SPIN OFFS

GREGORY E. OSTLING
PARTNER
WACHTELL, LIPTON, ROSEN & KATZ

Gregory is a corporate partner focusing primarily on mergers and acquisitions and complex corporate and securities law matters. He has been involved in numerous major domestic and cross-border merger and acquisition transactions, leveraged buyouts, joint ventures, divestitures, public offerings, proxy fights and takeover defenses.

DAVID K. LAM
PARTNER
WACHTELL, LIPTON, ROSEN & KATZ

David is a corporate partner focusing on mergers and acquisitions, securities transactions and corporate governance. His practice includes a wide range of matters, such as public and private acquisitions and divestitures, domestic and international transactions, carve-out IPOs, spin-offs, split-offs, joint venture transactions and private equity transactions.

The Decision to Separate and Considerations for the Board

Spin-offs provide companies with a means to potentially command higher valuations for certain businesses by separating them through the creation of one or more separate, publicly traded companies. When deciding to pursue a spin-off, boards must consider the myriad financial, legal, tax and other issues involved in these complex transactions.

A spin-off involves the separation of a company's businesses through the creation of one or more separate, publicly traded companies. Spin-offs have been popular because many investors, boards and managers believe that certain businesses may command higher valuations if owned and managed separately, rather than as part of the same enterprise. An added benefit is that a spin-off can often be accomplished in a manner that is tax-free to both the existing public company (referred to as the parent) and its shareholders.

Recently, robust debt markets have enabled companies to lock in low borrowing costs for the business being separated and monetize a portion of its value. There were 201 domestic and foreign spin-offs announced in 2013 and 175 in 2012, with an aggregate value of $45 billion and $61 billion, respectively. So far in 2014, there have been 91 spin-offs announced with an aggregate value of $7.6 billion.

The process of completing a spin-off is complex and requires consideration of myriad financial, capital markets, legal, tax and other factors. The issues that arise in an individual situation depend largely on:

- The business goals of the transaction.
- The degree to which the businesses were integrated before the transaction.
- The extent of the continuing relationships between the businesses after the transaction.
- The structure of the transaction.

Where the businesses were tightly integrated before the transaction or are expected to have significant business relationships following the transaction, it takes more time and effort to:

- Specify assets and liabilities.
- Identify personnel that will be transferred.
- Separate employee benefits plans.
- Obtain consents relating to contracts and other rights.
- Document ongoing arrangements for shared services (for example, legal, finance and human resources).
- Continue supply, technology sharing and other commercial or operating agreements.

Where the parent is expected to own a substantial portion of the spin-off company after the closing, it must carefully plan around issues that may create potential conflicts, such as:

- The composition of the new company's board.
- Independent director approval of related-party transactions.
- The handling of corporate opportunities and other matters.

In addition to these separation-related issues, spin-offs raise various issues associated with taking a company public, including:

- Drafting and filing the initial disclosure documents.
- Applying for listing on a stock exchange.
- Implementing internal controls.
- Managing ongoing reporting obligations and public investor relations.

Against this background, this article explores:

- The advantages and disadvantages of a spin-off.
- Separation transaction alternatives available to companies, in addition to a spin-off.
- Considerations related to the capital structure of the parent and the spin-off company following the transaction.
- Other key issues for boards to consider when contemplating a spin-off.

Search Spin-offs for a general overview of spin-off transactions.

Search Transaction Checklist: Spin-offs for key issues to consider when conducting a spin-off transaction.

ADVANTAGES AND DISADVANTAGES OF SPIN-OFFS

REASONS FOR A SPIN-OFF

There are several drivers of spin-off activity. The principal reasons often cited by companies for pursuing spin-offs include the following:

- **Enhanced business focus.** A spin-off allows each business to focus on its own strategic and operational plans without diverting human and financial resources from the other businesses.
- **Ability to pursue a business-appropriate capital structure.** A spin-off enables each business to pursue the capital structure that is most appropriate for its business and strategy. Each business may have different capital requirements that may not be optimally addressed with a single capital structure.
- **Creation of a distinct investment identity.** A spin-off creates distinct and targeted investment opportunities in each business. A more "pure-play" company may be considered more transparent and attractive to investors focused on a particular sector or growth strategy, thereby counteracting the "conglomerate discount" and enhancing the value of the business.
- **Increased effectiveness of equity-based compensation.** A spin-off increases the effectiveness of the equity-based compensation programs of both businesses by tying the value of the equity compensation awarded to employees, officers and directors more directly to the performance of the business for which these individuals provide services.
- **Use of equity as acquisition currency.** By creating a separate publicly traded stock, a spin-off enhances the ability of the spin-off company to effect acquisitions using its stock as consideration.

Shareholder activism is another and more recent potential driver of spin-off activity. Shareholder activists have become a more dominant force in the corporate landscape, and many activists agitate for "value maximizing" activity, including spin-offs. Activists are often a catalyst for spin-off activity, and the rise in shareholder activism may explain some of the increase in spin-off activity.

POTENTIAL DRAWBACKS OF A SPIN-OFF

Although spin-offs often have advantages, they also may involve a variety of disadvantages, including:

- The potential loss of both revenue and cost synergies associated with having two separate public companies.
- Disruptions to the business as a result of the spin-off.
- Separation costs.
- Reduced size and diversification, which could potentially result in greater cash flow volatility and reduced access to capital markets, and may affect the company's credit rating.
- The potential reduction of equity research coverage and investor focus if the separated companies are too small.
- Potential stock market index exclusion depending on the size or nature of the companies.
- The possible increased susceptibility to unsolicited takeover activity (given that the businesses of both the parent and the spin-off company will both be less diversified and smaller than the former consolidated parent).

These potential drawbacks should be considered in deciding whether or not to pursue a spin-off and weighed against the benefits of a spin-off.

SEPARATION ALTERNATIVES

It is common for a company in the initial planning phases to consider other types of separation transactions in addition to a spin-off. Separation transactions can generally be divided into two categories:

- A sale to a third party of the business being separated.
- A sale or distribution of the stock in a new public company holding the business being separated.

The decision as to which type of separation transaction to pursue depends on a variety of factors.

A sale to a third party can often generate the largest amount of cash proceeds to the parent. However, a sale or distribution of the stock in a new public company can often result in greater value to the parent's shareholders for two reasons:

- The public market may place a higher value on the business than a third party.
- A distribution of stock in a new public company to the parent's shareholders can be accomplished in a manner that is tax-free to both the parent and its shareholders, whereas a sale for cash would be a taxable transaction.

As compared to a spin-off, there is a greater risk that a sale to a third party may not close, for any number of reasons. Also, the parent can generally determine the terms and timing of a spin-off. However, a sale to a third party requires the negotiation of price, timing and other terms with a third party, execution of a definitive agreement that typically includes closing conditions, and receipt of regulatory approvals (such as antitrust approvals) in order to close.

Purchase agreements with third parties also often include various representations and warranties about the target business, supported by post-closing indemnities. By contrast, in a spin-off the business usually is transferred to the spin-off company on an "as-is, where-is" basis.

Within the category of transactions involving the sale or distribution of the stock in a new public company, a variety of structures can be employed to accomplish different financial and legal objectives, including:

- A full, or 100% spin-off.
- A partial spin-off.
- An initial public offering (IPO) plus spin-off/Up-C Structure.
- An IPO plus split-off.
- A sponsored spin-off.
- A spin-off combined with an M&A transaction.
- A real estate investment trust (REIT) separation transaction.

100% SPIN-OFF

In a typical 100% spin-off, all of the shares of the spin-off company are distributed to the shareholders of the parent as a dividend. This results in a full separation of the two entities in a single transaction.

There are other corporate mechanics available for accomplishing a spin-off. For example, in 2005 IAC/InterActiveCorp spun off Expedia by a charter amendment that reclassified each share of IAC common stock into a share of IAC common stock and a fraction of a share of mandatory exchangeable preferred stock that automatically exchanged into a share of Expedia common stock immediately following the reclassification. Because this structure involves a charter amendment, it requires a vote of the parent's shareholders. Conversely, a spin-off does not require a shareholder vote to issue the dividend under the law of most jurisdictions.

PARTIAL SPIN-OFF

In some cases, the parent may distribute fewer than all of the shares of the spin-off company. Typically, the parent would not intend to retain the remaining shares long-term, but rather would use them to generate cash proceeds or retire existing debt of the parent. However, for a spin-off to be tax-free, the parent generally must:

- **Distribute "control."** Control represents at least 80% of the voting power of all of the shares and at least 80% of any non-voting shares of the spin-off company.
- **Have a valid business purpose.** The parent must establish to the satisfaction of the Internal Revenue Service (IRS) that it has a valid business purpose for retaining any shares of the spin-off company.

In addition, the parent must dispose of the retained shares of the spin-off company within five years following the spin-off for the transaction to be tax-free. Examples of this type of transaction include:

- Valero's 2013 spin-off of Corner Store Holdings.
- Ralcorp's 2012 spin-off of Post Holdings.
- Cardinal Health's 2009 spin-off of CareFusion.

IPO PLUS SPIN-OFF/THE "UP-C" STRUCTURE

A parent may structure a separation transaction through an IPO of a portion of the common stock of the company to be spun off followed by a distribution of common stock to shareholders of the parent. In the IPO, the parent would sell a portion of the shares of the subsidiary to the public in an underwritten offering, with the proceeds either retained by the subsidiary or distributed to the parent. An IPO allows the formation of a natural investor base for the subsidiary in advance of distributing the remainder of the parent's stake in the spin-off.

Creating an investor base in advance of a spin-off may be helpful because the persons entitled to receive shares in a spin-off are the shareholders of the parent on the record date for the spin-off dividend, and those shareholders may or may not wish to hold shares of the spin-off company. In addition, an IPO not only allows for an additional means by which the parent can raise capital in the spin-off, but it also allows for the spin-off company to establish a trading market and market valuation before the distribution of the spin-off company stock to the parent's shareholders.

For the subsequent spin-off to qualify as tax-free, the parent must generally retain at least 80% of the voting power of the shares of the subsidiary after the IPO. An IPO followed by the distribution of the offering proceeds to the parent is generally tax-free to the corporations involved, provided the amount of cash distributed is less than the parent's basis in the stock of the subsidiary and certain other requirements are met. To effect a tax-free spin-off of the subsidiary in the future, an IPO should be limited to 20% of the voting stock of the subsidiary to ensure that the subsequent spin-off will satisfy the 80% control requirement.

Issuing low-vote stock to the public may preserve the ability to spin off the subsidiary in a subsequent step if the parent wants more than 20% of the value of the stock of the subsidiary to be issued to the public. However, the IRS no longer issues rulings regarding the tax consequences of a spin-off in which a high-vote/low-vote structure is put into place in anticipation of the spin-off.

Accordingly, under current IRS practice, any such spin-off would have to be done on the basis of an opinion of counsel, rather than an IRS private letter ruling. If the distribution of proceeds exceeds the parent's aggregate tax basis in the stock of the subsidiary, the excess would generally be includible in income of the parent either when the distribution occurs or when the parent divests the subsidiary.

If the parent desires to sell to the public more than 20% of the stock of the subsidiary, while preserving the ability to spin off its remaining interest in the subsidiary subsequently in a tax-free manner, an alternative to the traditional high-vote/low-vote structure is to structure the subsidiary as an "Up-C." An Up-C structure has the following characteristics:

- The business to be separated is contributed to an operating company that is a limited liability company or limited partnership (and is treated as a partnership for tax purposes).
- The public purchases low-vote stock in a newly formed corporation that holds a minority economic interest in the operating company and a majority of the vote and control over the operating company.
- The parent holds both non-economic high-vote stock in the newly formed corporation, giving it control over the corporation and at least a 50% direct economic interest in the operating company.

When the parent subsequently spins off its remaining interest after the IPO, the operating company merges with the corporation.

The Up-C structure allows the parent to sell up to 50% of the economics of the business being separated and, until it spins off the remaining interest, receive cash distributions from the operating company on a tax-efficient basis. Distributions can be received on a tax-efficient basis because the operating company is a partnership for tax purposes rather than a non-consolidated corporate subsidiary. The main downside of the structure is that the parent may pay tax on the upfront proceeds from the IPO of the corporation. As with the traditional high-vote/low-vote structure, the IRS no longer rules on spin-offs of corporations that have issued low-vote (or high-vote) stock in anticipation of the spin-off.

Some companies determine not to pursue a carve-out IPO because of the additional costs (such as additional underwriting fees) and complications involved in an IPO. An IPO also raises governance issues because the parent continues to control the subsidiary between the time of the carve-out IPO and the later spin-off, creating fiduciary duties to the subsidiary's public shareholders.

IPO PLUS SPLIT-OFF

In a split-off, the parent makes an offer to its shareholders to exchange their parent stock in exchange for all or a portion of the shares of the subsidiary. It is equivalent to a share buyback of the parent's stock using stock in a subsidiary as the consideration instead of cash. A split-off is typically done after the spin-off company has been taken public as a result of an IPO, so that the pricing of the split-off exchange ratio reflects a premium relative to the trading price of the spin-off company's shares.

Because the parent's shareholders elect whether to participate in a split-off, ownership of the spin-off company following the transaction generally is not proportionate (unlike a spin-off, in which shareholders receive a proportionate number of shares of the spin-off company), and the transaction must be registered under the Securities Act of 1933 because it involves an investment decision by the parent's shareholders. A split-off is also an issuer tender offer under the Securities Exchange Act of 1934 and, therefore, the parent must comply with the tender offer rules.

One advantage of a Reverse Morris Trust structure over a Morris Trust structure is that a Reverse Morris Trust generally does not require approval by the parent's shareholders for the spin-off or merger.

SPONSORED SPIN-OFFS

A spin-off also can be combined with a significant investment transaction in a "sponsored spin-off." In this type of transaction, the parent distributes the shares of the subsidiary in a tax-free spin-off concurrently with the acquisition by a sponsor of up to 49.9% of either the parent or the spin-off company. The sponsor's investment allows the parent to raise proceeds in the spin-off without having first to go through the IPO process, and can help demonstrate the value of the target business to the market. Sponsored spin-offs raise a number of complex issues, including those related to valuation, capital structure and governance.

SPIN-OFFS COMBINED WITH M&A TRANSACTIONS

A spin-off can also be used concurrently with an M&A transaction, although there are limitations on the types of these transactions that can be accomplished in a tax-free manner. For example, "Morris Trusts" and "Reverse Morris Trusts" effectively allow the parent to transfer a business to a third party in a transaction involving stock consideration in a manner that is tax-free to the parent if certain requirements are met.

In a traditional Morris Trust, all of the parent's assets other than those that will be combined with the third party are spun off or split off into a new public company and then the parent merges with the third party. In a Reverse Morris Trust, all assets to be combined with the third party are spun off or split off into a new public company and then the new company merges with the third party.

To be tax-free, the Morris Trust and Reverse Morris Trust structures generally require, among other things, that the merger partner be smaller than the spun-off business (with shareholders of the divesting parent owning a majority of the stock of the combined entity). One advantage of a Reverse Morris Trust structure over a Morris Trust structure is that a Reverse Morris Trust generally does not require approval by the parent's shareholders for the spin-off or merger.

In a Reverse Morris Trust transaction, the spin-off company is merging or combining with the merger partner, and the parent entity approves of this merger at the time when the parent entity is the sole shareholder of the spin-off company. In contrast, a Morris Trust transaction often requires approval by the parent's shareholders because the merging party (usually the parent) is already a public company at the time that the merger is submitted for approval by the parent's shareholders.

REIT SEPARATION TRANSACTIONS

Many companies have made substantial real estate investments in connection with their businesses. While real estate holdings give a company control over assets that can be critical from an operational perspective, they also tie up capital and may require significant management attention. One potential means of unlocking the value of a company's real estate in a tax-efficient manner is to split the company into an operating company and a separate REIT that owns the company's real estate. Long-term lease and other contractual relationships can be established between the two companies to ensure the operating business's ability to continue to use the real estate assets on satisfactory terms.

Separation transactions involving REITs can be complex given the requirements for tax-free treatment and the rules that an entity must comply with to be treated as a REIT. Among other things, for the separation to be tax-free, the following criteria must be met:

- The separation must have a non-tax corporate business purpose.
- The REIT must conduct an "active trade or business."
- The REIT must have no earnings and profits from the pre-REIT period.

Examples of recent REIT separation transactions include:

- CBS's 2014 IPO of its CBS Outdoor Americas business.
- Simon Property's 2014 spin-off of its strip center business and smaller enclosed malls into a REIT.
- Penn National Gaming's 2013 spin-off of its real estate assets into the first-ever casino REIT.

Search REITs for more on the requirements that must be satisfied to achieve REIT status.

CAPITAL STRUCTURE CONSIDERATIONS

In preparing for a spin-off, a key step is for the board to determine the capital structure of the parent and the spin-off company after the spin-off and the actions required to implement the desired capital structure. A company engaging in a spin-off generally wants to reallocate its existing cash and debt between itself and the spin-off company, as well as potentially raise additional cash.

There are a variety of techniques that can be used to accomplish the desired capital structure, and the strategy is often driven by tax considerations and the legal documents governing the company's existing debt. A common strategy is for the spin-off company to issue new debt in exchange for cash before the spin-off, and distribute that cash to the parent. The parent may then use the cash to retire its existing debt. The distribution of cash from the spin-off company to the parent can be effected in different ways, for example:

- The spin-off company can make a cash distribution to the parent.
- The parent can redeem some of its own shares in exchange for cash.
- The spin-off company can pay off an intercompany payable that is owed to the parent.
- The spin-off company can pay cash to acquire assets from the parent.

To retain favorable tax treatment, the proceeds of certain distributions made by the spin-off company to its parent must be further transferred by the parent to its shareholders or creditors. As an alternative, the spin-off company may assume some of the parent's indebtedness. However, the parent's existing debt agreements may restrict the assumption of debt. Each of these strategies raises complex tax issues, including potentially triggering gain recognition to the parent to the extent the payment or assumption of indebtedness exceeds the parent's basis in the spin-off company's stock or assets.

A parent may, however, be able to extract value from the spin-off company in excess of the parent's basis in the spin-off company's stock without recognizing gain for US federal income tax purposes. The techniques for doing so involve the parent's use of debt or equity of the spin-off company to retire the parent's indebtedness. While the variations are plentiful, the parent's use of the spin-off company's equity for this purpose is often called a "debt-for-equity exchange," and the parent's use of the spin-off company's debt for this purpose is often called a "debt-for-debt exchange."

In one variation, the parent distributes less than 100% of the stock of the spin-off company at the same time as it closes a debt-for-debt exchange, and then completes a debt-for-equity exchange at a later date. Another technique involves a spin-off with a simultaneous debt-for-debt exchange, but without a subsequent debt-for-equity exchange. Yet another structure is an IPO through a debt-for-equity exchange, followed by a subsequent distribution of the parent's remaining shares in the spin-off company.

The IRS recently announced that it will not issue private rulings on the tax treatment of debt-for-debt or debt-for-equity exchanges in spin-offs where the parent's debt that is exchanged for either debt or equity of the spin-off company was issued in anticipation of the spin-off. The inability to obtain a ruling where the parent debt is newly issued will likely lead to decreased use of this monetization technique. However, companies may consider undertaking debt-for-debt or debt-for-equity exchanges using historical parent debt. The IRS has not announced any changes in its ruling practice regarding these exchanges.

IMPACT OF RELATED FINANCING ON CHOICE OF STRUCTURE

Spin-offs often require significant coordination of related financing matters, which could include any of the following types of transactions:

- **Incurrence of new term debt.** The spin-off company may incur new term debt, in the form of a credit facility or notes, in order to fund a distribution to the parent.
- **Entry into a revolving credit facility.** The spin-off company may enter into a revolving credit facility or other line of credit to fund future liquidity needs.
- **Refinancing of debt.** The parent may need to amend or refinance its debt to avoid defaults or to right-size the now-smaller parent's capital structure.

One significant complicating factor is that the parent and/or the spin-off company may have different creditworthiness and business plans than the combined predecessor company. Each company will also have smaller assets and earnings (sometimes significantly) than the combined predecessor. As a result, the terms (including pricing, financial and operating covenants and required guarantees and collateral support) of the credit documents of the parent and spin-off company can be dramatically different than those of the predecessor firm.

Therefore, these transactions can require a significant amount of new drafting, negotiation and disclosure. Because of these considerations, the negotiation and execution of spin-off-related financing can take substantially more time than corporate officers have been accustomed to spending on similar transactions.

It is important that companies considering a spin-off begin to take action early in the spin-off planning process. Specifically, companies should:

- Identify the optimal financing structure for the parent and the spin-off company.
- Consider ideal terms of their debt instruments.
- Initiate discussions with potential financing sources and credit rating agencies.
- Consider the timing of the financing transactions in relation to the anticipated effective date of the spin-off (especially in light of then-prevailing market conditions).

The financing considerations should play a critical role in the determination of the structure for the spin-off itself, as the size of the spin-off company and the parent, and their capital structures and creditworthiness (including whether or not they will receive investment-grade ratings), can dramatically affect their cost of capital and the terms of their debt. Because the spin-off company's new debt documents are likely to govern its activities for five years or more, companies should also consider involving the spin-off company's future treasury and financial officers in the negotiations of the spin-off company's debt agreements, even if doing so might require identification of these officers earlier than might otherwise be planned.

In some cases, existing debt may logically "belong" with, or may be explicitly associated with, a specific business, such as debt used to fund the activities of a finance subsidiary or secured by assets used in a specific business. If the entity to be spun off has operated as a standalone subsidiary, an appropriate level of debt may already exist at the subsidiary level. In other cases, the parent debt may need to be allocated based on the desired balance of the capital structures of the businesses to be separated, as well as tax considerations.

From a diligence perspective, existing debt must be reviewed to determine the limitations on assumption of the debt by each of the businesses, as well as the contours of any covenants that may limit the parent's ability to spin off major portions of its business. These covenants can be restrictions on dividends or the ability to dispose of "all or substantially all" of the parent's assets, or financial maintenance tests.

In some cases it may be appropriate to seek consents for debt covenants. To the extent that covenants in the parent's existing debt prevent the desired allocation of debt among the various businesses, it may be possible to incur new debt at the level of the spin-off company and dividend the proceeds up to the parent. These proceeds may in turn be used to repay the parent's existing debt.

The need for new financing in a spin-off has the potential to introduce conditionality and risk into the spin-off transaction. If market conditions or other circumstances prevent the issuance of the required debt, then the spin-off could be delayed or even abandoned. Companies can mitigate these risks in a number of ways, including by obtaining financing commitments (the conditionality of which will need to be negotiated) during the spin-off planning process or by issuing debt or executing loan documents substantially in advance of completing the spin-off. These approaches, however, often come with their own risks, costs and considerations, which should be evaluated and discussed at the outset of the spin-off planning process.

OTHER KEY BOARD CONSIDERATIONS

There are several other key issues that boards should focus on in determining whether or not to pursue a spin-off and how to implement it, including issues related to:

- Separate legal representation for the parent and spin-off company.
- The duties of the parent board.
- IRS tax rulings and tax opinions.
- The legality of spin-off-related dividends.
- Shareholder approval requirements.
- Overlapping directors on the boards of the parent and spin-off company.

SEPARATE LEGAL REPRESENTATION

In planning for a spin-off, it is important to understand the role of the various internal constituencies that will be involved. Some aspects of the spin-off are, in practice, often largely determined by the board and management of the parent, such as the basic decision as to which businesses will be spun off, as well as the selection of the spin-off company's directors.

Other aspects of the spin-off may appropriately involve more input from the future directors and management of the spin-off company, such as the terms of its corporate documents (for example, committee charters, governance guidelines, insider trading policies and codes of ethics). Even on these matters, companies often decide to generally follow a "clone and go" approach by establishing a presumption in favor of using the parent's documents as models to simplify the already complex process of turning one public company into two (or more).

In some cases a company may choose to allow managers of the business to be spun off to take a more active role in planning for the spin-off, such as where the business to be spun off and the remaining business are of relatively equal size and have historically been managed independently. However, companies should recognize that these managers may begin to view themselves in a quasi-adversarial position to the parent, as they begin to focus on positioning the business to be spun off in the most advantageous manner. In some cases, the question arises whether management of the business to be spun off should have separate legal representation when negotiating the terms of the spin-off, either initially or when the process is closer to completion.

Establishing separate legal representation before the spin-off is complete generally is inappropriate, as it would unnecessarily exacerbate internal divisions and is inconsistent with the notion that it is the duty of the parent's board to establish the terms of the separation in a manner that serves the best interests of the parent's shareholders (who will also be the initial shareholders of the spin-off company). Moreover, for matters that will not affect the parent following the spin-off (such as the spin-off company's compensation policies), the spin-off company can make whatever changes it desires following the spin-off, lessening the need for internal negotiations over these topics.

Boards should consider these matters with appropriate thoughtfulness and sensitivity, balancing respect for the role of the future directors and officers of the company being spun off with the fundamental premise that the responsibility for the spin-off rests with the parent's board and management.

DUTIES OF THE PARENT BOARD

Under Delaware law, the parent board's decision to effect a spin-off typically is protected by the business judgment rule. The directors of the parent do not owe fiduciary duties to the spin-off company. Nor does the parent or its board owe fiduciary duties to prospective shareholders of the spin-off company, even after the parent declares its intention to spin off the subsidiary.

In structuring a spin-off transaction, directors of a solvent corporation owe their duties to the shareholders of the pre-spin-off company and may structure the transaction in a fashion that maximizes value for those shareholders. There is no duty of "fairness" as between the parent and the spin-off company. Accordingly, the parent board can make unilateral decisions as to the allocation of assets and liabilities between the parent and the spin-off company, subject to insolvency and tax considerations, before the spin-off is completed.

IRS TAX RULINGS AND TAX OPINIONS

Historically, companies would proceed with a spin-off only if they received a ruling from the IRS that the spin-off would be tax-free under Section 355 of the Internal Revenue Code. In June 2013, however, the IRS announced that it would no longer issue rulings for ruling requests received after August 23, 2013, but instead will only rule on "significant issues" arising under Section 355.

Moreover, the IRS will no longer issue private rulings regarding certain structures that have been utilized regularly in spin-off transactions, including debt-for-debt or debt-for-equity exchanges where the parent's debt is issued in anticipation of the spin-off and certain high-vote/low-vote structures at the company to be spun off. As a result, parent companies must now rely more heavily on opinions from its outside tax counsel or advisors.

For a spin-off to qualify as tax-free to both the parent and its shareholders for US federal income tax purposes, it must qualify under Section 355 of the Internal Revenue Code. Section 355 aims to provide tax-free treatment to transactions that separate two operating businesses and not to transactions that resemble either:

- Distributions of cash or other liquid assets.
- Corporate-level sales.

Under Section 355, the parent must:

- Distribute "control" of the spin-off company (generally, stock representing 80% of the voting power and 80% of each non-voting class of stock).
- Establish that any retention of stock or securities is not pursuant to a tax avoidance plan.

In the spin-off, the parent can distribute stock or stock and securities of the spin-off company, and the distributees can be shareholders or shareholders and security holders. In addition, each of the parent and the spin-off company must be engaged in an "active trade or business" that was actively conducted throughout the five-year period before the spin-off, with certain exceptions.

Further, the spin-off must be carried out for one or more corporate business purposes and not be used principally as a "device" for the distribution of the earnings and profits of the parent, the spin-off company, or both. Whether the spin-off is a "device" turns on whether the spin-off encompasses planned sales or exchanges of stock of the parent or spin-off company, or other transactions, the effect of which would be to permit the distribution of corporate earnings without a dividend tax. The "business purpose" standard requires that a real and substantial non-tax purpose germane to the business of the parent, the spin-off company, or both, in fact motivated, in whole or substantial part, the spin-off.

An opinion of tax counsel will rely on representations made by an officer of each of the parent and the company to be spun off that address the requirements above.

DIVIDENDS, SURPLUS AND SOLVENCY

Spin-offs typically involve the payment of at least one dividend (the distribution of the stock of the spin-off company to the parent's shareholders) and often involve others, including in the form of a payment of cash from the spin-off company to the parent before the spin-off.

Under the corporate law of most jurisdictions, a company may make a distribution to its shareholders only out of surplus or earnings (and only to the extent the company is not insolvent and would not be rendered insolvent by payment of the dividend or distribution). Directors cannot avoid personal liability for willful or negligent illegal dividends. Under Delaware law, "surplus" is the excess of the fair market value of the company's assets over its total liabilities and capital.

Directors are entitled under Delaware law to rely in good faith on the opinions of experts as to the existence and amount of surplus or other funds from which dividends might properly be declared and paid. It is common for boards to obtain valuation reports and opinions as to the availability of surplus. Some states also provide a safe harbor for directors who rely on the company's financial statements to determine that the company has sufficient surplus to make the distribution.

Under both state fraudulent conveyance law and the federal Bankruptcy Code, dividends are also subject to subsequent attack and recoupment by the payor or its creditors if a court later determines that the payor was insolvent at the time it made the distribution. To mitigate this risk, companies often seek solvency opinions from valuation firms regarding either or both of the parent and the spin-off company.

Although these opinions are not necessarily dispositive in a subsequent litigation about the payor's insolvency, they can be helpful in establishing solvency (along with the far more important factor of contemporaneous market pricing data for the stock and debt of the payor, among other things) and demonstrate that the board was focused on the issue. Whether the receipt of an opinion is worth the costs ultimately depends on the specific facts, including the creditworthiness of the payor after giving effect to the spin-off.

SHAREHOLDER APPROVAL

Under the law of most jurisdictions, a shareholder vote is required for the "sale or other disposition of all or substantially all" of a company's assets. In Delaware, the shareholder vote requirement is triggered if the corporation wishes to "sell, lease or exchange all or substantially all of its property and assets." Because a spin-off is effected by means of a dividend of shares of the spin-off company (as opposed to a sale of assets), there is law to support the view that a spin-off does not constitute a sale, lease or exchange within the meaning of Delaware law and, therefore, shareholder approval is generally not required.

Consistent with this analysis, shareholder approval has not been sought in significant spin-offs by Delaware companies. In other jurisdictions, however, such as New York and Maryland, the analogous statutes governing sales or transfers of substantially all of a company's assets potentially apply to spin-offs. Accordingly, careful consideration should be given as to whether or not a shareholder vote is required.

OVERLAPPING DIRECTORS

It is possible for a parent and the spin-off company to have overlapping directors once the transaction is complete. Any overlap in directors between the parent and the spin-off company generally is limited to at most a minority of each board in order to preserve the tax-free nature of the spin-off.

All of the facts and circumstances should be considered in determining the impact of overlapping directors on the tax treatment of the spin-off. If the parent decides to have overlapping directors with a spin-off company, it should consider the possibility that conflicts may arise between it and the spin-off company that may make it appropriate for any overlapping directors to recuse themselves from deliberations at each company's board meeting.

If it is possible that the parent and the spin-off company could become competitors of each other in the future, directors should note that Section 8 of the Clayton Antitrust Act prohibits any person from serving as a director or officer of two or more competing corporations unless the sales of competing products or services of the two companies are less than certain *de minimis* thresholds. Although Institutional Shareholder Services Inc. and Glass, Lewis & Co., LLC do not have a stated view or policy on overlapping boards, they have policies on overboarding generally.