The Continuing Conundrum of Escrowed Stock

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When stock is escrowed as part of a reorganization, it's usually not possible to be certain whether the stock will go to one party or another. This raises fundamental questions. Do you count the escrowed stock? If so, when do you count it?

The reasons for escrowed stock vary. Stock is often escrowed to satisfy contingencies in the deal, either conditions precedent or conditions subsequent. The most common reason for escrowed stock is a purchase price adjustment. Since many of the corporate reorganization rules hinge at least in part on percentages of ownership, percentages of continuity and so on, how this escrowed stock is treated is of significant moment.

Most of the existing legal authorities dealing with escrowed stock address which party is responsible for reporting and paying tax on the *income* (interest and dividends) from the escrowed stock. Commentators reach different conclusions. However, commentators have almost universally agreed that the transaction documents can help to avoid this issue by fixing which party has this responsibility.

A complete discussion of the ownership and reporting obligations with respect to the income earned on the escrowed funds or stock is beyond the scope of this article. Instead, this article focuses on a far more fundamental inquiry: How does escrowed stock impact the continuity of interest rules in the context of tax-free reorganizations?

Continuity of Interest Regulations

One of the biggest corporate tax developments of 2005, at least to corporate tax afficionados, was the release of the final continuity of interest regulations. The news of their release may have been overshadowed by hurricane news, but they still caused a considerable storm. The proposed continuity regulations came out in 2004, and they were generally followed in the final versions released this year.

A broad theme of the final regulations is to measure continuity of interest by using the values (of the stock in escrow, the target's stock or the acquiring company's stock), as of the binding contract date, rather than the values as of the actual closing date. Considerable time can pass between signing a deal and closing, so the point at which one assesses stock value can be significant. Yet, my sole focus here is on only one aspect of the continuity of interest regulations: escrowed stock.

The proposed regulations had suggested (if not downright stated) that escrowed stock could actually count *positively* towards continuity of interest, even if the escrowed stock was later forfeited. This is part of the old debate about precisely when you measure continuity of interest (or any other percentage stock ownership requirements for that matter) for purposes of a reorganization. This is particularly startling since the overall theme of the final regulations is that one should determine continuity of interest as of the date on which the contract first becomes binding. It is the binding contract date, rather than the closing date, that controls.

Binding Contract vs. Closing Date

Given this general overlay to continuity of interest, wouldn't one determine the lay of the land from a continuity perspective as of the binding contract date? Wouldn't that include the value of stock placed into escrow as of the binding contract date? The proposed regulations had suggested the answer was "yes." The final regulations answer this pregnant question with a resounding "no."

In fact, the final regulations state flatly that the forfeiture of escrowed consideration is in substance a purchase price adjustment. [*See* Reg. §1.368-1(e)(2).] As a result, forfeited escrow stock will not count in either the numerator or the denominator of the continuity fraction. Let's take a look at how this works in practice, so the depth of the pothole we are seeking to avoid here can be plumbed.

Example. Big Buyer tries to acquire Tiny Target. Since Tiny Target shareholders want to receive equity in Big Buyer, Buyer puts forward 40 shares of its own stock worth $40 plus $60 in cash, for total consideration as of the day of the contract $100. Let's assume that the continuity of interest requirement is satisfied as of that date, since the Target shareholders will get the 40 shares of stock when the deal closes.

However, let's assume that the 40 shares of Big Buyer stock is actually split into two pieces. One half of the shares (20 shares) are put into an escrow to secure the representations and warranties made by Tiny Target. The new final regulations say that the date of contract value governs the continuity determination, even if stock (and/or boot) is placed in escrow to secure customary pre-closing covenants, representations and warranties. So far, everything still seems fine.

What if there is a breach of warranty? Just to take a dire situation, let's assume that all of the 20 escrowed shares are forfeited because of the breach of warranty by the target. As a result, only 20 of the 40 shares now will count toward continuity of interest. That means the entire consideration for the deal is reduced to $80 ($60 in cash and $20 in stock). After all, the regulations take the view that this is simply a purchase price adjustment. That means the equity in this deal (viewed *after* the purchase price adjustment) is only 25 percent ($20 of equity consideration out of total consideration of $80). That 25-percent continuity is simply not enough for tax-free reorganization treatment.

Does this example seem far-fetched? I don't think so. Bear in mind that a purchase price adjustment will often occur not at closing time (when there still might be some possibility of fixing it), but rather much later. The purchase price adjustment might not even occur in the same tax *year* as the closing. If the escrowed stock is tied up for a year after closing (and it might even be more than this), the forfeiture of some of the escrowed stock with consequent purchase price adjustment might occur quite some time after the deal closes. That could be disastrous.

There may be an easy solution, though in some cases it might not be entirely palatable. The safe bet is to measure continuity based on a worst-case assumption and to not close a deal unless continuity will be met assuming that the escrowed stock goes back to the buyer. Thus, assuming that the escrowed stock will be forfeited, will continuity be met? In the context of the above example, that could significantly alter the mix of cash and stock. Arguably, that's a different deal, but that's what the regulations seem to require.

In many cases, I think this is going to alter current practice about escrowed shares significantly. In order to achieve tax-free reorganization treatment, a tax practitioner must ensure that a sufficient quantity of equity consideration is exchanged in the transaction (outside of any escrow provisions) so that continuity of interest standards are met. This might have the effect of severely limiting the type and amount of deals that actually close. Some parties may be unwilling to participate in a tax transaction, and some parties will not want the quantity of equity that is required to satisfy continuity. Tax practitioners will therefore lose some flexibility in planning.

Perhaps a more palatable approach in some cases will be to structure the escrow so that any adjustment is proportional between cash and stock.

Who's on First?

Although it seems to me that this was a significant change, catching practitioners in a kind of "gotcha," it is interesting that the Treasury does not seem to think so. The final regulations suggest that the law on escrowed stock has *not* changed, and that the only shift made here is a matter of the valuation date. The proposed regulations stated that one used the closing date for the determination of the mix of consideration. Now we are told the binding contract date will control.

The escrowed stock point, says the Treasury, is really a separate point dealing with how many shares of stock will count as equity consideration, which must be evaluated to determine the mix of cash and equity for continuity of interest purposes. The preamble to the new regulations further suggests that placing stock in escrow to secure customary representations and warranties of the target will not prevent the consideration in a contract from being fixed. Yet, given the sea change in valuation dates (closing date morphing into binding contract date), I don't know how one can view the escrowed stock point as entirely separate.

According to the Treasury, as long as the continuity of interest threshold is met with consideration outside of those shares placed in escrow, the escrowed stock will not prevent the transaction from qualifying for tax-free treatment under the reorganization rules (as long as other requirements are met). The final regulations extend this rule to include consideration placed in escrow to secure a target's performance of

customary pre-closing covenants. There is no reason to differentiate between pre-closing covenants and customary representations and warranties. In all of this, the IRS and the Treasury take the position that any escrowed consideration that is forfeited should not be taken into account in determining whether the continuity of interest requirement is satisfied. This supports the conclusion that forfeited escrow stock is in substance a purchase price adjustment.

Some of this may simply be a distinction without a difference. After all, the problem with a rigid rule is that it is rigid. If *every* forfeiture of escrowed stock is viewed as a purchase price adjustment no matter what, it may ignore the economic realities of the deal. Historically, the IRS wanted transactions to be closed and conditions subsequent (say, the amount of liabilities in an acquisition) to be fixed at least as of some point.

When Does the Fat Lady Sing?

If there is a three-year measurement, and escrowed stock can still be called back because of an undisclosed liability post-closing, does it make sense to hold all matters (such as continuity of interest) open for this entire duration? It may be possible, after all, to view some of these situations as supplying sufficient equity consideration as of the contract date and as of the closing date, and only later (at the time of the default and payment event) to view this as a redemption of stock.

In viewing such a situation as a redemption of stock, would the IRS have to take the position that the escrowed stock should be included in determining whether the continuity threshold is met? If that were the case, could the IRS then treat the redemption proceeds exchanged for the stock as replacement consideration for the redeemed stock? Again, this could leave the transaction open for several years after the closing of the deal (in the case of an earn-out, for instance). Additionally, it could result in a messy situation for both buyer and seller, not to mention the shareholders.

Despite the finality of these regulations, some uncertainty still remains regarding the effects of escrowed stock on the continuity of interest rules. Hopefully both the IRS and the Treasury recognize this uncertainty. Optimistically, the preamble to the new regulations suggests that the IRS and the Treasury will each continue to consider the effect that escrowed stock can have on the continuity requirement. Perhaps there are more regulations to come.