, 22 SAN DIEGO L. REV. 81 (1985); George K. Yin, *General Utilities Repeal: Is Tax Reform Really Going to Pass It By?*, 31 TAX NOTES 1111 (1986).

Other prominent scholars argued in favor of the doctrine. See Richard C. E. Beck, *Distributions in Kind in Corporate Liquidations: A Defense of General Utilities*, 38 TAX LAW. 663 (1985); Coveit, *supra* note 2; Douglas A. Kahn, *Should General Utilities Be Reinstated to Provide Partial Integration of Corporate and Personal Income—Is Half a Loaf Better Than None?*, 13 J. CORP. L. 953 (1988). It seems fair to characterize those who defend the doctrine as swimming against the current.

vored liquidating corporations over non-liquidating corporations. This irrational distinction could be eliminated by making *all* asset distributions—both liquidating and non-liquidating—tax-free to the distributing corporation and *all* asset sales—both liquidating and non-liquidating—taxable to the selling corporation. This, however, would create yet another irrational distinction between corporations that distributed assets to shareholders and those that sold their assets to third parties.²³ In addition, any attempt to distinguish between corporate asset distributions and sales was essentially arbitrary, turning on “shadowy and excessively formal”²⁴ considerations that elevated form over economic substance.²⁵ Furthermore, the doctrine’s advantageous treatment of new owners relative to historic owners—via § 338—created an undesirable non-neutrality that encouraged takeovers.²⁶

The lawmakers who enacted the repeal of the *General Utilities* doctrine relied on two grounds, both of which were drawn from the

²³ See, e.g., A.L.I. FEDERAL INCOME TAX PROJECT, *supra* note 22, at 111–12.

²⁴ *Id.* at 106.

²⁵ See, e.g., *id.* at 106–08.

²⁶ See Coven, *supra* note 2, at 167 (“[T]he taxing system ought not to provide a tax incentive to corporation acquisitions. Under current law, that principle of tax neutrality between continuing and acquired businesses is not a mere abstract ideal; rather, it has become a firmly established congressional policy. The repeal of the *General Utilities* doctrine . . . reflect[s] the entirely proper ascension of that policy of neutrality.”); Yin, *supra* note 22, at 1115–16 (“[F]ew could dispute that the *General Utilities* doctrine is not neutral, and that to the extent it bears any influence at all on acquisition and merger activity, it operates as a force in favor of such activity. It is difficult to see how the current Congress would want to preserve the *General Utilities* tax preference for this economic effect.”).

Tax scholars also made other arguments in favor of *General Utilities*’ repeal. They argued that the doctrine undermined collection of the corporate level tax. See, e.g., David J. Shakow, *Wither, “C”*, 45 TAX L. REV. 177, 192 (1990). They also criticized the doctrine for distorting corporate business decisions. See, e.g., A.L.I. FEDERAL INCOME TAX PROJECT, *supra* note 22, at 111–12. Furthermore, they complained that the doctrine added enormous complexity to the law by creating opportunities for avoidance behavior, which, in turn, engendered a web of statutory provisions and judicial doctrines attempting to thwart such avoidance behavior. See, e.g., Clark, *supra* note 1, at 152.

One avoidance strategy was the liquidation-reincorporation transaction, which enabled a corporation to “bail out” earnings—that is, distribute the liquid assets to shareholders at capital gains rates, rather than distributing them as higher-taxed dividends—and obtain a stepped-up basis for the operating assets returned to corporate solution. See *supra* note 20 and accompanying text.

Another avoidance technique involved the so-called “collapsible corporation,” that is, a corporation set up to acquire ordinary income-generating assets such as receivables and inventory. The corporation would then be liquidated, thereby stepping-up the basis of these assets in the hands of shareholders at the cost of only a capital gains tax at the shareholder level. To combat the collapsible corporation, Congress enacted § 341. See generally BITTKER & EUSTICE, *supra* note 6, ¶ 12 (describing § 341 and its operation). Section 341 has been described as “the most complex provision of Subchapter C,” “characterized by a pathological degree of complexity, vagueness and uncertainty.” A.L.I. FEDERAL INCOME TAX PROJECT, *supra* note 22, at 111; Clark, *supra* note 1, at 135.

academic literature. First, the doctrine "tend[ed] to undermine the corporate income tax."²⁷ Second, the doctrine encouraged tax-motivated, uneconomic acquisitions, which thereby contributed to an undesirably high level of takeover activity.²⁸ In order to understand fully the nature of this second ground, it is necessary to understand the hostility of politicians and business leaders toward takeovers during the 1980s.

The 1980s was a period of intense takeover activity in which "leveraged buy-outs"—takeovers financed by borrowed funds secured by target assets and cash flows—were prominent. Business leaders and members of Congress expressed concern that highly-leveraged corporations, owned by "raiders" whose focus was on short-term cash flow, would undermine the U.S. economy by increasing bankruptcy rates and causing under-investment in long-term research and development.²⁹ Against this backdrop of concern, many tax provisions were enacted that imposed new costs on takeovers.³⁰ For example, new restrictions were imposed on the deductibility of interest payments by highly-leveraged corporations.³¹ A new excise tax was imposed on "greenmail," that is, payments made by corporate targets to raiders to induce them to abandon their takeover bids.³² In addition, stringent limitations were imposed on an acquiring corporation's ability to use the tax attributes, such as net operating loss carryovers, of a target corporation.³³ Repealing the *General Utilities* doctrine—in particular, eliminating the ability of new owners to elect a tax-free step-up in target

²⁷ H.R. REP. NO. 99-426, at 282 (1985), *reprinted in* 3 C.B. 282 (1986).

²⁸ *See id.* at 267, *reprinted in* 3 C.B. 267 (1986).

²⁹ *See, e.g., Tax Treatment of Hostile Takeovers: Hearing Before the Subcomm. on Taxation and Debt Management of the Senate Comm. on Finance on S. 420, S. 476, and S. 632, 99th Cong. 68 (1985) (statement of James R. Jones, U.S. Representative from Oklahoma); Tax Aspects of Acquisitions and Mergers: Hearings before the Subcomm. on Oversight and Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 99th Cong. 48 (1985) (statement of John H. Chafee, U.S. Senator from Rhode Island).*

³⁰ *See generally* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., FEDERAL INCOME TAX ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS (AND S. 420, S. 476 AND S. 632) 9 (Comm. Print 1985) (description of tax provisions encouraging takeovers); STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., FEDERAL INCOME TAX ASPECTS OF MERGERS AND ACQUISITIONS 13 (Comm. Print 1985). For a good description of the political and business reaction to takeovers and leveraged buyouts during the mid-1980s, see Patricia L. Bryan, *Leveraged Buyouts and Tax Policy*, 65 N.C. L. Rev. 1039, 1039-43 (1987).

³¹ *See* I.R.C. § 163(j) (1994) (originally enacted by § 7210(a) of Pub. L. No. 101-239, 103 Stat. 2339 (1990)).

³² *See* I.R.C. § 5881 (1994) (originally enacted by § 10228(a) of Pub. L. No. 100-203, 101 Stat. 1330-1417 (1987)).

³³ *See* I.R.C. § 382 (1994) (originally enacted by § 621(a) of Pub. L. No. 99-514, 100 Stat. 2254 (1986)).

assets under § 338—was yet another tax law change that decreased the attractiveness of takeovers.

C. *The World of General Utilities' Repeal*

Without the *General Utilities* doctrine, corporate distributions of appreciated property, like sales of appreciated property, are taxable to the corporation.³⁴ Furthermore, after *General Utilities'* repeal, the purchaser of a target corporation's stock can no longer elect to have the target corporation step up its asset basis tax-free. The 1986 repeal of the *General Utilities* doctrine thus helped "build a level playing field"³⁵ for historic and new owners of corporations by eliminating the ability of new owners to step up asset basis without triggering corporate level tax.³⁶ It also eliminated the favorable tax treatment of corporate prop-

³⁴ Losses realized by a corporation upon distribution of property are not as freely recognized as gains. See I.R.C. § 311(a) (1994) (disallowing loss recognition for nonliquidating property distributions); I.R.C. § 336(d) (1994) (disallowing loss recognition for certain liquidating property distributions).

Certain exceptions to corporate gain recognition continue to exist under *General Utilities'* repeal, the most significant of which is the tax-free divisive reorganization, or "spin-off." See generally I.R.C. § 355 (1994) (requirements for tax-free treatment). The requirements for tax-free spin-offs have become more stringent in recent years as a result of regulatory and legislative action. For a detailed description of all the provisions governing spin-offs, see MARTIN D. GINSBURG ET AL., *MERGERS, ACQUISITIONS, AND BUYOUTS: A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL, AND ACCOUNTING CONSIDERATIONS* 833-921 (July 1996 ed.).

Another exception to the recognition rule exists for a corporation making a liquidating distribution to a corporate shareholder owning 80% of the stock of the distributing corporation. See I.R.C. § 337 (1994). In this case, the distributee corporation also recognizes no gain upon receipt of the distribution and takes a carryover basis in the property received. See I.R.C. §§ 332, 334(b) (1994). The purpose of these provisions is to prevent the possibility of more than two levels of tax being imposed with respect to assets in corporate solution. Recognition of any gain inherent in the assets is deferred until such time as the corporate shareholder itself liquidates and distributes assets to its individual shareholders. At that time, both the liquidating corporation and the shareholders recognize gain. See BITTKER & EUSTICE, *supra* note 6, ¶ 11.41 at 11-44.

A third exception to the recognition rule exists for distributions of appreciated property made within an affiliated group filing a consolidated return. Gains are recognized but are deferred until the occurrence of a triggering event, such as the subsequent sale of the property outside the affiliated group. See Treas. Reg. § 1.1502-13(f)(7) ex. 1 (as amended in 1996).

A fourth exception applies to certain tax-free acquisitive reorganizations where liquidation of the target corporation is either required or permitted. See, e.g., I.R.C. § 368(b)(2)(G) (1994) (requiring target corporation to distribute stock or securities of acquiring corporation; liquidation permitted). See generally George K. Yin, *Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986*, 42 TAX L. REV. 573, 596-619 (1987) (describing effect of *General Utilities'* repeal on reorganization provisions).

³⁵ Stephan, *supra* note 2, at 658.

³⁶ Section 338 remained unchanged on its face after 1986. However, because the deemed liquidation by the target corporation is no longer tax-free, an election to step up asset basis under § 338 now comes at the cost of recognizing all gain at the target corporation level. I.R.C. § 338(a) (1994).

erty distributions relative to corporate property sales. One must inquire, however, whether these new neutralities are desirable.

The following Part develops a framework that draws on economic finance and corporate theory to explain the causes and consequences of corporate acquisitions and divestitures. Using this framework, the Article then explores and evaluates the effects of the *General Utilities* doctrine and its repeal. The Article finds that certain of the non-neutralities caused by the *General Utilities* doctrine in fact were socially desirable because they offset the managerial tendency to acquire or retain assets when it was uneconomic to do so. Moreover, repeal of the doctrine created new non-neutralities that exacerbated this managerial tendency.

II. FIRM SIZE, FREE CASH FLOW AND THE MARKET FOR CORPORATE CONTROL

This Part examines the financial economic literature exploring the causes and consequences of takeovers. Financial economists have observed that mergers and acquisitions perform two, somewhat contradictory, roles in the economy. On the one hand, they are a means through which some managers promote their own parochial interests in building inefficient, diversified empires. On the other hand, they are a means through which market forces take corporate assets out of the hands of managers who behave too inefficiently. Moreover, they present an opportunity to increase leverage, which tends to align the incentives of post-acquisition management with interests of shareholders.

A. Managers' Urge to Merge

The large conglomerate is commonly viewed as a manifestation of the divergent interest of corporate management and shareholders.³⁷ Michael Jensen's "free cash flow" hypothesis conceptualizes the dy-

³⁷ Corporate law theorists characterize the relationship between shareholders and managers as that of principal and agent. The agency relationship between shareholders and managers is, in turn, incorporated into the nexus-of-contracts theory of the firm, which views the corporation as a nexus of contracts among shareholders, managers, creditors, employees and others. See generally Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). The nexus-of-contracts theory is undoubtedly the dominant paradigm today. See, e.g., Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1408 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1549 (1989); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1449 (1989).

namic by which firms can become too large or too diversified.³⁸ Jensen theorizes that managers have incentives to retain free cash flow rather than distributing it to shareholders, and to use the free cash flow to make negative net present value investments.³⁹ This incentive may stem from links between compensation and firm size, or from the correlation between a manager's power and prestige and the size of his or her firm.⁴⁰ It may also stem from managers' risk aversion coupled with their inability to diversify their human capital.⁴¹ Managers can reduce the risk of failure or poor performance by either increasing the size of their firms⁴² or by diversifying their firms' business,⁴³ and they may do

³⁸ See generally Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (Paper & Proceedings, May 1986) [hereinafter Jensen, *Agency Costs of Free Cash Flow*]; Michael C. Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988) [hereinafter Jensen, *Takeovers*]; Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314 (John C. Coffee, Jr. et al. eds., 1988) [hereinafter Jensen, *The Takeover Controversy*].

³⁹ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 323; Jensen, *Takeovers*, *supra* note 38, at 28-29; Jensen, *The Takeover Controversy*, *supra* note 38, at 321-22.

Some scholars have expressed skepticism about the empirical validity of Jensen's cash flow hypothesis. See, e.g., Sidney G. Winter, *Routines, Cash Flows, and Unconventional Assets: Corporate Change in the 1980s*, in THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 55, 72-74 (Margaret M. Blair ed., 1993). However, there is a growing body of empirical work supporting Jensen's hypothesis and its implications. See Larry H.P. Lang et al., *A Test of the Free Cash Flow Hypothesis: The Case of Bidder Returns*, 29 J. FIN. ECON. 315, 334 (1991) (gains from takeovers fall as free cash flow increases); Kenneth Lehn & Annette Poulsen, *Free Cash Flow and Stockholder Gains in Going Private Transactions*, 44 J. FIN. 771 (1989) (likelihood of going private is directly related to free cash flow, and premiums paid to shareholders in private transactions are positively and significantly related to undistributed cash flow); Richard L. Smith & Joo-Hyun Kim, *The Combined Effects of Free Cash Flow and Financial Slack on Bidder and Target Stock Returns*, 67 J. BUS. 281 (1994) (gains from merger and acquisitions activity reflect, in part, resolution of overinvestment problem associated with free cash flow hypothesis; bidders with high free cash flow tend to overpay for their targets); see also Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. REG. 119, 131-33, 149-50 (1992) (summary of empirical studies supporting free cash flow explanation of takeovers).

⁴⁰ See generally GORDON DONALDSON, *MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM* (1984); GORDON DONALDSON & JAY LORSCH, *DECISION MAKING AT THE TOP* (1983); George P. Baker et al., *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 609 (1988).

⁴¹ See John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, in KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 77, 82-85 (John C. Coffee, Jr. et al. eds., 1988); Jensen & Meckling, *supra* note 37, at 349-50, 352-53; Alan J. Marcus, *Risk Sharing and the Theory of the Firm*, 13 BELL J. ECON. 369 (1982); Susan Rose-Ackerman, *Risk Taking and Ruin: Bankruptcy and Investment Choice*, 20 J. LEGAL STUD. 277 (1991). See generally RONALD W. MASULIS, *THE DEBT/EQUITY CHOICE* 47-60 (1988); Jensen & Meckling, *supra* note 37, at 308-10.

⁴² See DONALDSON, *supra* note 40; DONALDSON & LORSCH, *supra* note 40.

⁴³ See Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605, 606 (1981); Larry H.P. Lang & Rene M. Stulz, *Tobin's q, Corporate Diversification, and Firm Performance*, 102 J. POL. ECON. 1248 (1994) (diversified firms perform

so even if it means making negative net present value investments. Because shareholders can easily diversify their portfolios, however, they have no interest in such strategies.

The precursor of Jensen's free cash flow theory is the growth maximization hypothesis developed by scholars including William Baumol, Robin Marris, Oliver Williamson and Merritt Fox.⁴⁴ Similar to Jensen's free cash flow theory, the growth maximization hypothesis posits that managers have incentives to maximize the growth or size of their firms even at the expense of shareholder wealth. These incentives are analogous to those Jensen identified. Marris theorizes that firm growth provides managers with greater monetary and psychic compensation, as well as increased job security.⁴⁵ Similarly, Williamson attributes to managers an "expense preference," that is, a preference for expenditures that increase staff, firm size and managerial discretion.⁴⁶

worse than undiversified firms); Randall Mørck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 31-32 (1990); Andrei Shleifer & Robert W. Vishny, *Value Maximization and the Acquisition Process*, 2 J. ECON. PERSP. 7, 13-15 (1988) [hereinafter Shleifer & Vishny, *Value Maximization*].

⁴⁴ See WILLIAM J. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* (1959); MERRITT B. FOX, *FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY* (1987); ROBIN MARRIS, *THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM* (1964) [hereinafter MARRIS, *MANAGERIAL CAPITALISM*]; Robin Marris, *A Model of the 'Managerial' Enterprise*, 77 Q.J. ECON. 185 (1963) [hereinafter Marris, *Managerial Enterprise*]; Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032 (1963); see also John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 20-21, 28-31 (1986) [hereinafter Coffee, *Strain in the Corporate Web*] (describing growth maximization hypothesis); John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance as a Multi-Player Game*, 78 GEO. L.J. 1495, 1499-1501 (1990) [hereinafter Coffee, *Unstable Coalitions*] (noting link between growth maximization and free cash flow theories).

⁴⁵ MARRIS, *MANAGERIAL CAPITALISM*, *supra* note 44, at 61-66; Marris, *Managerial Enterprise*, *supra* note 44, at 186-91.

⁴⁶ Williamson, *supra* note 44, at 1034-36. John Coffee restates Marris and Williamson's theories in terms of risk and posits that managers are more risk averse than shareholders because their investment in their firm cannot be diversified as easily as shareholders' portfolios. Therefore, managers maximize growth to increase job security and otherwise to reduce risk. See Coffee, *Strain in the Corporate Web*, *supra* note 44, at 16-25, 29-30.

An alternative theory explaining why firms may become suboptimally large is the hubris theory, first formulated by Richard Roll. See Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986). This theory posits that managers are overly optimistic about their ability to realize value from potential acquisitions and therefore overpay for businesses or buy them more often than they ought to. There is some empirical support for this theory. See Mathew L.A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, __ ADMIN. SCI. Q. __ (forthcoming 1998) (indicators of CEO hubris are highly associated with size of acquisition premiums paid; the greater the CEO hubris and size of premium paid, the greater the magnitude of shareholder losses); Nikhil P. Varaiya, *The "Winner's Curse" Hypothesis and Corporate Takeovers*, 9 MANAGERIAL & DECISION ECON. 209 (1988) (takeover premium exceeds combined market value of bidder and target firms). But see Romano, *supra* note 39, at 151 ("[T]arget gains are greater than bidder losses, indica[ting] that takeovers involve

The managerial preference for size and diversification reveals itself in acquisitions that reduce the value of the acquirer. Several empirical studies have uncovered such acquisitions. Michael Porter, for example, studied the diversification programs of thirty-three large prestigious U.S. companies from 1950 through 1986 and found most of them to be unsuccessful, as evidenced by subsequent divestitures.⁴⁷ Similarly, Randall Mørck, Andrei Shleifer and Robert W. Vishny studied 326 mergers from 1975 through 1987 and found that diversifying acquisitions and acquisitions that maximized growth had lower returns than other acquisitions.⁴⁸

B. Takeovers as a Solution to the Problem

Jensen's free cash flow theory casts takeovers not only as evidence of the conflict between shareholders and managers but also as a solution to the problem.⁴⁹ Takeovers reduce managers' ability to engage in self-serving, value-decreasing acquisitions in three ways.⁵⁰ First, bust-up

more than simply a wealth transfer from bidder shareholders to managers and target shareholders [The] hubris hypothesis, therefore, is not a long-run equilibrium explanation because bidders should learn from their experience and adjust their bids downward."). In addition, the theory is quite prevalent in the popular press. See, e.g., Charles V. Bagli, *Snapple Is Just the Latest Case of Mismatched Reach and Grasp*, N.Y. TIMES, Mar. 29, 1997, at A4; Terence Bendley, *Putting the Right People on In-House M & A Teams*, MERGERS & ACQUISITIONS, May/June 1996, at 30; Marcia Berss, *Hubris in Columbus*, FORBES, Feb. 27, 1995, at 56; Paula Dwyer, *Saatchi: The House that Hubris Wrecked*, BUS. WK., Feb. 3, 1997, at 15 (book review); Michael Geczi, *Say Why a Merger Is Beneficial*, U.S. BANKER, Feb. 1995, at 80; Steve Lohr, *To Divide or Combine?*, N.Y. TIMES, Sept. 25, 1995, at D1; *Mergers: Will They Ever Learn?*, BUS. WK., Oct. 30, 1995, at 178; Joan Warner, *The World Is Not Always Your Oyster*, BUS. WK., Oct. 30, 1995, at 132; Phillip L. Zweig et al., *The Case Against Mergers*, BUS. WK., Oct. 30, 1995, at 122, 125.

The hubris theory complements the theories discussed here in two ways. First, the opportunity for hubris may be especially attractive when the acquirer's management is paying with shareholders' money. Second, management's personal interest in an acquisition may color its perception of the shareholder value that is likely to arise.

⁴⁷ See Michael E. Porter, *From Competitive Advantage to Corporate Strategy*, HARV. BUS. REV., May-June 1987, at 43 [hereinafter Porter, *Competitive Advantage*]. The findings of Steven Kaplan and Michael Weisbach differ somewhat from Porter's. They report that 44% of target assets were divested in large acquisitions (both diversifying and nondiversifying) completed between 1971 and 1982, a somewhat smaller percentage than Porter's. Steven N. Kaplan & Michael S. Weisbach, *The Success of Acquisitions: Evidence from Divestitures*, 47 J. FIN. 107, 108 (1992). In addition, they differentiate between successful and unsuccessful divestitures and find only weak evidence that diversification programs are value-reducing. See *id.* at 109. However, in support of managerial motives for acquisitions, they do find that acquirers in unsuccessful acquisitions have higher levels of free cash flow than acquirers in successful acquisitions. See *id.*

⁴⁸ See Mørck et al., *supra* note 43; see also David J. Ravenscraft & F.M. Scherer, *Mergers, Sell-Offs, and Economic Efficiency*, Brookings Institution, Washington, D.C. (1987) (diversifying acquisitions of 1960s did not improve profitability; one-third of all acquisitions were subsequently divested).

⁴⁹ Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 328.

⁵⁰ Jensen's observation that takeovers can reduce agency costs follows a well-established view,

takeovers—those in which an acquirer subsequently breaks up the target and sells various businesses to various purchasers—dismantle suboptimally large or diversified firms.⁵¹ Second, leveraged buyouts—takeovers financed by borrowed funds secured by target assets and cash flows—increase debt levels of target firms, thereby decreasing free cash flow.⁵² Third, the threat of a hostile takeover deters managers from making noneconomic investments and motivates them to divest existing ones.⁵³ In sum, some takeovers are manifestations of managers' tendencies to make inefficient acquisitions, while other takeovers are evidence of the means through which the market disciplines these inefficient managers.

1. Inefficient Acquirers Become Targets

Managers who operate their firms too inefficiently run the risk of having their firms become takeover targets. Managers who too easily give in to the self-interested urge to merge may expose themselves to the discipline of the market for corporate control. This link between misusing free cash flow and being targeted for takeover has been borne out in several empirical studies.⁵⁴ Mark Mitchell and Kenneth Lehn found that bidders who make negative net present value acquisitions—that is, those who wasted excess cash flow—are likely to become takeover targets themselves.⁵⁵ Similarly, Jensen explains how firms in declining industries with high levels of free cash flow are likely to engage in value-reducing diversification programs and thereby face the threat of takeover. He cites the tobacco, oil, food and broadcasting industries

pioneered by Henry Manne, that takeovers motivate managers to maximize shareholder value. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965).

⁵¹ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 328; Jensen, *The Takeover Controversy*, *supra* note 38, at 319.

⁵² See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 324–26; Jensen, *Takeovers*, *supra* note 38, at 29–32; Jensen, *The Takeover Controversy*, *supra* note 38, at 322–23; *infra* note 68 and accompanying text (describing manner in which increased leverage reduces agency cost of free cash flow in more detail).

⁵³ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 328; Jensen, *Takeovers*, *supra* note 38, at 28; Jensen, *The Takeover Controversy*, *supra* note 38, at 319.

⁵⁴ See, e.g., Lang et al., *supra* note 39 (gains from takeovers fall as free cash flow increases); Lehn & Poulsen, *supra* note 39 (likelihood of going private is directly related to free cash flow and premiums paid to shareholders in ongoing private transactions are positively and significantly related to undistributed cash flow); Smith & Kim, *supra* note 39 (gains from merger and acquisition activity reflect, in part, resolution of overinvestment problem associated with free cash flow hypothesis; bidders with high free cash flow tend to overpay for their targets).

⁵⁵ See Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?* 98 J. POL. ECON. 372, 396 (1990) (empirical study finding that some takeovers discipline managers who use free cash flow to make value-reducing acquisitions while other takeovers promote economic efficiency by reallocating target assets to higher-valued uses).

as instances where this has occurred.⁵⁶ His account of the oil industry during the 1970s, for example, is well-developed and compelling. At that time companies were plagued by excess capacity while they enjoyed high cash flows and profits.⁵⁷ Managers wasted free cash flow by, among other actions, making poor acquisitions outside the industry.⁵⁸ Subsequently, the threat of hostile takeovers led to mergers and restructurings within the industry that paid out large amounts to shareholders, increased debt levels and reduced wasteful expenditures, thereby reducing the agency costs of free cash flow.⁵⁹

Mitchell and Lehn provide Sir James Goldsmith's unsuccessful attempt to acquire Goodyear Tire and Rubber Company in October 1986 as a case study supporting their claim that "bad bidders become good targets."⁶⁰ Three years before Goldsmith's attempted takeover, Goodyear had diversified into the oil business by purchasing an oil company for \$800 million.⁶¹ As evidenced by a \$359 million decline in the trading value of Goodyear's shares, the market perceived the purchase to be wasteful.⁶² Goldsmith made a hostile tender offer for Goodyear's shares and announced his intention, if successful, to sell Goodyear's diversified assets and return to its core business.⁶³ Although Goldsmith's offer failed, Goodyear responded to the attempted takeover by adopting a restructuring program similar to the one proposed by Goldsmith, and divested significant portions of its non-core-business

Roberta Romano describes Mitchell and Lehn's finding as: "[A] fascinating marriage of Marris's, Manne's, and Jensen's explanations: firms whose managers engage in non-value-maximizing acquisitions, wasting free cash flow, are themselves acquired, in keeping with the agency cost reduction's hypothesis that takeovers discipline inefficient managers." ROBERTA ROMANO, FOUNDATIONS OF CORPORATE LAW 263 (1993). Takeovers are thus both the epitome of the agency problem and its solution. *See id.*

⁵⁶ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 326-28; Jensen, *Takeovers*, *supra* note 38, at 32-36; Jensen, *The Takeover Controversy*, *supra* note 38, at 329-34.

⁵⁷ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 326; Jensen, *Takeovers*, *supra* note 38, at 32-33; Jensen, *The Takeover Controversy*, *supra* note 38, at 329-32.

⁵⁸ For example, Mobil bought Marcor (a retailing firm); Exxon bought Reliance Electric (manufacturing) and Vydec (office equipment); Sohio bought Kennecott (mining); ARCO bought Anaconda Minerals (mining) and Amoco bought Cyprus Mines (mining). *See* Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 327; Jensen, *Takeovers*, *supra* note 38, at 34; Jensen, *The Takeover Controversy*, *supra* note 38, at 332.

⁵⁹ For example, the Gulf/Chevron, Getty/Texaco and Dupont/Conoco mergers resulted in over \$17 billion in gains to shareholders. Also, Phillips, Unocal and ARCO undertook restructurings that produced increases in market value totaling \$6.6 billion. *See* Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 327; Jensen, *Takeovers*, *supra* note 38, at 34; Jensen, *The Takeover Controversy*, *supra* note 38, at 332-33.

⁶⁰ Mitchell & Lehn, *supra* note 55, at 374.

⁶¹ *See id.*

⁶² *See id.*

⁶³ *See id.*

assets.⁶⁴ Thus, Goldsmith's takeover threat disciplined Goodyear's managers, compelling them to divest their unwise acquisitions and pay out excess cash flows to shareholders.

Sanjai Bhagat, Andrei Shleifer and Robert Vishny provide an additional explanation of the merger wave of the 1980s consistent with the dual role of free cash flow theory in takeovers.⁶⁵ They studied a sample of sixty-two hostile takeover contests between 1984 and 1986 in an effort to determine the sources of gains from takeovers. They found that hostile takeovers by raiders and leveraged buyout firms were often followed by divestitures of target businesses to strategic buyers, that is, firms in the same industry as the target businesses they purchased.⁶⁶ They theorized that raiders and leveraged buyout firms acted as brokers who acquired diversified firms and then busted them up, reselling the assets to buyers with synergies to offer.⁶⁷ In this way, takeovers

⁶⁴ See *id.* at 374-75. Andrei Shleifer and Robert Vishny also theorize that the takeovers of the 1980s reversed the non-value-maximizing diversification undertaken in the 1960s by managers with large free cash flows. See Andrei Shleifer & Robert W. Vishny, *Takeovers in the '60s and the '80s: Evidence and Implications*, 12 STRATEGIC MGMT. J. 51, 57 (1991); see also Mørck et al., *supra* note 49 (finding that managerial objectives led to uneconomic diversification programs in the 1970s and 1980s; speculating that the takeovers and defensive restructurings of the 1980s simply reversed past conglomeration); Andrei Shleifer & Robert W. Vishny, *Management Buyouts as a Response to Market Pressure*, in MERGERS AND ACQUISITIONS 87, 90 (Alan J. Auerbach ed., 1988) [hereinafter Shleifer & Vishny, *Management Buyouts*] (high inflation in late 1970s and early 1980s reduced real corporate debt obligations, leading to excess free cash flow); Shleifer & Vishny, *Value Maximization*, *supra* note 43.

⁶⁵ See Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in BROOKINGS PAPERS ON ECONOMIC ACTIVITY (James R. Schneider et al. eds., 1990).

⁶⁶ See *id.* at 40.

⁶⁷ See *id.* at 44. Bhagat, Shleifer and Vishny do not adopt cash flow theory as an explanation for why the diversified firms came into existence, or for why they then became takeover targets. In fact, they explicitly reject Jensen's claim that the takeovers of the 1980s resulted in organizational and capital structure changes—concentrated ownership and high debt levels—that reduced the free cash flow of target firms. Instead, they note that many of the takeovers were followed by subsequent divestitures to strategic buyers. Thus, they argue, the concentrated ownership and high leverage created by initial takeovers were only temporary. See *id.* at 40, 44; see also Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96 (leveraged buyouts are inherently transitory; high debt levels and concentrated ownership impose costs of inflexibility); cf. Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287, 290 (1991) (leveraged buyouts are not permanent, but are not short-lived either; after going public, leveraged buyouts have higher levels of debt and concentrated ownership than pre-buyout and median public-company levels). Rather, Bhagat, Shleifer and Vishny offer competing explanations for these phenomena. They speculate that diversified firms came about through the conglomerate mergers of the 1960s, as a result both of aggressive antitrust regulation, which prevented consolidation of U.S. industries, and the market's overestimation of the gains from diversification. See Bhagat et al., *supra* note 65, at 55, 57. In the 1980s, antitrust regulation eased, and the bust-up acquisitions of the 1980s dismantled the conglomerates and reallocated assets to firms with the same industry specialization, thereby producing gains from increased concentration. See *id.* at 56.

dismantled the inefficient conglomerates resulting from unwise investments of excess cash flow.

2. Debt-Financed Versus Stock-Financed Acquisitions

Another implication of the free cash flow theory is that debt-financed acquisitions are more likely to be value-enhancing than equity-financed acquisitions. This follows from the fact that managers can bond themselves to pay out free cash flow on debt—which carries fixed payment obligations—but not on equity.⁶⁸ Empirical evidence demonstrates that acquisitions accompanied by high levels of debt reduce the

Despite their disavowal of cash flow theory as an explanatory aid, Bhagat, Shleifer and Vishny tell a story that is, for the most part, consistent with a cash flow theory account. Under the free cash flow theory account, diversified firms came into existence during the 1960s because managers used excess cash flow to fund uneconomic investments. The 1980s acquisitions reversed these uneconomic diversification programs and implemented organizational and capital structure changes—specifically concentrated share ownership and increased leverage—that reduce future cash flows. See *supra* notes 55–64 and accompanying text. Bhagat, Shleifer and Vishny's explanation is not completely consistent with cash flow theory because, as they point out, most of the acquisitions they studied, as well as other acquisitions during the same time period, involved reallocations of assets to related firms rather than permanent free-cash-flow-reducing organizational and capital structure changes in target firms. However, the reallocation of assets that resulted from these acquisitions is consistent with the unwinding of wasteful free cash flow expenditures. See Mørck et al., *supra* note 43 (finding that managerial objectives led to uneconomic diversification programs in 1970s and 1980s; speculating that takeovers and defensive restructurings of 1980s simply reversed past conglomeration). Moreover, as Jensen points out, to avoid being taken over, many firms adopted restructuring programs that did permanently reduce cash flow. See *supra* notes 55–64 and accompanying text.

⁶⁸ See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 324; Jensen, *Takeovers*, *supra* note 38, at 29; Jensen, *The Takeover Controversy*, *supra* note 38, at 322; see also René M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3 (1990) (use of debt to reduce free cash flow and managerial agency costs); Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61 (predicting decline of publicly-held, equity-funded corporations and rise of closely-held, debt-funded corporations in order to reduce agency costs of free cash flow).

Jensen's debt finance versus stock finance hypothesis is an outgrowth of the literature describing the role of debt generally in reducing managerial agency costs. Juxtaposed with this literature on conflicts of interest between managers and shareholders is an extensive literature on conflicts of interest between bondholders and shareholders. These two bodies of literature sometimes formulate conflicting theories that explain the same empirical observations. Thus, for example, the bondholder/shareholder literature theorizes that shareholders can expropriate wealth from bondholders by increasing outstanding debt, spinning off assets, or divesting low risk assets. See MASULIS, *supra* note 41, at 35–46 (general description of debt/equity agency costs). Under this theory, the observed correlation of new debt issuances with stock value increases is explained as a wealth transfer from bondholders to shareholders rather than by reference to a reduction in managerial discretion over free cash flow.

agency costs of free cash flow.⁶⁹ Moreover, empirical studies show that acquisitions funded by stock tend to be value-decreasing.⁷⁰

As described above, many of the conglomerate mergers of the 1960s proved to be unsuccessful.⁷¹ These mergers were often financed by the issuance of stock by the acquiring company in exchange for target company stock or assets.⁷² Shleifer and Vishny theorized that the 1960s merger wave was driven by large corporate cash flows and high valuations of company stock. Rather than paying out cash flows to

⁶⁹ See George P. Baker & Karen H. Wruck, *Organizational Changes and Value Creation in Leveraged Buyouts*, 25 J. FIN. ECON. 163, 167 (1989) (case study of leveraged buyout of O.M. Scott & Sons Company finds that pressure of servicing heavy debt load and management equity ownership leads to improved performance); Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (post-management-buyout improvements in performance attributable to reduced agency costs produced by increased leverage, centralized ownership and increased monitoring by buyout team); Michael T. Maloney et al., *Managerial Decision Making and Capital Structure*, 66 J. BUS. 189 (1993) (bidder returns increase with level of debt which is consistent with claim that, where there is less free cash flow or more creditor monitoring, acquisitions are value-maximizing); Karen H. Wruck, *Financial Policy, Internal Control, and Performance: Sealed Air Corporation's Leveraged Special Dividend*, 36 J. FIN. ECON. 157 (1994) (leveraged special dividend produced dramatic improvement in performance).

⁷⁰ See Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporation Acquisitions?*, __ J. FIN. __ (forthcoming 1998); Maloney et al., *supra* note 69, at 189 (bidder returns increase with level of debt, which is consistent with claim that, where there is less free cash flow or more creditor monitoring, acquisitions are value-maximizing).

Many studies find that an acquiring firm's stock has a negative price reaction upon the announcement of stock-financed acquisitions, or that bidder returns are lower for stock-financed as compared to cash or debt-financed acquisitions. See Julian R. Franks et al., *Means of Payment in Takeovers: Results for the United Kingdom and the United States*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 221 (Alan J. Auerbach ed., 1988); Henri Servaes, *Tobin's Q and the Gains from Takeovers*, 46 J. FIN. 409 (1991); Nickolaos G. Travlos, *Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns*, 42 J. FIN. 943 (1987); James W. Wansley et al., *Gains to Bidder Firms in Cash and Securities Transactions*, 22 FIN. REV. 403 (1987); see also Yakov Amihud et al., *Corporate Control and the Choice of Investment Financing: The Case of Corporate Acquisitions*, 45 J. FIN. 603 (1990) (significant negative bidder returns for stock-financed acquisitions but only for those bidders with low management ownership). In addition, other studies find that post-acquisitions returns are lower for stock-financed acquisitions than for cash-financed acquisitions. See, e.g., Anup Agrawal et al., *The Post-Merger Performance of Acquiring Firms: A Re-Examination of an Anomaly*, 47 J. FIN. 1605 (1992).

The empirical studies described above are consistent with the cash flow theory prediction that stock-financed acquisitions are more likely to be value-reducing than debt-financed acquisitions. The theoretical work prompting these studies, however, has focused on asymmetric information about the value of the acquirer or the target as a determinant of method of payment. See B. Espen Eckbo et al., *Asymmetric Information and the Medium of Exchange in Takeovers: Theory and Tests*, 3 REV. FIN. STUD. 651 (1990); Robert G. Hansen, *A Theory for the Choice of Exchange Medium in Mergers and Acquisitions*, 60 J. BUS. 75 (1987).

⁷¹ See *supra* notes 55-67 and accompanying text.

⁷² See Shleifer & Vishny, *Management Buyouts*, *supra* note 64, at 51-52.

shareholders, managers issued new stock to make acquisitions.⁷³ In contrast, the mergers of the 1980s—financed primarily by debt—enhanced value in part through increased debt levels.⁷⁴

The current merger wave, which consists primarily of stock-financed acquisitions, may prove to support the claim that stock-financed acquisitions are not value-enhancing. The merger wave of the 1990s is becoming a tsunami. It has already surpassed the 1980s wave in terms of volume. In 1988, the height of the 1980s wave, \$353 billion in deals were completed; in 1995, \$518 billion in deals were completed;⁷⁵ and in 1996, \$650 billion were completed.⁷⁶ The current mergers differ, however, from those of the 1980s in that they are primarily financed by stock of the acquiring company rather than by debt.⁷⁷ Consistent with the predictions of free cash flow theory, there is already evidence that the current mergers are not value-enhancing. Business Week and Mercer Management Consulting conducted a survey of 150 recent deals valued at \$500 million or more. They found that about half decreased shareholder wealth, as measured in relation to the Standard & Poor's industry indexes, and that one-third contributed only marginally to shareholder wealth.⁷⁸ Anecdotal evidence also indicates that some prominent mergers are misconceived. For example, Time's merger with Warner,⁷⁹ Disney's acquisition of Capital Cities/ABC,⁸⁰ AT&T's acquisition of NCR,⁸¹ and Time Warner's acquisi-

⁷³ See *id.* at 52. Shleifer and Vishny's hypothesis contradicts Jensen's casual remark that stock acquisitions are likely to be associated with growth opportunities and a *shortage* of free cash flow. See Jensen, *Agency Costs of Free Cash Flow*, *supra* note 38, at 329.

⁷⁴ See Shleifer & Vishny, *Management Buyouts*, *supra* note 64, at 57.

⁷⁵ See Charles V. Bagli, *MCI Deal Would Speed Pace of Current Mergers*, N.Y. TIMES, Nov. 2, 1996, at A5.

⁷⁶ See Steven Lipin, *Merger Wave Gathers Force as Strategies Demand Buying or Being Bought*, WALL ST. J., Feb. 26, 1997, at A1.

⁷⁷ Unlike the mergers of the 1960s, however, the current mergers are motivated primarily by perceived synergies rather than diversification. See, e.g., Michael H. Lubatkin & Peter J. Lane, *Psst . . . The Merger Mavens Still Have It Wrong*, 10 ACAD. MGMT. EXECUTIVES 21, 28-31 (1996); David Whitford & Caroline Bollinger, *Sale of the Century*, FORTUNE MAG., Feb. 17, 1997, at 92; Zweig et al., *supra* note 46, at 122.

⁷⁸ See Zweig et al., *supra* note 46, at 124 (describing survey).

⁷⁹ See Zweig et al., *supra* note 46, at 128 (chart listing "worst megadeals of the 1990s" includes Time/Warner merger).

⁸⁰ See Lohr, *supra* note 46, at D1 (quoting Michael Porter, "Disney's a great company, but for the life of me, I don't see the advantages of buying ABC."); Zweig et al., *supra* note 46, at 124 (acquisition "leave[s] many media-industry observers scratching their heads over where the gains are going to come from.").

⁸¹ See George J. Church, *Just Three Easy Pieces: Running Against the Trend of American Business, AT&T Announces the Biggest Corporate Split-Up Ever*, TIME, Oct. 2, 1995, at 38; Lohr, *supra* note 46, at D1; Zweig et al., *supra* note 46, at 122.

tion of Turner Broadcasting⁸² have all been criticized as non-value-enhancing deals.⁸³

C. Divestitures

Once a firm's management has made an ill-advised acquisition, it can, of course, divest the acquired business. The same incentives that motivate managers to make value-decreasing acquisitions, however, create a disinclination to divest unsuccessful acquisitions.⁸⁴ Divestiture would, after all, reduce firm size or diversification. In addition, there may be other disincentives. Michael Porter theorized that a manager might avoid divesting an under-performing business because doing so would be a blow to a manager's professional pride in his ability to run the business.⁸⁵ Porter also theorized that managers might avoid divesting under-performing assets because doing so might threaten the manager's career by signaling failure or by eliminating the need for the manager's expertise.⁸⁶ Nonetheless, divestitures do occur.

When divestitures do occur, however, they sometimes take a form that fails to advance shareholder interests. A divestiture can be structured in one of two ways: either a sell-off, in which a firm sells assets for cash or other consideration; or a spin-off, in which the firm distributes a subsidiary conducting one or more businesses to its shareholders.⁸⁷ Sell-offs appear to be less value-enhancing than spin-offs. Numerous studies have found that spin-offs result in positive stock price reactions.⁸⁸ In contrast, the evidence on sell-offs is mixed. Where firms

⁸² See Zweig, *supra* note 46, at 128 (quoting James Quella: "Turner overpaid for much of what he bought, and now Time Warner is paying a premium on top of that.").

⁸³ Michael Lubatkin and Peter Lane speculate that because current mergers are stock-financed, it is less likely that managers will be disciplined for bad deals than in the case of debt-financed deals. Lubatkin & Lane, *supra* note 77, at 21.

⁸⁴ This Article focuses on managerial barriers to divestiture. Just as there are many explanations for takeovers, however, there are many explanations of barriers to exit. See generally Irene M. Duhaime & John H. Grant, *Factors Influencing Divestment Decision-Making: Evidence from a Field Study*, 5 STRATEGIC MGMT. J. 301 (1984) (in large, diversified firms, the major determinants in divestment decisions are unit strength, unit interdependency and firm financial strength relative to industry averages); Kathryn Rudie Harrigan, *Deterrents to Divestiture*, 24 ACAD. MGMT. J. 306 (1981) (testing the influence of various economic and strategic exit barriers across different industries); Michael E. Porter, *Please Note Location of Nearest Exit: Exit Barriers and Planning*, 19 CAL. MGMT. REV. 21 (1976) (hereinafter Porter, *Nearest Exit*) (describing economic, strategic and managerial exit barriers).

⁸⁵ See Porter, *Nearest Exit*, *supra* note 84, at 25, 26.

⁸⁶ See *id.*

⁸⁷ Spin-offs are tax-free to both the divesting corporation and its shareholders. See *infra* note 116 and accompanying text.

⁸⁸ See, e.g., Gailen L. Hite & James E. Owers, *Security Price Reactions Around Corporate Spin-Off*

retain the proceeds of the sale, sell-offs tend to reduce firm value; where firms pay out the proceeds to shareholders, sell-offs tend to increase firm value.⁸⁹

The occurrence of wealth-decreasing divestitures, like that of wealth-decreasing acquisitions, may reflect managerial incentives.⁹⁰ If a firm sells off an asset and retains the sale proceeds, managers have the opportunity to use the new free cash flow, possibly for another inefficient investment. If, on the other hand, the firm pays out the sale proceeds, free cash flow and the agency costs thereof are reduced.⁹¹ Similarly, spin-offs entail paying out assets to shareholders, thereby precluding the possibility of wasteful investment by managers.⁹²

In sum, financial economists have identified certain takeover-related transactions that tend to be value-increasing and others that tend to be value-decreasing. The value-increasing transactions include bust-up acquisitions, leveraged acquisitions, spin-offs and sell-offs in which the proceeds are distributed to shareholders. Value-decreasing transactions include stock-financed acquisitions and sell-offs in which sale proceeds are retained. As the next Part will explain, the *General Utilities* doctrine encouraged precisely those transactions that tend to be value-

Announcements, 12 J. FIN. ECON. 409, 434 (1983); James A. Miles & James D. Rosenfeld, *The Effect of Voluntary Spin-off Announcements on Shareholder Wealth*, 38 J. FIN. 1597 (1983); Katherine Schipper & Abbie Smith, *Effects of Recontracting on Shareholder Wealth: The Case of Voluntary Spin-offs*, 12 J. FIN. ECON. 437 (1983).

⁸⁹ See Larry Lang et al., *Asset Sales, Firm Performance, and the Agency Costs of Managerial Discretion*, 37 J. FIN. ECON. 3, 6-7 (1995) (positive stock price reaction significant only when asset sale proceeds are paid out rather than retained); Myron B. Sloven et al., *A Comparison of the Information Conveyed by Equity Carve-Outs, Spin-Offs, and Asset Sell-Offs*, 37 J. FIN. ECON. 89, 102 (1995) (same).

In addition, sell-offs that are part of an integrated strategic plan increase firm value; other sell-offs decrease firm value. See Cynthia A. Montgomery et al., *Divestiture, Market Value, and Strategy*, 27 ACAD. MGMT. J. 830, 838-39 (1984) (sales that are part of integrated, strategic plans are associated with large positive stock market effects; routine, nonstrategic divestitures are associated with negative stock price effects; those undertaken because of liquidity needs, government pressure or unstated reasons exhibit no stock price effects).

⁹⁰ The literature on debt/equity agency costs offers an alternative explanation for empirical observations. Managerial agency theory predicts managers will prefer sell-offs to spin-offs. In contrast, debt/equity agency theory posits that shareholders will use spin-offs to expropriate wealth from bondholders.

⁹¹ See Lang et al., *supra* note 89, at 6, 22 (sell-offs decrease shareholder wealth where firms retain proceeds because expectation is that managers will waste proceeds); Sloven et al., *supra* note 89, at 93 (same).

⁹² See Sloven et al., *supra* note 89, at 93 (predicting less favorable stock effects for sell-offs than spin-offs because agency problems are a factor in sell-offs but not in spin-offs, and because spin-offs are subject to market monitoring while sell-offs are not). But see Scott C. Lin & Michael S. Rozeff, *The Effect of Voluntary Spin-Offs on Stock Prices: The Agency Hypothesis*, 1 FIN. PLAN. & FORECASTING 265, 271-72, 281 (1985) (growth maximization hypothesis fails to explain, and is inconsistent with, value-enhancing spin-offs).

increasing and discouraged those that tend to be value-decreasing. Conversely, the repeal of the doctrine discourages the former transactions and encourages the latter.

III. THE *GENERAL UTILITIES* DOCTRINE: EFFECTS AND EVALUATION

The *General Utilities* doctrine plays a complex role in takeovers, a role that has not yet been fully explored in the existing literature. The finance literature exploring the impact of tax laws on takeovers generally focuses on only one aspect of this role—the increased depreciation deductions available to a new owner who elects basis step-up.⁹³ Tax scholars offer a more comprehensive account of the effect of the doctrine on takeovers, but fail to integrate their analysis with the finance theories that explain takeovers and evaluate their social desirability.⁹⁴ This section attempts to bridge the discontinuity between tax and finance analysis. It explores the various ways in which the *General Utilities* doctrine affected takeovers, and evaluates these effects by reference to the framework developed in the previous Part.

A. *Bust-Up Acquisitions*

The *General Utilities* doctrine favored bust-up acquisitions which, as discussed above, tend to be socially desirable. Accordingly, the doctrine's repeal eliminated this favorable treatment. Under the *General*

⁹³In general, the finance literature on the effect of tax laws on takeovers focuses primarily on three features of the tax law that, arguably, encourage takeovers: the deductibility of interest, the transferability of corporate tax attributes such as net operating losses, and the ability of an acquirer to step up the basis of a target corporation's assets without incurring the corporate level tax. See Alan J. Auerbach & David Reishus, *The Impact of Taxation on Mergers and Acquisitions*, in *MERGERS AND ACQUISITIONS* 69 (Alan J. Auerbach ed., 1988) [hereinafter Auerbach & Reishus, *Impact of Taxation*] (effects of interest deduction, tax loss and credit transfers, and basis step-up); Alan J. Auerbach & David Reishus, *Taxes and the Merger Decision*, in *KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* 300 (John C. Coffee, Jr. ed., 1988) [hereinafter Auerbach & Reishus, *Taxes and the Merger Decision*] (same); Ronald J. Gilson et al., *Taxation and the Dynamics of Corporate Control: The Uncertain Case for Tax-Motivated Acquisitions*, in *KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* 271 (John C. Coffee, Jr. ed., 1988) (effects of interest deduction, basis step-up and tax loss transfers); Kaplan & Weisbach, *supra* note 47 (effects of interest deduction and basis step-up). The third of these features—basis step-up—implicates the *General Utilities* doctrine and affords two principal benefits to acquirers: increased depreciation deductions and the ability to bust up the target corporation without incurring any additional tax. However, the commentators focus only on the increased depreciation deductions afforded by basis step-up, and disregard the possibility that the target corporation will be busted up. See Auerbach & Reishus, *Impact of Taxation*, *supra*, at 69; Auerbach & Reishus, *Taxes and the Merger Decision*, *supra*, at 300; Ronald J. Gilson et al., *supra*, at 271; Kaplan & Weisbach, *supra* note 47.

⁹⁴See, e.g., Coven, *supra* note 2; Stephan, *supra* note 2; Yin, *supra* note 22, at 1111.

Utilities doctrine, an acquirer of the stock of a target corporation could elect a tax-free step-up in the target corporation's assets under § 338, thereby obtaining the ability to later divest target assets with no tax on asset appreciation accruing prior to the acquisition.⁹⁵ The prior owners of corporations were not permitted to do this.⁹⁶ Repeal of the doctrine, therefore, has eliminated the ability of an acquirer to escape the corporate level tax in a bust-up acquisition.

As discussed above, the bust-up acquisitions of the 1980s that the *General Utilities* doctrine facilitated were probably socially valuable. They "unwound" the inefficient acquisitions of the 1960s that incumbent managers—for reasons described above—were reluctant to unwind themselves. They also motivated managers to pay out excess cash flows through leveraged share repurchases and other leveraged takeover defense strategies. Furthermore, the threat of such takeovers deterred managers from making additional inefficient acquisitions. By enabling acquirers to bust up target corporations with no corporate level tax, the *General Utilities* doctrine facilitated these value-enhancing transactions. Thus, repeal of the doctrine may have a tendency to leave intact inefficient acquisitions of the 1990s.

B. *Stock-Financed Acquisitions Versus Cash-Financed Acquisitions*

The *General Utilities* doctrine favored efficient, cash-financed acquisitions—and conversely discouraged inefficient, stock-financed acquisitions—by providing an acquirer with the benefits of stepped-up basis in the target assets at the cost of only one tax, namely, to the target shareholders. After *General Utilities'* repeal, obtaining the benefits of a cash-financed acquisition now requires two levels of tax to be recognized—tax to the corporation and tax to the shareholders—rather than the single, shareholder level tax that was imposed under the doctrine.⁹⁷ As a result, inefficient, stock-financed acquisitions have become relatively more attractive, while efficient, cash-financed acquisitions have become relatively less attractive.⁹⁸

⁹⁵ See *supra* notes 18–19 and accompanying text. The step-up in target asset basis did not trigger any corporate level tax; however, target shareholders, of course, incurred a tax on any gain they recognized when they sold their shares for cash.

⁹⁶ See *supra* note 20 and accompanying text.

⁹⁷ This discussion assumes that sale proceeds—whether from the sale of stock or assets, and whether stock-financed or cash-financed—ultimately end up with the shareholders.

⁹⁸ Other tax scholars have remarked upon this effect but have not explored its role in exacerbating managerial tendencies to waste free cash flow. See Coven, *supra* note 2, at 149, 155; Stephan, *supra* note 2, at 676; Zolt, *supra* note 2, at 871–72. But see Shakow, *supra* note 26, at 180–83 (no strong empirical evidence exists that tax provisions affect form of acquisition).

The decision to finance an acquisition with cash or stock depends to some extent on competing tax considerations. On the one hand, a stock-financed acquisition of a target corporation's stock or assets is tax-free to both the target shareholders and the target corporation, provided the acquisition qualifies as a tax-free reorganization.⁹⁹ A cash-financed acquisition¹⁰⁰ of a target corporation's stock or assets is not tax-free, and in this respect is less desirable than a stock-financed acquisition. On the other hand, a cash-financed acquisition can provide the acquirer with a stepped-up basis in the target assets. Stock-financed acquisitions provide the acquirer with a carryover basis in the stock or assets it acquires.¹⁰¹

Under the *General Utilities* doctrine, the benefits of a cash-financed acquisition—stepped-up basis in target assets—could be obtained at the cost of only one tax, imposed on the target shareholders. The acquirer could accomplish this by purchasing target stock for cash

⁹⁹ A tax-free stock acquisition usually takes one of two forms. It can be structured as a "B" reorganization, in which target shareholders "swap" their shares in exchange solely for voting stock of the acquiring corporation. See I.R.C. § 368(a)(1)(B) (1994). Alternatively, it can be structured as a "reverse subsidiary merger," in which a target corporation merges with a subsidiary of the acquiring corporation. Target corporation survives the merger and becomes a wholly-owned subsidiary of the acquiring corporation. Target shareholders' shares are converted into the right to receive acquiring corporation shares. In contrast to the "B" reorganization, target shareholders in a reverse subsidiary merger may receive a limited amount of "boot," that is, consideration other than stock of the acquiring corporation. See, e.g., I.R.C. § 368(a)(2)(E) (target shareholders must exchange controlling interest in target corporation for voting stock of acquiring corporation); BITTKER & EUSTICE, *supra* note 6, ¶ 14.12 at 14-32 to 14-33 (statutory merger, or "A" reorganization, has no statutory limitation on amount of boot, but is subject to judicial requirement that target shareholders have continuing proprietary interest in target assets). Target shareholders must recognize gain, if any, to the extent of the boot they receive. See I.R.C. § 356 (1994).

A tax-free asset acquisition is usually structured as an "A" reorganization in which the target merges into the acquiring corporation (a "forward merger") or a subsidiary of the acquiring corporation (a "forward subsidiary merger"). See I.R.C. §§ 368(a)(1)(A), 368(a)(2)(D). The acquiring entity survives the merger and becomes the owner of target assets. Target shares are converted into the right to receive acquiring corporation shares. Alternatively, the asset acquisition can be structured as a "C" reorganization, in which the target corporation transfers its assets in exchange for stock of the acquiring corporation and then liquidates, distributing the acquiring corporation stock to its shareholders. See I.R.C. § 368(a)(1)(C). All these forms of tax-free asset acquisition permit target shareholders to receive some boot. See, e.g., I.R.C. § 368(a)(2)(B) (in "C" reorganization, voting stock of acquiring corporation must be used to acquire at least 80% of target assets; boot may be used to acquire remaining assets); BITTKER & EUSTICE, *supra* note 6, ¶ 14.12 at 14-32 to 14-33 ("A" reorganization has no statutory limitation on amount of boot, but is subject to judicial requirement that target shareholders have continuing proprietary interest in target assets). Target shareholders must recognize gain, if any, to the extent of the boot they receive. See I.R.C. § 356.

¹⁰⁰ "Cash-financed acquisition" means a taxable acquisition for cash or any other consideration.

¹⁰¹ See I.R.C. § 362 (1994).

and making a § 338 election,¹⁰² or the acquirer could purchase target assets, with the target corporation distributing the sale proceeds to its shareholders in liquidation within twelve months.¹⁰³

General Utilities' repeal has imposed an additional tax cost—the corporate level tax—on obtaining stepped-up asset basis in a cash acquisition. Thus, although an acquirer of target stock can still make a § 338 election to step up asset basis, the target corporation will recognize gain.¹⁰⁴ Similarly, a cash-financed acquisition of a target's assets is taxable to the target corporation even if the target corporation then liquidates and distributes the sale proceeds to its shareholders.¹⁰⁵ This tax is in addition to the tax incurred by target shareholders upon sale of their stock or receipt of a liquidating distribution.¹⁰⁶ *General Utilities'* repeal has increased the attractiveness of stock-financed acquisitions relative to cash-financed acquisitions. Cash-financed acquisitions are more efficient than stock-financed acquisitions for several reasons. First, efficient bust-up acquisitions tend to be cash-financed.¹⁰⁷ Second, cash-financed acquisitions may be funded by debt incurred by the borrower, and debt-financed acquisitions are more likely to be efficient than stock-financed acquisitions.¹⁰⁸ Finally, because stock-financed acquisitions provide the acquirer with a carryover basis in target assets or stock, managers contemplating disposition of ill-advised acquisitions will face the prospect of a tax on pre-acquisition appreciation, thereby augmenting the non-tax barriers to divestiture described above.¹⁰⁹ Repeal of the *General Utilities* doctrine has encouraged inefficient, stock-financed acquisitions by eliminating the tax-favored treatment of efficient, cash-financed acquisitions.

C. Divestitures

1. Historic Versus Stepped-Up Basis in Acquired Assets

The *General Utilities* doctrine favored transactions in which the acquirer of a target corporation obtained a stepped-up basis in the

¹⁰² See *supra* note 18 and accompanying text.

¹⁰³ See I.R.C. § 337 (1982) (as amended by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986)) (no gain or loss recognized to corporation upon sale or exchange of assets, provided sale or exchange is pursuant to a plan of liquidation completed within 12 months).

¹⁰⁴ See *supra* note 22 and accompanying text.

¹⁰⁵ See *supra* notes 10, 13 and accompanying text.

¹⁰⁶ See I.R.C. §§ 331, 1001 (1994).

¹⁰⁷ See *supra* notes 65-66 and accompanying text.

¹⁰⁸ See *supra* notes 68-83 and accompanying text.

¹⁰⁹ See *supra* notes 84-92 and accompanying text.

target assets, thereby enabling managers who made ill-advised acquisitions to subsequently divest them without paying tax on pre-acquisition appreciation in the target assets. In contrast, repeal of the doctrine has encouraged transactions in which the acquirer's basis in the target assets equals the target's historic basis. A subsequent divestiture of these assets thereby requires recognition of pre-acquisition appreciation, thus creating a tax barrier to divesting these assets. This barrier augments the non-tax managerial barriers to divesting poor acquisitions.

Under the *General Utilities* doctrine, an acquirer of a target corporation could elect to step up basis in the target's assets with no corporate level tax on the appreciation in those assets.¹¹⁰ Without the doctrine, an acquirer wishing to obtain a stepped-up basis in target assets must incur the corporate level tax. Repeal of the doctrine thus increases the likelihood that an acquirer will choose not to step up basis in the target's assets. Instead, the acquirer will choose to avoid the corporate level tax, and to inherit historic basis in the target's assets.¹¹¹ Any subsequent divestiture of the target assets will then result in recognition of historic, pre-acquisition appreciation as well as any post-acquisition appreciation.

As discussed above, managers already have non-tax reasons for failing to divest ill-advised acquisitions. The recognition of taxable gain upon such a divestiture can be another significant barrier. By encouraging historic-basis acquisitions over stepped-up-basis acquisitions, repeal of the *General Utilities* doctrine increases the likelihood that tax cost of divesting an acquisition will be a significant deterrent.

2. Sell-Offs

Under the *General Utilities* doctrine, a corporate sale of appreciated assets—a sell-off—was taxable to the corporation, but a distribution of these assets to shareholders was not.¹¹² This created an incentive

¹¹⁰ Alternatively, an acquirer making a stock purchase could decline to make a § 338 election, thereby acquiring a target corporation with historic basis in its assets. Assuming, however, that the target assets were appreciated and that the target did not have tax attributes—such as net operating losses—that the acquirer wished to preserve, the acquirer would most likely make the election.

¹¹¹ The acquirer can avoid the corporate level tax—and inherit historic basis in the target's assets—by purchasing the stock of the target corporation and forgoing the § 338 election. Alternatively, the acquirer can acquire the target in a tax-free reorganization. See *supra* note 99 and accompanying text.

¹¹² This discussion assumes that a distribution of appreciated property did not qualify as a tax-free spin-off under § 355. Tax-free spin-offs are discussed in the next subsection.

for corporations to divest assets by distributing them rather than by selling them.¹¹³ A corporation wishing to sell an appreciated asset could avoid the corporate level tax if it could successfully "disguise" the sale as a distribution of the property to its shareholders followed by the shareholders' sale of the asset.¹¹⁴ One necessary consequence of a disguised sale was that the sale proceeds ended up in the shareholders' hands.

The *General Utilities* doctrine favored corporate distributions of appreciated property relative to corporate sales of appreciated property, thereby encouraging efficient, size-reducing divestitures. Repeal of the doctrine eliminated this favorable treatment.

The repeal of the *General Utilities* doctrine has imposed a corporate level tax on the distribution of appreciated property to its shareholders. As was the case under prior law, shareholders also recognize income or gain with respect to their shares when either property or cash is distributed to them.¹¹⁵ A distribution of appreciated property currently results in two levels of tax. Similarly, a sale followed by distribution of the sale proceeds likewise results in two levels of tax. The only avoidable tax today is the shareholder level tax, which can be avoided if the corporation sells assets and retains the sale proceeds.

The doctrine encouraged transactions that were equivalent in result to efficient, size-reducing corporate sell-offs. In contrast, after *General Utilities'* repeal, inefficient, size-maintaining sell-offs—those in which managers retain the sale proceeds—are tax-advantaged. This reinforces managerial incentives to retain sale proceeds and reinvest free cash flows to the detriment of shareholders.

3. Spin-Offs

A spin-off is another means of divesting assets. In a spin-off, a corporation distributes one or more of its businesses, held in subsidiary form, to its shareholders. A spin-off is tax-free to both the corporation and the shareholders.¹¹⁶ Spin-offs have always been tax-advantaged

¹¹³ The shareholders were taxed when they received the property distribution. Depending on the circumstances and form of the distribution, shareholders might have dividend income (if, for example, the distribution were a dividend or a pro rata redemption of stock and the corporation had sufficient earnings and profits) or capital gain (if, for example, the distribution was a non-pro-rata redemption of stock, or the corporation had insufficient earnings and profits). See generally I.R.C. §§ 301, 302, 312 (1994). Thus, the incentive for corporations to avoid the corporate level tax by distributing appreciated property rather than selling it was offset by the tax to the shareholders.

¹¹⁴ See *supra* notes 8–13 and accompanying text.

¹¹⁵ See *supra* note 113.

¹¹⁶ The term "spin-off" is used loosely here to encompass the three types of divisive reorgani-

relative to sell-offs. After *General Utilities'* repeal, spin-offs are even more tax-advantaged because the corporate level tax is now imposed on all types of sell-offs.

The implications are uncertain. On the one hand, as noted above, spin-offs entail paying out assets to shareholders, thereby precluding the possibility of wasteful investment by managers. In support of this, many empirical studies find that spin-offs result in positive stock price reactions.¹¹⁷ On the other hand, firms may undertake spin-offs only when they are desperate, i.e., when it is clear that they must get rid of an under-performing business. Moreover, unlike a sell-off followed by distribution, spin-offs retain the divested assets in corporate solution—along with managers from the distributing firm—and therefore, the same managerial problems persist, albeit split into two corporate entities. Furthermore, managers of the distributing firm may be using spin-offs to further their own interests by reducing debt levels of the distributing firm, which is one way to increase free cash flows and reduce monitoring by creditors.

In summary, the *General Utilities* doctrine facilitated the transactions that financial economists have identified to be value-increasing: bust-up acquisitions, leveraged acquisitions and sell-offs in which sale proceeds are distributed to shareholders. Repeal of the doctrine has increased the relative attractiveness of value-decreasing transactions: stock-financed acquisitions and sell-offs in which sale proceeds are retained. The next Part argues that certain features of the *General Utilities* doctrine ought to be reinstated.

zation under § 355: the pro rata distribution (the prototypical "spin-off"), the non-pro-rata redemptive distribution (the prototypical "split-off") and the liquidating distribution (the prototypical "split-up"). In brief, a spin-off of a controlled subsidiary will qualify for tax-free treatment both to the distributing corporation and to the distributee shareholders if the following requirements are met: (1) immediately after the spin-off, both the distributing corporation and the distributed subsidiary are engaged in an active trade or business that has been carried on for at least five years; (2) the spin-off is not principally a device to distribute earnings and profits of either the distributing corporation or the distributed subsidiary; (3) the distributing corporation must distribute a controlling interest in the distributed subsidiary to shareholders; and (4) there must be a business purpose for the spin-off. In addition, there are various statutory and judicial holding period requirements, which are applicable to the distributing corporation, the distributed subsidiary and the distributee shareholders. For a detailed description of all the provisions governing spin-offs, see GINSBURG ET AL., *supra* note 34, at 893-921.

¹¹⁷ See *supra* note 88.

IV. PROPOSALS FOR CHANGE

A. *Revisiting the Arguments Supporting General Utilities' Repeal*

As described in Part I, the *General Utilities* doctrine created tensions that academics and lawmakers perceived to be undesirable. These tensions ultimately led to the repeal of the doctrine. Parts II and III argue, however, that the doctrine served useful purposes in constraining managerial self-interest. For example, the doctrine favored corporations that distributed assets to shareholders over corporations that sold their assets to third parties and created—according to academics and lawmakers—an irrational and arbitrary distinction between a distribution and sale.¹¹⁸ The difference in the treatment of distributions and sales, however, was neither irrational nor arbitrary. Rather, the doctrine extended tax-favored treatment to efficient sell-offs (those in which the divesting firm distributed either assets or sale proceeds therefrom to its shareholders), while denying such treatment to sell-offs that financial economists have found to be inefficient (those in which the divesting firm retained the sale proceeds).

Similarly, both lawmakers and tax scholars believed the advantage enjoyed by acquirers vis-à-vis historic owners was an undesirable non-neutrality that contributed to a high level of takeover activity.¹¹⁹ The non-neutrality, however, was desirable in some respects. By favoring acquirers, the *General Utilities* doctrine promoted efficient acquisitions—cash- or debt-financed bust-up takeovers—and helped reverse past, inefficient acquisitions. Meanwhile, the doctrine withheld this treatment for inefficient, stock-financed acquisitions. Furthermore, the doctrine's advantageous treatment of new owners relative to historic owners heightened the disciplinary effect of the takeover threat.

It is important, though admittedly speculative, to consider the effect of the current corporate tax system on the ongoing merger wave. As noted above, many of the current acquisitions are stock-financed, tax-free acquisitions, and many of them are already showing signs of trouble. Of course, many factors determine the level of takeover activity and the structure and form of the deals. The current tax regime—by weakening the threat of discipline for bad acquisitions and by encouraging free-cash-flow-enhancing, non-value-enhancing acquisitions and divestitures—may be a significant contributing factor. Furthermore, the current merger wave, like the 1960s wave, may require a "correct-

¹¹⁸ See *supra* notes 22–25 and accompanying text.

¹¹⁹ See *supra* notes 26–33 and accompanying text.

ing" merger wave in the future. The current tax system, in contrast to the tax rules in place during the corrective merger wave of the 1980s, impedes rather than facilitates such a correcting merger wave. Reinstating the *General Utilities* doctrine would restore incentives for value-enhancing takeovers and reduce the current biases toward value-destroying takeovers. This reinstatement would help unwise acquisitions to be "unwound" quickly and efficiently.

B. *Reinstating the Doctrine*

There are two potential bases for reinstating the *General Utilities* doctrine. The first hinges upon the distinction between distributions and sales of appreciated property. Both distributions and certain sales—those in which the corporation distributes the sale proceeds to its shareholders—tend to be efficient; sales in which the corporation does not distribute the sale proceeds tend to be inefficient. Therefore, it may be appropriate to tax inefficient divestitures differently from efficient ones. Under this proposal, both non-liquidating and liquidating distributions of appreciated assets would be tax-free to the distributing corporation. Similarly, both non-liquidating and liquidating sales of appreciated assets would be tax-free to the distributing corporation, provided that the selling corporation distributed the sale proceeds to its shareholders.

The second basis for reinstating the doctrine focuses upon the disparate treatment of new owners relative to historic owners, and of cash- or debt-financed acquisitions relative to stock-financed acquisitions. The proposal would essentially restore § 338 to its pre-1986 form. Under this proposal, a purchaser of stock of a target corporation would have the ability to elect under § 338 to step up the target's basis in its assets with no gain recognition to the target. The proposal would restore the tax-advantaged treatment of efficient acquisitions, i.e., bust-up acquisitions and those financed with cash or debt rather than stock.

C. *The Ideal Solution and Practical Considerations*

This Article argues that the non-neutralities created by the *General Utilities* doctrine were socially valuable because they offset managerial tendencies to make and retain wasteful investments of free cash flow. In so doing, it departs from traditional tax policy analysis which views neutrality as one of the hallmarks of an ideal tax system.¹²⁰ Under the

¹²⁰ By "ideal," I mean the system that most accurately measures income under the Haig-Simons definition. Under this definition, income is the sum of personal consumption and accre-

traditional view, the distortions that arise either with or without the *General Utilities* doctrine are only one manifestation of two systemic imperfections in our tax laws: (1) a classical, rather than integrated, corporate tax¹²¹ and (2) the taxation of realized, rather than accrued, gains and losses.¹²² Rather than evaluating the relative merits of a world with or without the *General Utilities* doctrine, traditionalists argue that the only real solution is to adopt the ideal—a fully integrated corporate tax system and accrual taxation. If this solution were adopted, then the *General Utilities* doctrine would become irrelevant, because there would be no corporate tax whatsoever and appreciated gains would be taxed as they accrued rather than upon the occurrence of a realization event.

tions to wealth over a specified time period. See Robert Murray Haig, *The Concept of Income—Economic and Legal Aspects*, in *THE FEDERAL INCOME TAX 7* (Robert M. Haig, ed., 1921), reprinted in *AMERICAN ECONOMIC ASSOCIATION, READINGS IN THE ECONOMICS OF TAXATION* 54, 59 (Richard A. Musgrave & Carl S. Shoup eds., 1959); HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1938); see, e.g., 1 *TREASURY DEPARTMENT, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH* 17 (1984); MICHAEL J. GRAETZ & DEBORAH H. SCHENK, *FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES* 31–32 (3d ed. 1995).

A neutral tax system has traditionally been viewed as desirable because it does not interfere with the ideal allocation of goods and services that would occur in a perfect market economy. More recently, tax scholars have acknowledged that a neutral tax system is not necessarily desirable because market imperfections and other government actions also affect the allocation of resources. To the extent that our non-neutral tax system offsets these other distortions, a neutral tax system would actually decrease social welfare. See R.C. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 *REV. ECON. STUD.* 11 (1956); Robert H. Scarborough, *Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax*, 48 *TAX L. REV.* 677, n.9 (1993); Daniel N. Shaviro, *Selective Limitations on Tax Benefits*, 56 *U. CHI. L. REV.* 1189, 1218–19 (1989); Zolt, *supra* note 2, at 842.

¹²¹ Our system adopts the classical model of corporate taxation, which imposes two levels of tax on corporate income: first, on the corporation as earned and second, on the shareholders upon distribution. Under an integrated corporate tax, corporate income would be taxed once, at the shareholder level, rather than at both the corporate and shareholder level. See generally A.L.I. *FEDERAL INCOME TAX PROJECT, supra* note 22; CHARLES E. MCCLURE, JR., *MUST CORPORATE INCOME BE TAXED TWICE?* (1979).

¹²² Our system taxes gains and losses upon the occurrence of a realization event, that is, upon the sale of an asset or other disposition resulting in ownership of a materially differing asset. See *Treas. Reg. § 1.1001-1(a)* (as amended in 1986). Under accrual taxation, gains and losses would be taxed as they accrued—that is, as the value of assets increased or decreased within the taxable period. See generally Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate Shareholder Integration Proposal*, 50 *TAX L. REV.* 265 (1995); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 *U. PA. L. REV.* 1111 (1986); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 *TAX L. REV.* 1 (1992); Theodore S. Sims, *Long-Term Debt, the Term Structure of Interest and the Case for Accrual Taxation*, 47 *TAX L. REV.* 313 (1992); Jeff Sarnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 *YALE L.J.* 1817 (1990); Note, *Realizing Appreciation Without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 *STAN. L. REV.* 857 (1982).

Adoption of the ideal tax system, however, is not likely to occur soon.¹²³ Given that imperfections in our tax system are likely to persist, we must make a pragmatic choice among imperfections. That choice can be better informed by considering the interaction of tax non-neutralities with other, non-tax non-neutralities.¹²⁴ This Article argues that the *General Utilities* doctrine helped to counteract undesirable managerial tendencies, while repeal of the doctrine has exacerbated these managerial problems.

CONCLUSION

Tax scholars have always been ambivalent about the *General Utilities* doctrine, despite its centrality to our corporate tax system. Although both lawmakers and scholars welcomed its appeal in 1986, the work of financial economists exploring the causes and consequences of takeovers reveals that *General Utilities'* repeal may have had unintended, undesirable consequences. Repeal of the doctrine has encouraged value-decreasing transactions in which managers are likely to make or retain poor investments of free cash flow. In contrast, the doctrine encouraged value-enhancing transactions in which managers paid out free cash flows to shareholders or in which wasteful investments of free cash flow were reallocated more efficiently.

This Article evaluates the *General Utilities* doctrine within a framework that is broader than the one traditionally used to evaluate tax laws, one that incorporates managerial non-neutralities affecting takeovers and divestitures. Viewed within this broader context, the non-neutralities created by the *General Utilities* doctrine may have been socially desirable. Thus, the doctrine ought to be reinstated.

¹²³ See Jennifer Arlen & Deborah M. Weiss, *A Political Theory of Corporate Taxation*, 105 YALE L.J. 325, 329-31 (1995) (noting persistence of corporate tax despite widespread academic and political support for integration); David A. Weisbach, *A Partial Mark-to-Market Tax System*, __ TAX L. REV. __ (forthcoming) (likelihood of eliminating realization requirement remains remote despite academic proposals for accrual taxation).

¹²⁴ I am not making the more radical argument that, given a choice between a perfect and an imperfect tax system, we ought to choose the imperfect system to offset the managerial biases described in Part II. Of course, many tax law provisions intentionally depart from the ideal arguably to correct perceived market imperfections. See, e.g., I.R.C. § 1(h) (1994) (capital gains preference); I.R.C. § 103 (1994) (exclusion from gross income for interest on municipal bonds); I.R.C. § 168 (1994) (accelerated depreciation); I.R.C. § 401(k) (1994) (exclusion from gross income for contributions to employer-provided pension accounts).