VALUING STOCK FOR CONTINUITY OF INTEREST IN SECTION 368 REORGANIZATIONS

Thomas A. Geraghty

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Legend

T	Target company
A	Acquiror company
COI	Continuity of Interest
IRS	Duh!

Introduction

Section 368 exempts certain corporation combinations ("reorganizations") from gain recognition because such transactions "effect only a readjustment of continuing interest in property under modified corporate forms." Reg. 1.368-1(b)

Qualification of transaction as a reorganization results in deferral of gain recognition for former T shareholders on their A stock received and for the T on consideration received from A and distributed to T shareholders or creditors. §§354, 356, and 361

For a transaction to qualify as a tax-free reorganization, the following requirements must be met:

- The transaction must be motivated by a legitimate business purpose
- A must continue T's historic business, or use a significant portion of T's historic business assets in its own business. Reg. 1.368-1(d)(1).
- T shareholders must receive a "continuing interest" in the combined entity. Reg. 1.368-1(e). This is what we'll be discussing today.

COI Requirement

This requirement provides that, in exchange for their T shares, T shareholders must receive a definite, material, and substantial proprietary interest in A. General purpose: prevent transactions that are in substance sales from receiving tax-free treatment.

The continuity of interest doctrine emerged from case law.

Revenue Act of 1926: merger was tax-free reorganization if A received substantially all of the properties of another corporation

Courts: sale of assets for notes and cash could qualify under this statute; required that T's former shareholders maintain some continuing equity interest in surviving entity

See Cortland Specialty Co. v. Com'r: distribution of cash and promissory notes did not create sufficient continuity

How Much COI Is Required?

The **Supreme Court** has held that a part-cash, part-stock merger satisfied COI where T shareholders received A stock equal to 38.5% of aggregate consideration received. John A. Nelson v. Helvering (1935). However, the judicial doctrine regarding COI has historically been flexible and lacking clear parameters.

IRS Ruling Practice. IRS's PLR policy regarding Section 368 reorganizations has required that the T shareholders receive a continuing stock interest (not cash) in A with a value equal to at least 50% of the value of the formerly outstanding T stock, as of the effective date of the reorganization. Rev. Proc. 77-37.

- **Cash** includes all payments of (i) non-stock property pursuant to the relevant transaction documents, (ii) T shareholders' expenses incurred in connection with the transaction, (iii) cash to dissenters, and (iv) certain dividends made in connection with the transaction.
- Reg. 1.368-1(e) (1998): Pre- and post-reorganization sales of T and A stock, respectively, to unrelated parties disregarded for measuring COI. Notion of "historic T shareholders" done away with. COI requirement focuses solely on quality of consideration, not on whom it is furnished.
- Practitioners often go below the 50% threshold, but when they do, great care is taken to dig more deeply than mere acceptance of a representation from the parties. See G&L, ¶610.2.

How Much COI Is Required?
(cont.)

Important Development

Although not the focus of the new regulations concerning "when" continuity is measured, the regulations make it official (in the preamble) that the IRS has committed itself to a lower level of COI. Thus, former T shareholders will be treated as having preserved a "substantial" part of the value of the proprietary interests in T where at least ***40 percent*** of T's stock is exchanged for A stock.

When is COI Measured? – Old Rules

Prior to New Regulations

It was clear that the determination of COI was only to be made on the effective date of the acquisition. Rev. Proc. 77-37.

Problem

- The deal struck between A and T almost always is measured as of the date of signing and is not based on market activity that occurs before or after the merger closes.
- Significant time, however, may elapse between the signing date and the closing date (e.g., mergers that are subject to antitrust or other regulatory review, which approvals may take months or longer to obtain)
- Changes in the price of A stock that occur post-signing may jeopardize a merger that would otherwise have satisfied continuity.

When is COI Measured? – Old Rules

Example

On 6/1/04, A and T sign an agreement under which T will be merged into A. A and T intend for the merger to be treated as a reorganization under §368(a)(1)(A) (and have a closing condition whereby each must receive an opinion to that effect). In the merger (if measured at signing), T shareholders will receive (in the aggregate) 50 A shares (worth $1/share on 6/1/04) and $50 cash; the agreement contains no provision that would readjust the merger consideration in the event that the COI requirement is not met. Post-signing, the trading price of A stock fluctuates wildly; on the closing date, 10/1/2004, the value of A stock has fallen from $1 per share $0.25 per share. Consequently, T shareholders will receive (in aggregate) $50 cash and 50 A shares worth a total of $12.50. The mix of 80% cash/20% A stock (based on the closing date value) will not satisfy the COI requirement.

The parties in this example are left with few options.

1. Either party may refuse to close the transaction because tax counsel would be unable to render an opinion. **Result**: The tax rule in this situation alters one party's relative bargaining power, interfering with the business deal originally reached by the parties. In order for the transaction to proceed, the parties must reach a new agreement.

2. The parties could agree to (or simply unknowingly) proceed with the merger as originally structured. **Result**: the merger transaction will be treated (undesirably) as a taxable event requiring gain or loss recognition by the Target shareholders and the Target.

3. The parties could agree to restructure the transaction to provide more tax-efficient results. **Result**: Alteration of the business deal struck months earlier.

When is COI Measured? – Old Rules

Alternative Approaches to Pre-Closing Stock Value Fluctuation

Prior to the promulgation of Reg. 1.368-1(e)(2), agreements were structured with “backup” provisions to account for instances in which COI would not be met due to preclosing changes in the value of A stock, including:

Alter Consideration Formula: A must provide additional shares of A stock, or reduce the amount of cash it pays (or both), as the price of A stock declines below a certain level prior to the closing. Although designed to provide T shareholders with stock consideration with value sufficient to meet COI requirement, downsides include (i) being complicated to administer; (ii) elevates tax considerations over financial rationale of the transaction.

Taxable Reverse Subsidiary Merger: Direction of the merger would automatically reverse (i.e., sub of A merges into T). While T would have no corporate-level gain (and thus A would not inherit any corporate-level tax liability), the downside is that this would be a a taxable transaction for T shareholders.

Holding Company (§351) Transaction: Transaction would be restructured to satisfy §351--a new holding company (HC) would be formed, and HC would form two subs, one merging into A, another merging into T. A shareholders would receive HC stock, and T shareholders would receive HC stock and cash in the amounts originally agreed to. Since COI does not apply in §351 transactions, any decrease in the value of A stock after signing would not affect the qualification of a transaction under §351. Downsides: (i) not always practical for A to readjust its corporate structure in order to acquire t; (ii) state law may require a vote of A’s shareholders that would not otherwise be required; (iii) may effect debt issued by A.

All-Stock or All-Cash Merger: T shareholders receive all A stock (in which case, the COI requirement will be met), or T shareholders receive all cash (in a reverse merger). Downside: dramatic alteration to negotiated deal.

When is COI Measured? – Old Rules

Overall Effect

The prior method of measuring COI (i.e., using closing date values) created considerable uncertainty regarding the outcome of an executed merger agreement. Parties to a merger did not know whether a proposed reorganization would satisfy the COI requirement at closing. Further, where alternative mechanisms were built into agreements, T shareholders would not be certain of the type or amount of stock and/or cash consideration they would receive (and A would not know the type and amount of consideration it would be required to pay).

Practice note: The prior practice of measuring COI at closing also created problems for transactions subject to the federal securities laws. For example, a proxy statement describing a transaction to T shareholders and soliciting their vote is typically reviewed by the SEC for compliance with SEC requirements, one being that the proxy statement describe the expected federal income tax consequences. If those consequences hinge on the value of A stock at closing, the consequences cannot be described with any certainty. Furthermore, the SEC in recent years has often insisted that the proxy statement include or reflect a legal opinion, given at the time the proxy statement is finalized, as to federal income tax consequences. Providing an opinion as of the proxy statement date regarding tax consequences that depend on facts at closing is problematic.

When is COI Measured? – New Rules

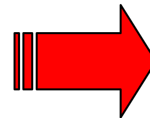
New Reg. 1.368-1(e)(2) provides that, in determining whether COI in T is preserved (in a potential reorganization), the consideration to be exchanged pursuant to a contract (to effect the potential reorganization) shall be valued on the last business day before the first date on which such contract is a binding contract, *but only* if such contract provides for fixed consideration.

Question 1: Is there a **binding contract**?

Question 2: If so, does the binding contract provide for **fixed consideration**?

Question 3: How is value on the **last business day** measured?

Effective Date: These regulations apply to transactions occurring pursuant to binding contracts that are entered into after Sept. 16, 2005 (so, that means now).



The new regs do not affect the date on which realization occurs and the date on which the amount of gain recognized by T shareholders is determined. That date would continue to be the closing date of the transaction.

Is There a “Binding Contract”?

Binding Contract (Reg. 1.368-1(e)(2)(ii)): An instrument that is enforceable (against the parties to such instrument) under applicable law.

Presence of a condition outside of the control of the parties, such as the need to secure the approval of a regulatory agency, shall not, by itself, prevent the agreement from constituting a binding contract.

Similarly, the fact that "insubstantial terms" remain to be negotiated, or that "customary conditions" remain to be satisfied, will not deprive the agreement of its status as such a binding contract.

A tender offer can be a binding contract (on the announcement date) where the offer is subject to Section 14(d) of the 1934 Act, even if the tender offer may be modified and/or such tender offer is not enforceable against the T shareholders to whom the offer is directed.

Modifications: if (i) a term of an otherwise binding contract relates either to the amount or type of consideration to be offered is modified, and (ii) the contract as modified is a binding contract, the date of modification will be regarded as,the first date on which there is a binding contract.

Exception →

Date of modification will be ignored where the modification (i) has the sole effect of providing for the issuance of additional shares of A stock and (ii) the transaction, even without taking the modification into account, exhibits "good" COI.

Is There "Fixed Consideration"?

Fixed Consideration (Reg. 1.368-1(e)(2)(iii)): A contract provides for fixed consideration if it provides for any of the following:

(1) The number of shares of each class of stock of A, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for all of the proprietary interests in T

Example. See example on slide 8, above. Under new regulations, COI would be satisfied since, on the signing date (6/1/04), the aggregate consideration received by T shareholders would be 50% stock and 50% cash.

(2) The number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for each proprietary interest in the target corporation

Example. A and T sign an agreement to merge T into A (on 7/1/04) whereby each T share will be exchanged for .80 shares of A stock and $ 1.20 cash. On 7/1/04, the value of A is $1 per share, and 100 shares of T stock are outstanding.

(3) and (4) – see following slide

Is There "Fixed Consideration"?

(3) The percentage of the number of shares of each class of proprietary interests in the target corporation, or the percentage (by value) of the proprietary interests in the target corporation, to be exchanged for stock of the issuing corporation, provided that the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange.

Example. A and T sign an agreement to merge T into A (on 7/1/04) whereby 40% of all T shares will be exchanged for A stock and 60% of all T shares will be exchanged for cash. On its face, the agreement meets COI, provided the exchange is "economically reasonable."

(4) The percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation, provided that the portion of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation and the portion of each proprietary interest in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange.

Example. A and T sign an agreement to merge T into A (on 7/1/04) whereby 40% of each T share will be exchanged for A stock and 60% of each share will be exchanged for cash. On its face, the agreement meets COI, provided the exchange is "economically reasonable."

Is There "Fixed Consideration"?

Shareholder Election: A contract that does not satisfy the foregoing standards, and where T shareholders have an election (in respect of the consideration to be received in exchange for its T stock) is still treated as providing for fixed consideration if either:

(A) the minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money and other property to be exchanged for all of the proprietary interests in T; or

(B) the minimum percentage of the number of shares of each class of proprietary interests in T, or the minimum percentage by value of such proprietary interests, to be exchanged for stock of the issuing corporation.

Note: Higher standard for COI in these cases -- actual amount of stock and other property conveyed to the T shareholders in exchange for their stock is not relevant. In case (A), COI determined by assuming the issuance of the minimum number of shares and the maximum amount of "non-stock property." In case (B), COI determined by assuming the issuance of stock (of the issuing corporation) for the minimum percentage of proprietary interests in T.

Is There “Fixed Consideration”?

“Qualifying” Shareholder Election Provision

At the Effective Time, each T Share issued and outstanding immediately prior to the Effective Time (other than cancelled shares and dissenting shares) shall automatically be converted into, and shall be canceled in exchange for, the right to receive, at the option of the holder, (i) 0.822 [the exchange ratio, which may be adjusted] of a A Share (the “Share Consideration”); or (ii) an amount in cash equal to $33.81, without interest (the “Cash Consideration”). If the number of Cash Election Shares times the Cash Consideration is less than the Aggregate Cash Consideration, then all Cash Election Shares shall be converted into the right to receive the Cash Consideration. If the number of Cash Election Shares times the Cash Consideration is greater than the Aggregate Cash Consideration, then (i) all Share Election Shares shall be converted into the right to receive the Share Consideration; (ii) a sufficient number of Cash Election Shares shall be converted into Share Election Shares such that the number of remaining Cash Election Shares times the Cash Consideration equals the Aggregate Cash Consideration, and (iii) the Cash Election Shares which are not converted into Share Election Shares shall be converted into the right to receive the Cash Consideration. In the event the some Cash Election Shares must be converted into Share Election Shares, such conversion shall be allocated on a pro rata basis among the Cash Election Shares.

Is There “Fixed Consideration”?

Contingent Consideration: Obviously, providing for contingent consideration prevents a contract from providing for fixed consideration. Many exceptions, however:

Contingent consideration consisting solely of stock where transaction would exhibit "good COI" even if none of such contingent consideration was ultimately paid. (e.g., earnout paid in A stock).

Escrowed consideration is OK, but only if for the purpose of securing T's performance of "customary pre-closing covenants" or "customary representations and warranties."

The preamble to the new regulations makes clear that (i) forfeited escrowed stock is not treated as preserving the COI, and (ii) forfeited escrowed non-stock consideration is not treated as counting against the preservation of COI.

Other contingencies that will not prevent a contract from being treated as providing for fixed consideration include (i) customary anti-dilution clauses, (ii) possible exercise of dissenters’ rights, and (iii) payments of cash in lieu of fractional shares.

Absence of anti-dilution clause, however, will prevent contract from being treated as providing for fixed consideration if issuing corporation alters its capital structure between the first date there is an otherwise binding contract and the effective date in a manner that materially alters the economic arrangement between the parties.

Is There “Fixed Consideration”?

Unresolved Issues

The preamble to the new regs states that the IRS and Treasury Department are still considering whether other arrangements involving contingent consideration should be within the scope of the signing date rule. Among these arrangements are cases in which (i) the contingent consideration consists not only of issuing corporation stock but also of money or other property and (ii) the issuing corporation stock to be issued in respect of target corporation stock is determined pursuant to a collar.

Contingent Cash: One method involves a “cash top-up" formula (i.e., involves the addition of cash to the pool of consideration up to a limit). This formula is designed to protect T shareholders against declines in A stock price. For example: When A’s stock price is $1 per share, A and T sign a merger agreement that provides that each T share will be entitled to (a) $1 of cash, (b) 1 share of A stock and (c) if A's stock price is less than $1 per share, cash (up to a maximum of $ 0.10) equal to the excess of $1 over the value of A's stock price.

Collar. Number of A shares to be paid depends on the value of A stock (designed to guarantee that T shareholders receive a fixed value per share of T stock so long as the A stock price remains within a specified band). For example: When A’s stock price is $1 per share, A and T sign a merger agreement that provides that each T share will be entitled to (a) $1 of cash and (b) either (i) A stock worth $1 provided that a share of A stock is worth at least $0.85 and no more than $1.15, (ii) 1.18 shares of A stock if A stock is worth less than $0.85 per share or (iii) 0.87 shares of A stock if A stock is worth more than $1.15 per share.

Presumably, these arrangements could be handled under the min/max rule applicable in the case of shareholder elections. However, as currently drafted, these arrangements are not subject to the signing date value rule.

Measuring Value on the Last Business Day Before Binding Contract

The proposed regs provided that, if the signing date rule applied, the consideration to be exchanged for T shares should be valued as of the end of the last business day before the first date there is a binding contract to effect the transaction.

What does this mean?

- an average of the high and low trade price on that day?
- the closing price of the A stock on the relevant market?

Rather than provide a specific rule, the final regs removed the requirement that the consideration be valued as of the end of the last business day before the first date that there is a binding contract. In its place, the final regs provide simply that the consideration to be exchanged for T shares pursuant to a contract must be valued the day before such contract is a binding contract. Thus, the IRS seems to have left it to taxpayers to choose a reasonable method.

New Issuances

What happens if A issues a new class of its stock in exchange for the shares of T? The final regs clarify that such a new class of stock will be deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization for purposes of applying the signing date rule.