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February 26, 2010

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Temporary and Proposed Regulations Regarding the Measurement of  
Continuity of Interest Under Section 368

Dear Commissioner Shulman:

Enclosed are comments concerning temporary and proposed regulations regarding the measurement of continuity of interest under Section 368. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink, appearing to read "Stuart M. Lewis".

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury  
William D. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service  
Lee A. Kelley, Deputy Associate Chief Counsel (Corporate), Internal Revenue Service

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**AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION**

**COMMENTS ON TEMPORARY AND PROPOSED REGULATIONS  
REGARDING THE MEASUREMENT OF CONTINUITY OF  
INTEREST UNDER SECTION 368**

These comments (“Comments”) are submitted on behalf of individual members of the Corporate Tax Committee of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association or the Section of Taxation.

Principal responsibility for preparing these Comments was exercised by John Sweet and Bob Woodward, Committee Chair, of the Corporate Tax Committee of the Section of Taxation. Substantive contributions were made by Erik Corwin, Julie Divola, David Strong and Rose Williams. The Comments were reviewed by Bob Wellen of the Section’s Committee on Government Submissions and by Peter Blessing, Council Director for the Corporate Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, or have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 26, 2010

## EXECUTIVE SUMMARY

Continuity of interest (“COI”) is a nonstatutory, judicially created requirement for acquisitive reorganizations under section 368.<sup>1</sup> The applicable Treasury Regulations state that the purpose of the COI requirement is “to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss,” and that COI requires that “in substance a substantial part of the value of the proprietary interests in the target corporation be preserved.”<sup>2</sup> Examples in the Regulations generally indicate that COI is achieved if at least 40 percent of the aggregate value of the consideration received by the target corporation shareholders in exchange for their target corporation stock constitutes stock of the acquiring corporation.<sup>3</sup> Accordingly, an important aspect of the COI requirement is the valuation of the acquiring corporation stock and other consideration received by the target corporation shareholders in exchange for their target corporation stock.

Temporary Regulations issued in 2007 (the “2007 Temporary Regulations”)<sup>4</sup> represent the latest attempt by the Internal Revenue Service (the “Service”) and the Department of the Treasury (the “Treasury”) to address COI in a transaction in which (1) target corporation shareholders receive acquiring corporation stock and cash or other property, and (2) the value of the acquiring corporation stock changes between the signing date and the closing date. Proposed Regulations were issued in 2004 (the “2004 Proposed Regulations”),<sup>5</sup> followed by final Regulations in 2005 (the “2005 Regulations”),<sup>6</sup> which were replaced by the 2007 Temporary Regulations.

The preamble to the 2004 Proposed Regulations framed the issue as follows:

In a transaction in which the shareholders of the target corporation receive both money and acquiring corporation stock, commentators have expressed concern that the transaction could fail to satisfy the COI requirement as a result of a decline in the value of the acquiring corporation’s stock between the date the parties agree to the terms of the transaction (the signing date) and the date the transaction closes. Commentators have noted that attempts to mitigate this concern have led to complexity in structuring transactions intended to qualify as reorganizations.<sup>7</sup>

The 2004 Proposed Regulations, the subsequent 2005 Regulations and the 2007 Temporary Regulations have addressed the issue by establishing a signing date rule for measuring COI where there is a “binding contract” which provides for “fixed consideration.” Under the signing date rule, the consideration to be exchanged for the

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<sup>1</sup> See, e.g., *Paulsen v. Commissioner*, 469 U.S. 131 (1985), and cases cited therein. References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

<sup>2</sup> Reg. § 1.368-1(e)(1)(i).

<sup>3</sup> See Temp. Reg. § 1.368-1T(e)(2)(v), Exs. (1), (6), (12), 72 Fed. Reg. 12,974 (2007).

<sup>4</sup> See Temp. Reg. § 1.368-1T(e)(2). The text of the 2007 Temporary Regulations also serves as the text of Proposed Regulation section 1.368-1(e)(2).

<sup>5</sup> Prop. Reg. § 1.368-1(e)(2), 69 Fed. Reg. 48,429 (2004).

<sup>6</sup> Reg. § 1.368-1(e)(2) (2005).

<sup>7</sup> 69 Fed. Reg. 48,429 (2004).

proprietary interests in the target corporation is valued on the last business day before the first date of the binding contract. When it applies, the signing date rule ensures that changes in the value of the acquiring corporation stock between signing and closing will not affect the determination of COI. The signing date rule is deemed appropriate in cases where a binding contract provides for fixed consideration, because in those cases the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the acquiring corporation as of the signing date.

We commend the Service and the Treasury for their continuing efforts to develop and improve these Regulations. However, we believe further improvements can be made. We recommend (as discussed more fully below) that the final Regulations:

1. Expand the scope of the signing date rule to cover contracts that provide for contingent adjustments to the consideration that increase the amount of acquiring corporation stock and/or reduce the amount of cash or other property delivered to the target corporation shareholders.
2. Provide a special rule for valuing acquiring corporation stock in measuring COI for certain contracts that employ “collar” arrangements to insulate target corporation shareholders from the effect of certain price fluctuations of acquiring corporation stock between the signing date and the closing date of a transaction.

In addition, we note that the applicability of the 2007 Temporary Regulations “expires on or before March 19, 2010.”<sup>8</sup> In order to avoid the disruption that would result if the 2007 Temporary Regulations were to expire, we recommend that the Service and the Treasury take action to ensure that taxpayers may continue to rely on the signing date rule set forth in the 2007 Temporary Regulations.

## DISCUSSION OF RECOMMENDATIONS

### 1. Expand Scope of Signing Date Rule to Cover Certain Additional Cases Involving Contingent Consideration.

Under the 2007 Temporary Regulations, a contract that provides for contingent adjustments to the consideration may be treated as providing for “fixed consideration” under limited circumstances.<sup>9</sup> However, a contract will not be treated as providing for fixed consideration (and thus will not qualify for the signing date rule) if --

the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the [acquiring] corporation stock after the last business day before the first date the contract is a binding contract. For example, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration in the event

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<sup>8</sup> See Temp. Reg. § 1.368-1T(e)(8)(ii); I.R.C. § 7805(e)(2).

<sup>9</sup> See Temp. Reg. § 1.368-1T(e)(2)(iii)(B)(1).

that the value of the stock of the [acquiring] corporation, the value of the assets of the [acquiring] corporation, or the value of any surrogate for either the value of the stock of the [acquiring] corporation or the assets of the [acquiring] corporation increase or decrease after the last business day before the first date there is a binding contract; or in the event the contract provides for contingent adjustments to the number of shares of the [acquiring] corporation stock to be provided to the target corporation shareholders computed using any value of the [acquiring] corporation shares after the last business day before the first date there is a binding contract.<sup>10</sup>

Accordingly, for contracts that provide these types of contingent adjustments, which we refer to in this report as “Contingent Value Adjustments,” acquiring corporation stock would be valued for COI purposes by reference to its value as of the closing date of the transaction. We believe this approach is too restrictive, and that the scope of the signing date rule should be expanded as described below.

In particular, we recommend that the final Regulations apply signing date principles to a binding contract that provides for one or more Contingent Value Adjustments if (i) the contract would satisfy COI (without regard to any Contingent Value Adjustment) and (ii) the Contingent Value Adjustments would have the effect of (A) increasing the number of acquiring corporation shares to be delivered to the target corporation shareholders (for example, a contract that provides for the issuance of additional acquiring corporation shares if the value of acquiring corporation stock during a period shortly before the closing date is less than its value on the signing date), and/or (B) decreasing the amount of money or other property to be delivered to the target corporation shareholders.<sup>11</sup>

We acknowledge that Contingent Value Adjustments of the type described above would reduce the extent to which target corporation shareholders are subject to the benefits and burdens of owning acquiring corporation stock as of the signing date. That is, our recommendation would represent a departure from the general principle that the signing date rule should be limited to cases in which the target corporation shareholders are subject to the benefits and burdens of owning acquiring corporation stock as of the signing date. We believe that the policy justification for applying this principle, especially in cases where the target corporation shareholders’ proprietary interests in the acquiring corporation are increased, is not compelling.

The 2007 Temporary Regulations themselves seem to permit certain deviations from the benefits-and-burdens principle. For example, under Temporary Regulation section 1.368-1T(e)(2)(ii)(B)(2), a binding contract providing for fixed consideration that

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<sup>10</sup> Temp. Reg. § 1.368-1T(e)(2)(iii)(B)(2).

<sup>11</sup> Similarly, we recommend that the final Regulations apply signing date principles to a binding contract that provides for one or more Contingent Value Adjustments if (i) the contract would not have satisfied COI (without regard to any Contingent Value Adjustment), and (ii) the Contingent Value Adjustments would have the effect of (A) decreasing the number of acquiring corporation shares to be delivered to the target corporation shareholders, and/or (B) increasing the amount of money or other property to be delivered to the target corporation shareholders. This rule would provide assurance that transactions originally structured to fail COI based on signing date values would not satisfy COI unexpectedly.

is modified does not lose the benefit of the signing date rule if COI would have been satisfied absent the modification, provided that the modification would (i) have the sole effect of increasing the number of shares of acquiring corporation stock to be delivered to target corporation shareholders, (ii) have the sole effect of decreasing the amount of cash or other property to be delivered to target corporation shareholders, or (iii) have the effect of increasing the number of shares of acquiring corporation stock to be delivered to target corporation shareholders and decreasing the amount of cash or other property to be delivered to target corporation shareholders. The preamble to the 2005 Regulations (which included a predecessor of this rule) explained that in cases such as these, where a modification “only enhances the preservation of the target corporation shareholders’ proprietary interests,” it is appropriate to value the consideration by reference to the original binding contract date.<sup>12</sup>

We believe the same rationale supports the application of signing date principles to contracts that would satisfy COI absent any adjustment and provide for Contingent Value Adjustments of the type described above, which likewise would only enhance the preservation of the target corporation shareholders’ proprietary interests (*i.e.*, by providing for the delivery of more acquiring corporation stock, and/or less cash or other property, than would have been delivered in the absence of the Contingent Value Adjustments).<sup>13</sup> In other words, a Contingent Value Adjustment built into an original contract should not be treated more harshly than an adjustment resulting from a contract modification. Such an expansion of the signing date rule would not violate the purpose of the COI requirement “to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations.”<sup>14</sup> A transaction that is subject to a Contingent Value Adjustment that increases the percentage of the aggregate consideration represented by acquiring corporation stock does not resemble a sale more than a similar transaction that is not subject to such an adjustment.

## **2. Provide Special Valuation Rule for Certain Collar Arrangements.**

We believe the Regulations should also be expanded to provide guidance on certain collar type arrangements that are used frequently in corporate reorganizations. We believe that, in general, such arrangements do not detract from COI and should not be discouraged by the Regulations. Under a typical collar arrangement, the number of shares of acquiring corporation stock, and/or amount of cash or other property, to be delivered by the acquiring corporation is adjusted within designated bounds to account for increases or decreases in the value of the acquiring corporation stock between the signing date and the closing date:

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<sup>12</sup> 70 Fed. Reg. 54,631 (2005).

<sup>13</sup> The preamble to the 2005 Regulations relied on similar reasoning to support the application of the signing date rule to contracts that provided for contingent consideration where (i) the contingent consideration consisted solely of stock of the acquiring corporation and (ii) the transaction would have satisfied the COI requirement if none of the contingent consideration were delivered to the target corporation shareholders. 70 Fed. Reg. 54,631, 54,632 (2005); *see* Reg. § 1.368-1(e)(2)(iii)(C) (2005). No comparable provision was included in the 2007 Temporary Regulations.

<sup>14</sup> Reg. § 1.368-1(e)(1)(i).

- The number of shares of acquiring corporation stock, and/or amount of cash or other property, to be delivered is reduced if the market value of acquiring corporation stock is higher on (or shortly before) the closing date as compared to its value on the signing date. If the closing date value exceeds a value specified by (or otherwise determinable under) the contract (the “ceiling price”), which is greater than the signing date value, the amount of the reduction in consideration is determined by reference to the ceiling price rather than the closing date value.
- The number of shares of acquiring corporation stock, and/or amount of cash or other property, to be delivered is increased if the market value of acquiring corporation stock is lower on (or shortly before) the closing date as compared to its value on the signing date. If the closing date value of acquiring corporation stock is less than a value specified by (or otherwise determinable under) the contract (the “floor price”), which is lower than the signing date value, the amount of the increase in consideration is determined by reference to the floor price rather than the closing date value.

The purpose of a collar arrangement is to insulate target corporation shareholders from the effect of fluctuations in the price of acquiring corporation stock within a range, bounded by the floor price on the low end and the ceiling price on the high end, between the signing date and closing date. The discussion below assumes that the transaction would have satisfied COI in the absence of the collar arrangement.

For purposes of computing COI, in transactions involving a collar arrangement in which the closing date value is less than the floor price, we recommend that the final Regulations provide for the acquiring corporation stock received by the target corporation shareholders to be valued using the floor price. In these cases, the target corporation shareholders incur the detriment of declines in the value of the acquiring corporation stock below the floor price, as target corporation shareholders in a fixed consideration transaction incur the detriment of value declines below the signing date value. As a result, we believe this recommendation is consistent with the general principle underlying the 2007 Temporary Regulations. The suggested approach would ensure, with respect to contracts involving collar arrangements -- as the existing Regulations ensure with respect to contracts providing for fixed consideration -- that a post-signing decline in value of acquiring corporation stock that is borne by target corporation shareholders would not adversely affect the computation of COI.

For similar reasons, in transactions involving a collar arrangement in which the closing date value exceeds the ceiling price, we recommend that the final Regulations provide that COI be determined using the ceiling price to value the acquiring corporation stock received by the target corporation shareholders. We do not recommend that the final Regulations provide a special valuation rule in cases in which the closing date value of acquiring corporation stock is between the floor price and the ceiling price. Accordingly, in those cases, COI generally would be measured by reference to the closing date value of acquiring corporation stock.

## Examples

The following examples illustrate the application of the recommendations described above. For purposes of these examples, P is the acquiring corporation; T is the target corporation; P and T each has only one class of stock outstanding; no transactions other than those described occur; and the transactions are not otherwise subject to recharacterization.

### Example 1 -- Contingent Value Adjustment to Provide Additional Stock or Less Cash (Illustration of Recommendation 1 Above).

On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, the T shareholders will receive 40 shares of P stock and \$60 cash in exchange for all the outstanding stock of T, subject to the following Contingent Value Adjustment: (i) if the average trading price of P stock over a specified number of trading days shortly before the closing date exceeds \$1, the amount of cash will be reduced by the product of (A) 40 and (B) the average trading price of P stock during the specified period minus \$1; and (ii) if the average trading price of P stock during the specified period is less than \$1, P will issue an additional number of P shares to the T shareholders with a value (determined using the average trading price of P stock during the specified period) equal to the product of (A) 40 and (B) \$1 minus the average trading price of P stock during the specified period, provided that in no event will P deliver less than \$40 cash or more than 80 P shares to the T shareholders. The Contingent Value Adjustment ensures that the T shareholders will be entitled to receive aggregate consideration with a value of \$100 on the closing date if the average trading price of P stock during the specified period is at least \$.50 and no more than \$1.50.

On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. The average trading price of P stock during the specified period is \$.25 per share. In the merger, the T shareholders receive \$60 cash and 80 P shares with a value (determined using the average trading price of P stock during the specified period) of \$20. If the contract did not include the Contingent Value Adjustment, T shareholders would have been treated for COI purposes as receiving 40 P shares valued for COI purposes at \$1 per share and \$60 cash (resulting in COI of 40%), and therefore the contract would have satisfied COI based on the signing date value of the P stock (even though they actually would receive at closing P stock worth \$10 and \$60 cash). Because the Contingent Value Adjustment could only increase the number of P shares, or decrease the amount of cash, to be delivered to T shareholders, COI would be measured using the value of P stock on January 2 of Year 1 (\$1 per share). Accordingly, COI would be satisfied (\$80 deemed

value of P stock, with each of 80 P shares valued at \$1,<sup>15</sup> divided by total consideration having a deemed value of \$140, resulting in COI of 57.14%).<sup>16</sup>

Example 2 -- Contingent Value Adjustment to Provide More or Less Stock or Cash (Illustration of Recommendation 2 Above).

a. Adjustment to Provide More or Less Stock; COI satisfied. The facts are the same as in Example 1 except the contract is subject to the following Contingent Value Adjustment: (i) if the average trading price of P stock over a specified number of trading days shortly before the closing date exceeds \$1, the P stock to be issued will be reduced by a number of P shares having a value (determined using the average trading price of P stock during the specified period) equal to the product of (A) 40 and (B) the average trading price of P stock during the specified period minus \$1; and (ii) if the average trading price of P stock during the specified period is less than \$1, P will issue an additional number of P shares to the T shareholders with a value (determined using the average trading price of P stock during the specified period) equal to the product of (A) 40 and (B) \$1 minus the average trading price of P stock during the specified period, provided that in no event will P deliver less than 26.67 or more than 80 shares of P stock to the T shareholders.<sup>17</sup> The Contingent Value Adjustment ensures that the T shareholders will be entitled to receive cash of \$60 and P stock with a value (determined using the average trading price of P stock during the specified period) of \$40 if the average trading price of P stock during the specified period is greater than or equal to a floor price of \$.50 and less than or equal to a ceiling price of \$1.50.<sup>18</sup>

On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of P stock is \$.25 per share. The average trading price of P stock during the specified period is also \$.25 per share. In the merger, the T shareholders receive \$60 cash and 80 P shares with a value (determined using the average trading price of P stock during the specified period) of \$20. COI would be measured using the floor price of \$.50. Under these facts, COI would be satisfied (\$40 deemed value of P stock, with each of 80 P shares valued at \$.50, divided by total consideration having a deemed value of \$100, resulting in COI of 40%).

If the value of P stock on June 1 of Year 1 and the average trading price of P stock during the specified period were \$1.65 per share (rather than \$.25 per share), the T shareholders would receive \$60 cash and 26.67 shares of P stock with a value

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<sup>15</sup> Use of the January 2 value is consistent with the approach taken in the Regulations for changes in contracts not deemed to result in a modification. See Reg. § 1.368-1T(e)(2)(ii)(B)(2).

<sup>16</sup> The contract described in this example would also satisfy COI under our recommendation relating to collar arrangements. Under that recommendation, COI would be 40% (\$40 of P stock, with each of 80 P shares valued at the floor price of \$.50, divided by total consideration of \$100).

<sup>17</sup> Thus, the commercial difference from the Contingent Value Adjustment in Example 1 is that the number of shares rather than cash may be reduced.

<sup>18</sup> The maximum reduction in value of consideration (at \$1.50 share price) and maximum increase in value (at \$.50 share price) is \$20. Thus, at \$1.50 per share, the maximum reduction in the number of shares is 13-1/3 shares, resulting in 26-2/3 shares as the minimum number issued, and at \$.50 per share, the maximum increase is 40 shares, resulting in a maximum issuance of 80 shares.

(determined using the average trading price of P stock during the specified period) of \$44. COI would be measured using the ceiling price of \$1.50. Under this variation of the facts too, COI would be satisfied (\$40 deemed value of P stock divided by total consideration having a deemed value of \$100, resulting in COI of 40%).

b. Adjustment to Provide More or Less Cash; COI Not Satisfied. The facts are the same as in Example 2a. except the contract is subject to the following Contingent Value Adjustment: (i) if the average trading price of P stock over a specified number of trading days shortly before the closing date exceeds \$1, the amount of cash will be reduced by the product of (A) 40 and (B) the average trading price of P stock during the specified period minus \$1; and (ii) if the average trading price of P stock during the specified period is less than \$1, the amount of cash will be increased by the product of (A) 40 and (B) \$1 minus the average trading price of P stock during the specified period, provided that in no event will P deliver cash of less than \$40 or more than \$80. The Contingent Value Adjustment ensures that the T shareholders will be entitled to receive aggregate consideration with a value of \$100 on the closing date if the average trading price of P stock during the specified period is greater than or equal to a floor price of \$.50 and less than or equal to a ceiling price of \$1.50.

On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of P stock is \$.25 per share. The average trading price of P stock during the specified period is also \$.25 per share. In the merger, the T shareholders receive \$80 cash and 40 shares of P stock with a value (determined using the average trading price of P stock during the specified period) of \$10. COI would be measured using the floor price of \$.50. Under these facts, COI would not be satisfied (\$20 deemed value of P stock, with each of 40 P shares valued at \$.50, divided by total consideration having a deemed value of \$100, resulting in COI of 20%).

c. Adjustment to Provide More or Less Cash; COI Satisfied. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, the T shareholders will receive 50 shares of P stock and \$50 cash in exchange for all of the outstanding stock of T, subject to the following Contingent Value Adjustment: (i) if the average trading price of P stock over a specified number of trading days shortly before the closing date exceeds \$1, the amount of cash will be reduced by the product of (A) 50 and (B) the average trading price of P stock during the specified period minus \$1; and (ii) if the average trading price of P stock during the specified period is less than \$1, the amount of cash will be increased by the product of (A) 50 and (B) \$1 minus the average trading price of P stock during the specified period, provided that in no event will P deliver cash of less than \$40 or more than \$60 to the T shareholders. The Contingent Value Adjustment ensures that the T shareholders will be entitled to receive aggregate consideration with a value of \$100 on the closing date if the average trading price of P stock during the specified period is greater than or equal to a floor price of \$.80 and less than or equal to a ceiling price of \$1.20.

On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the

value of P stock is \$.25 per share. The average trading price of P stock during the specified period is also \$.25 per share. In the merger, the T shareholders receive \$60 cash and 50 shares of P stock with a value (determined as of the closing date) of \$12.50. Because the value of P stock on the closing date is less than the floor price of \$.80 per share, COI would be measured using the floor price, resulting in COI of 40% (\$40 deemed value of P stock, with each of 50 P shares valued at \$.80, divided by total consideration having a deemed value of \$100). Accordingly, COI would be satisfied.