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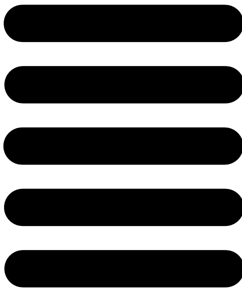

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Continuity of Interest and Creditors

By Robert W. Wood and David E. Libman • Wood & Porter • San Francisco

Hamlet's "neither a borrower nor a lender be" may be good advice, but it is rarely practiced. Just look at Wall Street, Washington and now Detroit.

In these economic hard times (our current era unfortunately qualifies as such), borrowing may be more fashionable than ever before. Even so, the chilling of credit markets may make borrowing a fashion that is hard to attain. Here at the M&A TAX REPORT we logically turn to subjects near and dear to our hearts: continuity of interest, for one. You generally cannot have a tax-free reorganization without it.

Code Sec. 368 is a definitional provision, which sets forth various types of transactions in which a fundamental change in the ownership or structure of a corporation will be partially or wholly tax-free. Not unlike diseases, these tax-free reorganizations get catchy surnames like "Type A," "Type B," *etc.* To qualify as a tax-free reorganization under Code Sec. 368, certain statutory and nonstatutory requirements must be satisfied.

One of the biggies on the nonstatutory side of the aisle is continuity of interest, although its siblings, continuity of business enterprise and business purpose, also get their share of respect.

The general rule is that an exchange of property produces gain or loss that must be accounted for if "the new property differs in a material particular, either in kind or in extent, from the old property." [Reg. §1.368B-1(b).] Tax-free reorganizations allow an exception to that rule, and the statutory provisions regarding those reorganizations are meant to ensure that reorganizations are, among other things, limited to readjustments of continuing interests in property under modified corporate form. So says Reg. §1.368-1(b).

The continuity of interest requirement is meant to prevent transactions that resemble sales from qualifying for nonrecognition treatment. [*See* Reg. §1.368-1(b) and Reg. §1.368-1(e)(1).] If the latter rule about nixing transactions that resemble sales sounds a bit like the "device" rules to you (a device to distribute earnings

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and profits is hard to define, but it's always bad), you're not wrong. In large part, the continuity of interest rules struggle with the implicit dividing line between when things look and smell good and when they do not. Sometimes, a transaction looks and smells good, but might resemble something that looks or smells bad.

Whether the requisite continuity of interest exists depends on a substantive facts-and-circumstances test, which requires that a substantial part of the value of the proprietary interests in the target corporation must be preserved post-reorganization. But what is a "substantial part"? What are proprietary interests? And how does this fit into a proprietary interest that creditors may own? As is discussed below, regulations promulgated by the Treasury attempt to grapple with these questions.

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2005 Proposed Rules

In 2005, the IRS and the Treasury issued proposed regulations dealing with insolvent corporations, as well as liquidations and reorganizations of these entities. In December 2008, they issued final regulations adopting (with some relatively minor modifications) the portion of the proposed regulations that dealt with the circumstances in which (and the extent to which) creditors of a company will be treated as the company's proprietors. Whether creditors are treated as proprietors is relevant, of course, in determining if continuity of interest is preserved in a reorganization.

These regulations, published as T.D. 9434 (Dec. 12, 2008) explain the situations in which stock that is received by creditors may count for purposes of satisfying continuity of interest. The rules apply both inside and outside of bankruptcy (for example, they apply to insolvent target corporations, which are not necessarily bankruptcy debtors). These rules should be of interest to many in this tough and cash-strapped year. Like it or not, many creditors are likely to end up as equity owners in some fashion.

Separating the Sheep from the Goats

Many M&A TAX REPORT readers may be familiar with the concept that in a potential reorganization, a proprietary interest in a target corporation will be preserved:

- if it is exchanged for a proprietary interest in the issuing/acquiring corporation;
- if the acquiring corporation exchanges the interest for a direct interest in the target corporation enterprise; or
- if the interest otherwise continues as a proprietary interest in the target corporation. [Reg. §1.368-1(e)(1)(i).]

However, proprietary interests are not preserved when the issuing corporation acquires the interest for something *other* than the issuing corporation's stock, or if the issuing corporation stock exchanged for the proprietary interest in the target corporation is redeemed. [*Id.*]

To apply the recently finalized rules for valuing creditors' proprietary interests, senior and junior creditors need to be separated. Specifically, the claims of the most senior class of creditors to receive a proprietary interest in

the issuing corporation are treated separately. Senior claims are treated as representing proprietary interests in the target corporation.

The junior claims—basically everybody else—can also be treated as representing a proprietary interest in the target. However, the senior creditors' proprietary interests in the target (represented by the senior claims) must be valued separately from junior claims by calculating the average treatment for all senior claims.

To determine the value of a proprietary interest in the target represented by a senior claim, you must multiply the fair market value of the particular creditor's claim by a fraction. The numerator of the fraction is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims. The denominator is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. [*See* Reg. §1.368-1(e)(6)(ii)(A).] The value of the propriety interests in the target corporation represented by a junior claim is the fair market value of the junior claim.

If it isn't obvious (and it certainly wasn't to us) the effect of this rule is that there will be 100-percent continuity of interest if each senior creditor's claim is satisfied with the same ratio of stock to nonstock consideration, and if no junior claim is satisfied with non-stock consideration. [*See* Preamble to T.D. 9434.] That would seem to make sense, since junior claims are presumably more likely to be classified as equity with the holders being given stock, while more senior claims are more likely to get a package of better consideration, which may include cash or other property in addition to some stock.

New Examples

An Example 10 was added in the final regulations, which discusses two scenarios: In the first, two senior creditors receive proportionate amounts of cash and stock in exchange for their respective claims. In the second, the IRS attempts to demonstrate the bifurcation of senior claims, where the creditors of that class receive disproportionate amounts of the acquiring corporation's stock and other property. [*See* Reg. §1.368-1(e)(8), Example 10.]

In the first proportionate example, target corporation is insolvent immediately prior to the reorganization with $150x in assets and $200x in liabilities. Target has two senior creditors that each have a $25x claim, and one junior creditor with a $150x claim. In a reorganization transaction, Target transfers all of its assets to Issuing corporation in exchange for $95x in cash and Issuing stock with a $55x fair market value. Each senior creditor receives $20x in cash and $5 in Issuing stock. The junior creditor receives $55x in cash and $45 in Issuing stock. The Target shareholders receive no consideration in exchange for their stock.

The creditors' claims can be considered proprietary interests in Target because Target was insolvent immediately prior to the transaction, and because the creditors receive proprietary interests in Issuing in the transaction in exchange for their claims. As such, the senior claims are valued as follows: $25x (the value received for each senior creditor's claim) multiplied by a fraction $10x/$50x (which is the aggregate fair market value of Issuing stock received by the senior creditors divided by the aggregate fair market value of the cash and stock received by the senior creditors for their claims). $25x multiplied by $10x/$50x equals $5x.

Each senior creditor's proprietary interest in Target is valued at $5x and counted in measuring continuity of interest. The junior creditor's proprietary interest in Target is valued at $100x (the $55x in cash plus $45x in Issuing stock received for the junior claim). The senior and junior creditors' proprietary interests in Target total $110x ($5x + $5x + $100x), and those creditors received $55x of Issuing stock in exchange for their proprietary interests in T. Hence, Issuing acquired 50 percent of the value of Target's proprietary interests in exchange for Issuing's stock. A substantial part of the value of Target's proprietary interests has been preserved. As such, the continuity of interest requirement is satisfied.

Disproportionality

In the second scenario, Target is insolvent immediately prior to the reorganization with

$80x in assets and $200x in liabilities. Target has one class of two senior creditors, A and B, who each have a $100x claim. In a reorganization transaction, Target transfers all of its assets to Issuing in exchange for $60x in cash and Issuing stock with a $20x fair market value. For their claims, A receives $40x in cash, and B receives $20x in cash and $20x in Issuing stock. The Target shareholders receive no consideration in exchange for their stock.

The creditors' claims can be proprietary interests in Target because Target was insolvent immediately prior to the transaction, and the creditors receive proprietary interests in Issuing in the transaction in exchange for their claims. As such, the senior claims are valued as follows: $40x (the value received for each senior creditor's claim) multiplied by a fraction $20x/$80x (which is the aggregate fair market value of Issuing stock received by the senior creditors divided by the aggregate fair market value of the cash and stock received by the senior creditors for their claims). $40x multiplied by $20x/$80x equals $10x.

Even though A received only cash, while B received both cash and stock, each senior creditor's (A and B) proprietary interest in Target is valued at $10x and counted in measuring continuity of interest. Thus, $10x of the cash received by A and $10x of the Issuing stock received by B are counted in measuring continuity of interest. The total value of A's and B's proprietary interests in Target equal $20x. Since Issuing acquired 50 percent of the value of Target's proprietary interests in exchange for Issuing's stock, a substantial part of the value of Target's proprietary interests has been preserved. As a result, the continuity of interest requirement is satisfied.

Keep in mind that in the foregoing examples, Issuing exchanged more than a *de minimis* amount of its stock in exchange for Target's proprietary interests. In that regard, the final regulations specify that where only one class of creditors is receiving stock, more than a *de minimis* amount of the acquiring corporation stock must be exchanged for the creditor's proprietary interest relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of continuity of interest. [*See* Reg. §1.368-1(e)(6)(ii)(A).]

Conclusion

The continuity of proprietary interest requirement is probably unlikely to go away any time soon. How much continuity is enough to satisfy the IRS and/or the courts may change over time, but the continuity hurdle is here to stay. And sometimes, debt-to-equity swaps are going to occur.

Perhaps, more of them will occur in the current economy than ever before. Creditors may not traditionally be considered proprietors or owners of a business. Yet particularly for financially strapped businesses, creditors often end up with equity ownership. The recently finalized continuity of interest regulations appropriately recognize that fact.