Continuity of Interest in Reorganizations

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The continuity of interest requirement is fundamental. Whatever other statutory tests may be required, to qualify for tax-free reorganization treatment, a transaction must also satisfy this judicially created requirement. The continuity of interest rule ensures that the shareholders of the target must maintain a continuing interest in the acquiring company after closing by receiving at least 40 percent of their aggregate consideration in the form of stock in the acquiring company.

That sounds easy to verify, and in practice it can be. But it can also be nettlesome, especially where there are contingencies and elections, and one has some uncertainty about exactly what will occur. It can be nerve-wracking, since failing the continuity of interest requirement can be fatal.

Final Word

Final regulations have been issued concerning the continuity of interest requirement for reorganizations. [T.D. 9565, 2011 TNT 243-15.] These regulations adopt with only relatively minor changes the proposed regulations that were issued in 2007. They describe the circumstances in which the consideration to be exchanged for the proprietary interests in the target will be valued on the last business day before the first date there is a binding contract.

Of course, this is known as the signing date rule. It applies only to contracts that provide for fixed consideration. The final regulations modify the definition of fixed consideration and clarify its application when the consideration includes other property that is identified by value.

However, along with the final regulations came additional proposed ones reflecting a more liberal approach involving various collar option and value average mechanisms. The 2007 temporary regulations contained the signing date rule and provided that if the consideration is fixed, continuity of interest is measured using the value of the consideration as of the last business day before the signing date.

If the consideration is variable, however, continuity of interest is measured using the value of the consideration as of the closing date.

More Flexibility?

Notice 2010-25 allowed parties to transactions entered into after March 19, 2010, to elect whether to apply the mechanical signing date rule, subject to a consistency requirement. With the final regulations, transactions under binding contracts entered into after December 19, 2011, are not subject to that election.

The final regulations made several small changes. The regulations clarify that the presence of a shareholder's election to receive consideration in exchange for all of its proprietary interests in the target will not cause a contract to fall outside the definition of fixed consideration. Thus, if a contract allows for a shareholder election of consideration, this does not mean the contract does not call for fixed consideration.

In fact, many shareholders will want a mix of cash and stock upon closing. The final regulations address this too. Even if that mix is uncertain when the contract is signed, as long as the consideration is fixed, continuity is safe.

The final regulations broaden the contract modification rule to provide that contract modifications will not result in a new signing date if the terms of the original contract would have prevented the transaction from qualifying as a reorganization. The regulations also clarify the anti-dilution provisions and expand the applicability of the signing date rule to some transactions providing for contingent adjustments to the consideration.

Significantly, however, the Treasury has recognized that the underlying principles of the signing date rule can support additional ways for determining whether continuity of interest is satisfied. The newly proposed regulations provide for a different method for determining whether there is continuity of interest where a contract to effect a potential reorganization provides for variable consideration based on the changing value of issuing corporation stock. In lieu of the value of issuing corporation stock on the closing date, the regulations allow the use of an average value for issuing corporation stock in some cases.

Conclusion

Continuity of interest is a simple requirement and is often simple to satisfy. But how you value consideration and how consideration is assessed matter.

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