Key Issues When Considering a Spin-off

In his regular column, Frank Aquila drafts a sample memo to a board identifying the principal legal issues to consider when determining whether to undertake a proposed spin-off of a subsidiary.

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MEMORANDUM

TO: **The Board of Directors**

FROM: **Frank Aquila**

RE: **Issues When Considering a Spin-off**

As we have discussed, the Investor has proposed the spin-off of a subsidiary of the Company. The Investor believes that the separation of the Company and the subsidiary into two independent, public companies will enhance shareholder value. The Investor premises its view on the fact that the Company and the subsidiary possess different business, financial and growth attributes, and that currently the capital markets do not fully value all of the elements of the combined business. In determining whether the proposed spin-off is in the best interest of the Company and its shareholders, the Board will need to consider a range of legal, financial and practical factors.

Spin-offs are considered a distribution of dividends by the parent company and, therefore, the only approval needed to complete a spin-off is that of the board of the parent company. As the Board decides whether to spin off the subsidiary, the directors are bound by their fiduciary duties to act in good faith, on an informed basis, and in the best interest of the Company and its shareholders. In making a decision to spin off a wholly owned subsidiary, the board of the parent company does not owe fiduciary duties to the newly spun-off company or to any prospective shareholders of the spun-off company.

Under the Delaware General Corporation Law (DGCL), companies are not required to obtain the approval of their shareholders before proceeding with a spin-off. (This is the case in most states. However, shareholder approval for spin-offs is required in some states, such as in New York and Maryland.)

A shareholder of a company can challenge the board's decision to engage in a spin-off transaction as a breach of fiduciary duty. However, Delaware courts will generally apply the business judgment presumption (a very beneficial standard) to a board's decision to approve a transaction. Under the business judgment rule, it is extremely likely that the Delaware Court of Chancery would generally confirm a board's decision to undertake a spin-off, provided that the board acted on an informed basis in the best interest of the company.

Search Fiduciary Duties of the Board of Directors for a discussion of a director's core duties of care and loyalty and certain circumstances when the board holds heightened duties.

In considering whether to approve the proposed spin-off, the Board should consider: (i) the business purpose of the spin-off; (ii) tax consequences for the Company and its shareholders; (iii) the responsibilities of the Company's and the subsidiary's boards; (iv) corporate governance issues; (v) alternative methods for structuring a separation transaction; and (vi) the timeline of the spin-off. This memo provides a broad overview of the principal legal issues that should be considered in the Board's analysis.

Search Spin-offs: Overview for a detailed explanation of spin-off transactions, including information on alternative separation transactions.

1. BUSINESS PURPOSE OF THE SPIN-OFF

Although utilized for many decades, spin-offs have become an increasingly popular business and financial tool in recent years. With many companies announcing spin-off plans this year, it is likely that this so-called "spinmania" will continue. Many companies are opting to do a spin-off because, as the Investor suggested, spin-offs often further the business purpose of increasing the combined market value of the parent company and the subsidiary. Under the right circumstances, a spin-off can release latent shareholder value by removing obstacles to both valuation and growth.

A. INCREASING BUSINESS FOCUS

Although a combined organizational structure has historically allowed the Company to take advantage of synergy opportunities, it appears that those significant cost synergies no longer exist to the extent that they once did. Nevertheless, the Board should consider whether the benefits of a combined organizational structure justify the negative cost of duplicative management structures. Since the Company and the subsidiary operate in unrelated business sectors with little crossover, the responsibility to operate the subsidiary in the framework of the Company's overall performance may be distracting managers from the Company's core operations and, as a consequence, limiting the subsidiary's growth. Furthermore, the external optics of controlling a business in an unrelated sector could cause brand confusion.

By spinning off the subsidiary, the Company's senior executives will be able to devote more attention and resources to the Company's core operations. The newly spun-off subsidiary will have its own directors and officers who can tailor their decision-making to the subsidiary's characteristics, needs and growth potential, without being constrained by any limitations imposed by the Company's core business.

In addition, the equity compensation awarded to directors and officers of each entity will be tied directly to the performance of that entity and will serve as a more direct and meaningful incentive as intended. Under separate management, both the Company and the subsidiary could provide more directed and consistent messaging to current and prospective investors, collaborators, suppliers, customers and employees.

B. ALLEVIATING MARKET CONFUSION

Since 1987, US GAAP (generally accepted accounting principles) have required companies to provide consolidated financial statements, which report the financial positions of the parent company and all the subsidiaries it controls as a single entity. The consolidated reporting can lead to investor confusion about the financial position of each stand-alone business.

For example, General Electric's consolidated balance sheet is dominated by the activity of its financial services subsidiary, GE Capital, which its board has recently determined to sell. Although companies like General Electric often supplement consolidated financial statements with financial statements that break down the revenues, assets and liabilities of their subsidiaries, supplemental statements may not be enough to resolve the market's confusion about the various business segments. To achieve greater transparency and avoid the "conglomerate discount," some companies, including those in high-risk and often misunderstood sectors like the mining and metals industries, have spun off segments of their business so that single sector businesses can be more easily understood by analysts and investors.

If the Company is struggling to realize value for some of its businesses and assets, a spin-off to deconsolidate businesses that perform in fundamentally different ways could be in the best interest of both the Company and the spun-off businesses. Deconsolidating a slower growth subsidiary could increase the parent company's value by revealing a clearer picture of the parent company's business performance and ongoing potential. At the same time, a deconsolidation could increase the market value of the subsidiary by helping investors understand the business fundamentals of the spun-off business lines.

C. ATTRACTING NEW INVESTORS

A company could stabilize its operational earnings by spinning off a relatively high-risk subsidiary. After the spin-off, the former parent company and the spun-off subsidiary would be able to obtain capital and finance projects based on their own risk level and growth projections. Since the spin-off will result in a more "pure play" company, it may also attract portfolio managers, analysts and new investors who are interested in that particular sector.

For example, this summer, Babcock & Wilcox is scheduled to complete a spin-off that will deconsolidate its government and nuclear operations business from its power generation business. The government and nuclear operations business is likely to generate steady cash flows and consistent performance in earnings that should attract conservative, income-oriented investors, while the riskier power generation business should attract growth-oriented investors.

Aside from increasing business focus, alleviating market confusion and attracting new investors, engaging in a spin-off can lead to other benefits. The Company might structure a spin-off to separate businesses in regulated and unregulated industries. In that case, the spin-off would allow the unregulated businesses to expand and operate without being encumbered by heightened regulatory restrictions. Tax advantages, discussed below, could also make a spin-off the right decision.

Notwithstanding the many potential advantages, a spin-off might not be the right decision for the Company due to the accompanying risks and burdens. Preparing the parent company and the subsidiary for a spin-off is a complicated process that entails substantial planning and transaction costs and can cause significant disruption in business operations. Although management will have greater focus on the core business once the spin-off is completed, during the run up to the spin-off, management will be more focused on the spin-off.

The spun-off businesses may also attract unsolicited takeover bids and the Company may have a harder time resisting a takeover. In addition, failure to comply with the array of tax, securities, listing, financial reporting and other requirements in completing a successful spin-off can expose the parent company and the subsidiary to unwelcome liabilities. Moreover, another type of separation transaction (such as an equity carve-out or split-off) could be more appropriate for the Company. An alternative separation transaction could offer the same benefits as a spin-off, as well as other attractive features. These alternative separation transactions are discussed further in Section 5 below.

2. TAX CONSIDERATIONS

Subject to certain requirements under Section 355 of the Internal Revenue Code, a parent company can distribute subsidiary stock to shareholders without triggering gain at either the corporate or the shareholder level, making the spin-off tax free for both the parent company and its shareholders. One requirement of Section 355 is that the parent company distribute "control" of shares in the spun-off company, which is defined as shares representing at least 80% of the total combined voting power and at least 80% of any non-voting shares.

In addition, the spin-off must be carried out for a corporate business purpose. It should be pointed out that if the IRS has reason to suspect that the spin-off would not result in a true separation of the businesses, or is a disguised divestiture, shareholders may have to pay income taxes on the stock dividends, and the parent company may be liable for capital gains tax on the difference between the fair market value of the subsidiary stock and the parent company's tax basis in the subsidiary.

Given the potential tax advantages of a spin-off, tax law will no doubt be integral to the Board's deliberations regarding the proposed spin-off. If the Board considers proceeding with the spin-off, detailed tax advice must be obtained.

3. DIRECTOR RESPONSIBILITIES IN STRUCTURING A SPIN-OFF

The directors of a company and its subsidiary are bound by their usual fiduciary duties of good faith, due care and loyalty when making corporate decisions throughout the process of completing a spin-off. In addition, when a parent company distributes a subsidiary's stock to shareholders, or if the subsidiary makes a pre-spin cash payment to the parent company (which is often the case), directors must be aware of the solvency concerns raised by these payments under the Federal Bankruptcy Code and state fraudulent conveyance laws.

A board cannot approve a transfer of assets with the intention of hindering, delaying or defrauding creditors. A court would find a transaction to be a fraudulent conveyance if a company transferred its assets for less than reasonably equivalent value while it was insolvent. Directors of a company and its subsidiary can face breach of fiduciary duty lawsuits if they approve a transaction that constitutes a fraudulent conveyance. As a consequence, the Board should consider the solvency of the Company and the subsidiary in evaluating a spin-off and whether to obtain solvency opinions from appropriate financial advisors to provide a defense if actions are commenced under fraudulent conveyance laws.

Typically, directors are not exposed to personal liability for their corporate decisions. However, spin-offs generally involve the payment of at least one dividend, and if the directors acted with negligence in approving a spin-off that involved unlawful dividends (for example, dividends not paid out of the company's currently available surplus or net profits), they could face personal liability under the DGCL. Personal liability will not attach if the board approved an unlawful dividend based on reports from employees or committees of the board as to the availability of surplus or other funds, or if the board acted in honest reliance on the opinions of outside advisors.

4. CORPORATE GOVERNANCE CONSIDERATIONS

A. INCORPORATION DOCUMENTS

Early in the planning stages of a spin-off, the Board should decide whether to effectuate a spin-off by creating a new corporation to take on the spun-off assets and businesses, or by separating the two existing corporations, the Company and the subsidiary, into independent public companies. If the Board decides to pursue the latter route, it should make sure that the subsidiary's current name, state of incorporation, charter and by-laws will be appropriate for the identity and operations of the spun-off entity (although name, charter and by-laws can be easily changed prior to the spin-off).

After the spin-off, the subsidiary will change from a wholly owned subsidiary to an independent public company, and its incorporation documents may need to be revised to accommodate its changing needs. The charter of a wholly owned subsidiary does not typically permit flexible issuance of capital stock, which could present a problem for a public company. Charter and by-law provisions that are designed for the efficient administration of a wholly owned subsidiary (such as shareholder action by written consent) may not make sense after the subsidiary becomes a public company.

In addition, while it might be tempting to simply adopt the Company's governance mechanisms for the subsidiary, consider that the Company's governance structure may not be the most efficient structure for the spun-off business. If the Company's charter and by-laws are used as a starting point, any necessary revisions to those documents should be made before the spin-off due to the challenges of obtaining shareholder approval to amend these documents after the subsidiary becomes a public company with an expanded shareholder base.

When updating the subsidiary's incorporation documents, keep in mind that a spin-off could make both the Company and the subsidiary attractive unsolicited takeover targets. A potential acquiror may want to snatch up the newly public subsidiary at a low price before the market recognizes the subsidiary's full potential. Putting takeover defenses (such as establishing a classified board, authorizing blank check preferred stock and adopting "fair price" provisions and advance notice requirements) in the subsidiary's charter or by-laws puts the subsidiary's board in a better negotiating position against a potential acquiror, allowing directors to protect the interests of the shareholders by fending off unfair or undesirable bids.

However, arming the spin-off entity with too many unpopular anti-takeover devices could lead to a negative reaction from institutional shareholders and proxy advisory firms, such as ISS and Glass Lewis. After a spin-off, the Company might also attract unsolicited bids since a spin-off will reduce the size and diversification of the Company, leaving it in a potentially weaker position to resist an unsolicited bid at the same time as it becomes a more attractive takeover target. Nonetheless, it is not likely that the Company will be able to enact new takeover defenses in anticipation of a spin-off to avoid triggering investor or proxy advisor backlash.

Search Defending Against Hostile Takeovers for a discussion of the legal constraints and challenges that boards face in adopting defensive measures that can stand up to judicial scrutiny while satisfying their fiduciary duties.

Search Certificate of Incorporation: Staggered Board Provision for a standard clause for the certificate of incorporation creating a staggered board.

B. DIRECTORS AND OFFICERS

Identifying, vetting and selecting directors and officers for the spun-off company will be another important task in the planning stages of a spin-off. In cases where the spun-off company shared only a few officers with its parent company before the separation, management selection will probably be a straightforward process. Officer selection becomes more complicated if there is significant overlap between the management of the spun-off company and its former parent company, and will require an evaluation of the needs of each business and the hiring of new management.

Besides vetting individual director candidates based on background and relevant experiences, the Board should also consider whether the directors would satisfy the corporate governance requirements of the SEC and the stock exchanges. Listed companies are required to have a majority of "independent" directors under both the relevant stock exchange definitions and Rule 10A-3 under the Exchange Act, as well as have audit, compensation and nominating committees comprised of independent directors. A company listing in connection with a spin-off will have a grace period of up to one year to fully comply with all aspects of these requirements.

Search Corporate Governance Standards for an overview of the corporate governance standards established by the NYSE, NASDAQ and the SEC.

Search Director Independence Standards Chart for an outline of the director independence standards under the NYSE and NASDAQ rules.

If there is too much overlap between the directors of the spun-off company and its former parent company, the companies may not be able to fulfill the independence requirements of the applicable stock exchange and SEC rules. In the context of a spin-off, a director of the spun-off subsidiary might not be "independent" if she worked for the parent company or its affiliates in the past. It is important to keep in mind that limiting director and officer overlap is necessary to preserve the tax-free treatment of the spin-off.

Overlap also increases the potential for conflicts of interest, amplifying the companies' exposure to shareholder litigation. Moreover, extensive overlap raises concerns under Section 8 of the Clayton Antitrust Act, which prohibits interlocking directors and officers by US companies competing in the same industry under certain circumstances. All things considered, it is crucial for parties planning a spin-off to seek out new and independent management and directors, even though the selection process is likely to be time consuming.

C. OTHER GOVERNANCE ISSUES

There are many other governance issues that the Board will need to attend to at the planning stages of a spin-off, especially if the Company and the subsidiary are tightly integrated at the present time, or if the companies plan to have ongoing collaboration in the future. For example, if the Company and subsidiary currently have employees in common, the employees will need to be assigned to either the Company or the subsidiary. Related assets and liabilities, such as employment agreements, pensions, stock options and other benefit plans, as well as relevant union contracts, must also be assigned.

Some parent companies continue to share resources with the spun-off company during a transition period or license their intellectual property to the spun-off entity. A newly spun-off company can benefit from its former parent company's older brand name and goodwill. The Company should consider protecting its brand by maintaining the right to perform quality control checks on products and services of the spun-off company that bear the Company's trademark.

5. ALTERNATIVES TO A SPIN-OFF

In the initial planning stages of a spin-off, the Board should also consider alternative types of common separation transactions and evaluate whether a spin-off is the most advantageous option. Some of these alternative transactions involve a distribution of stock in a new public company to shareholders that resembles a traditional spin-off. For example, in a split-off, the parent company's shareholders receive a tender offer to exchange parent company stock for subsidiary stock, rather than automatically receiving subsidiary stock as a dividend. An equity carve-out, in which the spin-off is coupled with an initial public offering of the subsidiary's stock, is a popular alternative to a traditional spin-off. Other transactions (known as Morris Trust or Reverse Morris Trust transactions) involve a sale to a third party by combining a spin-off with an M&A transaction, which may not be tax free for the parent company and its shareholders, but can generate more cash for the parent company than a spin-off. For these reasons, the decision between a spin-off and other available alternatives (or the decision to combine several types of transactions) will implicate a thorough assessment of the Company's present tax and financial needs.

6. THE SPIN-OFF PROCESS

While the sections above identify substantive considerations that should accompany the Board's deliberations about a spin-off, this section describes the main procedural considerations. Please note that this is not an exhaustive list of tasks that must be completed, but merely a guide to assist the Board in addressing the key issues.

Generally, a traditional spin-off takes approximately six months from the initial planning stages to completion. The timeline and process for a spin-off can vary substantially from one transaction to another, depending on the level of integration between the parent company and the subsidiary and whether the spin-off will be coupled with another transaction, as is often the case.

Search Transaction Checklist: Spin-offs for a list of the key matters and issues that should be considered by a company and its advisors before, and while conducting, a spin-off transaction.

A. MONTHS 1 AND 2

The first two months of the planning process will be a crucial decision-making period involving extensive consultations with the Company's employees and advisors. The Board should identify the businesses to be spun-off as early as possible. To do so, the Board should assess the historical performance of these businesses, and evaluate the post-separation financial viability of both the parent company and the subsidiary that will be spun off. The Board will likely find it useful to seek independent financial advice as it examines the historical and post-separation performance of the businesses. The Board would be prudent to obtain solvency opinions from an appraisal firm in order to avoid fraudulent conveyance concerns.

We would work with the Company throughout this initial stage to comply with tax law requirements under Section 355. Since failure to comply with Section 355 could expose both the Company and its shareholders to significant tax liabilities, we might seek an IRS private letter ruling on the proposed transaction. (However, since the IRS will only give tax rulings on significant issues, private letter rulings are not available to determine if the deal is tax free.)

Towards the end of the initial decision-making period, the Company should file a Form 8-K and announce its intention to conduct a spin-off. We would assist the Company in drafting the Form 8-K, and begin drafting the necessary SEC filings and disclosures for the spin-off. Typically, this includes a Form 10 to register under the Exchange Act the class of equity securities of the subsidiary that will be distributed in the spin-off and an Information Statement that will be distributed to the Company's shareholders explaining the spin-off and describing the subsidiary.

B. MONTH 3

By Month 3, the Board will have already decided what businesses to spin off. The Board's focus in Month 3 should be on the preparation of the necessary documents to effectuate the spin-off and execute asset transfers between the Company and the subsidiary. These documents include, among others: (i) a separation and distribution agreement; (ii) a tax allocation agreement; (iii) a transition services agreement; (iv) a management services agreement; and (v) licensing agreements.

We would also work with the Board to review the subsidiary's current charter and by-laws. At the end of Month 3, the Company should file the Form 10 and Information Statement.

C. MONTHS 4 THROUGH 6

In the final stages of the spin-off process, we would work with the Company to fulfill SEC disclosure obligations, including finalizing the Form 10 and Information Statement, and to comply with technical requirements for listing the subsidiary's stock on a stock exchange. The Board should consider whether a road show to review the spin-off transaction is necessary or desirable. If desired, in or around Month 4, the Company should begin preparing for road shows, which would take place during Month 6. Finally, in Month 6, the parties should execute the completed spin-off agreements and distribute the subsidiary's stock to shareholders to effect the spin-off.

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A spin-off can unlock hidden value for shareholders, but the process of completing a spin-off often demands considerable planning and can lead to significant transactional costs. As the Board considers whether the proposed spin-off serves the best interest of the Company and its shareholders, it must weigh the value-releasing potential of the separation transaction against the burdens and risks of the transaction.

In the upcoming weeks, the Board will need to communicate with the officers of both the Company and the subsidiary, and consult with its legal, financial, tax and accounting advisors, to get a full picture of the advantages and disadvantages of the proposed spin-off and alternative transaction structures. We should discuss these issues further if the Board decides to move forward with the spin-off.

F.J.A.