Spin-Offs:

Frequently Asked Questions
Like many cycles in the M&A world, spin-offs come and go. At the moment, spin-offs (and to some extent split-offs) appear to continue to be something that many companies are considering. Over 100 spin-offs and similar transactions were announced in 2014 and 2015. For example, eBay spun-off PayPal, Hewlett-Packard spun-off its PC and printer business, Yahoo! initially announced its intention to spin-off its majority stake in Alibaba and subsequently announced that it was suspending work on the spin-off, Symantec announced its intention to spin-off Veritas Software (but instead eventually agreed to sell the business, something that happens from time to time) and Madison Square Garden completed a spin-off in which it separated its cable networks from the rest of its operations.

Spin-offs allow companies to get out of certain business while often giving their shareholders value on a “tax-free” basis. Below are some FAQs with respect to spin-offs covering some of the basic and preliminary questions that companies considering spin-offs may have.
**What is a spin-off?**

A spin-off is a distribution (dividend) by a company (“parent”) of the shares of a subsidiary (“spin-co”) to the shareholders of parent, pro rata in accordance with their common stock ownership. Parent may decide to spin-off all or a portion of the shares that it holds, and the spin-off could be preceded by an IPO of spin-co (raising some proceeds for parent and creating a trading market for spin-co) followed by the distribution of the remaining shares of spin-co to the shareholders of parent. Tax considerations are extremely important and are likely to guide the manner in which the spin-off is executed.

**What is a split-off?**

A split-off involves a distribution to shareholders of a subsidiary, but is implemented by way of an exchange offer whereby parent offers shares in spin-co in exchange for the shares of parent. In this case parent is using spin-co shares as consideration for the repurchase of parent’s stock.

A split-off is generally preceded by an IPO of spin-co to establish a market price for spin-co stock and to determine an appropriate exchange ratio. Often an inducement is provided for making the exchange (i.e., the shares of parent are acquired at a premium to their market price). Generally, if there is a failure to receive a full subscription to the offer, the remaining shares of spin-co are distributed pro rata to parent shareholders. In these FAQs, we refer generally to spin-offs, although most of the considerations discussed also apply to split-offs.

**What are some of the factors contributing to the frequency of spin-offs in recent years?**

Spin-offs are pursued for a variety of reasons. Spin-offs often create significant incremental market value, including by enhancing management focus on, and increased investor awareness of, spin-co. Spin-offs can eliminate conflicts of interest between spin-co and parent and provide spin-co with strategic autonomy and its own acquisition currency.

A recent study by The Boston Consulting Group concluded that spin-offs generate cumulative abnormal returns that have exceeded those generated by selling spin-co in an IPO or to a strategic or financial buyer. Pressure from activist investors has also increased the prevalence of spin-off activity and the frequency with which Boards of Directors are called upon to review spin-offs as well as other restructuring activities.

**Is a spin-off taxable?**

A spin-off or split-off is generally completed in a manner that is non-taxable to the companies and to the shareholders receiving the spin-co shares. The tax rules relating to spin-offs and split-offs are complicated, and tax attorneys should be consulted prior to commencing any work on a spin-off process.
**Will a private letter ruling be obtained from the IRS in connection with a spin-off?**

Historically, taxpayers have frequently sought private letter rulings from the IRS addressing spin-offs that are intended to qualify as tax-free; taxpayers then obtain an opinion from counsel on spin-off requirements that are not addressed by the ruling. In 2013, the IRS modified its ruling practice to limit the ability to obtain the previously-sought rulings in many cases. This development has increased the relative number of spinoffs that are completed relying solely on opinions of counsel. However, as a practical matter, taxpayers do still tend to favor seeking a ruling where possible, if for no other reason than the “halo” effect from having obtained a ruling.

In September 2015, the IRS indicated that it will suspend issuing rulings in three types of situations: (1) spinoffs involving a conversion into a REIT or RIC (common in so-called “opco propco structures”), (2) spinoffs where the assets constituting the required “active trade or business” account for less than 5% of the value of the gross assets of each of parent and spin-co, and (3) spinoffs involving substantial investment assets that are “skewed” between parent and spinco and where the assets constituting the “active trade or business” are less than 10% of the fair market value of the investment assets. The IRS indicated that it is studying these issues and could issue future guidance that is potentially adverse with respect to the “no rule” fact patterns.

**How can spin-offs provide financing for the parent company?**

A variety of structures have been used in conjunction with spin-offs to provide financing for parent. For example, spin-co may incur indebtedness prior to the spin-off and distribute the proceeds to parent. Alternatively, prior to the spin-off, spin-co may conduct an IPO and distribute the proceeds to parent, or parent may sell a portion of its ownership to the public directly in a secondary offering. A spin-off may also be coupled with a private equity investment (for less than 50% of spin-co), with parent realizing the economic benefit of such proceeds.

In addition, parent may use spin-co debt or equity to retire parent debt, although the ability to do so for recently-issued debt for parent has been limited by IRS’s ruling policy. The structure used is often driven by tax considerations, including those relating to preserving the tax-free nature of the spin-off and those relating to the potential that subsidiary distributions to parent in excess of the parent’s basis in spin-co’s stock is taxable. If significant debt is incurred, fraudulent conveyance concerns will be increased. In addition, tax considerations may favor reversing the direction of the spin-off to achieve the optimal monetization strategy, and the use of that structure could raise additional debt covenant, consent and other concerns.
What are the considerations involved in conducting an IPO of a subsidiary prior to a spin-off?

An IPO of spin-co prior to a spin-off allows an investor base to form for spin-co prior to the distribution or exchange of spin-co shares to parent stockholders and also establishes a value for spin-co shares that can be used to calculate an appropriate exchange ratio for a split-off.

In addition, an IPO can raise proceeds to finance spin-co, parent or both. In order to preserve the ability to complete the spin-off on a tax free basis, parent must continue to own 80% or more of the voting power of spin-co's voting stock after the IPO, and such IPOs have, therefore, generally been limited to 20% of spin-co's stock.

Also, recent ruling guidelines restricting the use of high-vote/low-vote stock have limited the ability to issue shares in an IPO representing more than 20% of the economic interest in spin-co. Following the IPO of spin-co and prior to the spin-off, parent will be a controlling shareholder of spin-co and have fiduciary duties to spin-co's public shareholders. As a result, the contractual arrangements between parent and spin-co relating to the spin-off should be in place at the time of the spin-off.

What are the securities law implications of a spin-off?

Generally, spin-offs can be completed without registration of spin-co's stock under the Securities Act (the SEC's Staff Legal Bulletin No. 4 describes the conditions to ensure Securities Act registration is not required). However, an Exchange Act registration statement on Form 10, which will need to be declared effective by the SEC, is generally necessary to complete a spin-off. The Form 10 will contain an information statement that is distributed to shareholders of parent.

If the spin-off is preceded by an IPO, then a Securities Act registration statement on Form S-1 will be necessary for the issuance of the spin-co stock in the IPO, but a full Form 10 filing is not required. A split-off requires a Securities Act registration statement as well as tender offer documents.

The registration statement on Form 10 contains disclosure requirements that are similar to the disclosure requirements applicable to a registration statement under the Securities Act in an IPO. The Form 10 will be subject to review and comment by the SEC Staff, as would any Securities Act registration statement.

What are some of the complexities involved in separating the business to be spun-off from the parent?

In effecting a spin-off, the business and assets to be spun-off must be separated and placed in a separate legal entity. Even if that business has been historically operated in a separate subsidiary, additional assets frequently need to be transferred into or out of the subsidiary prior to the spin-off. These asset transfers frequently require third-party consents or governmental approvals and may raise complex structuring issues.
The appropriate capital structure of spin-co will need to be determined, and cash, debt and other liabilities may need to be allocated between parent and spin-co. Also, complicated operational arrangements may need to be put together to ensure that the business continues to function.

**What consideration should be given to the solvency of the parent and spin-co in connection with a spin-off?**

In connection with a spin-off, it is important to consider the solvency of both the parent and spin-co after giving effect to inter-company transfers, the incurrence of indebtedness and the consummation of the spin-off. Some of the inter-company transactions (including dividends of spin-co to parent and by parent of spin-co stock to parent's stockholders) may not be for reasonably equivalent value and may be susceptible to challenge as constructive fraudulent transfers if the transferor is not solvent after giving effect to the transfer.

Spin-offs that impair creditors’ ability to enforce their debts may be challenged as involving actual fraud. Separate but inter-dependent steps of a transaction may be collapsed for purposes of these analyses. Depending on the circumstances, it may be appropriate and helpful to obtain one or more third-party solvency opinions.

In addition, spin-offs involve one or more transactions that are dividends under state corporation laws, including the distribution of spin-co shares to parent stockholders and, potentially, the distribution by spin-co of assets to its parent. Under Delaware law, for example, such dividends may be paid only out of surplus or the net profits of the company for the fiscal year in which the dividend is paid and/or for the preceding fiscal year. Directors of a corporation who act negligently in connection with the approval of an unlawful dividend may be held personally liable. However, directors are entitled to rely in good faith on the opinions of experts as to the availability of surplus or other funds from which a dividend may be paid and, accordingly, it is frequently prudent for a Board of Directors to obtain a valuation report or opinion from a financial expert to support a conclusion that a lawful source exists for those dividends. Although a split-off involves an exchange of spin-co stock for shares of parent rather than a dividend, state corporation laws generally require that such repurchases not impair the capital of parent, which has a similar effect as the restriction on dividends.

**How do I execute a spin-off?**

The securities laws documents discussed above will need to be filed and disseminated. In the case of a spin-off (but not a split-off), a dividend will need to be declared by the board of the parent. The stock of spin-co will need to be listed for trading. Agreements will need to be put into place to document the actions required and, if necessary, to allocate assets and liabilities and establish necessary contractual relationships between spin-co and parent. In certain cases (discussed below), approval by parent share-holders may be required. Third-party consents and regulatory approvals may need to be obtained.
What documentation do I need to complete a spin-off/split-off?

There are a number of categories of documentation required. In addition to the securities law documentation discussed above and the documentation needed in connection with spin-co becoming public through the spin-off (or a prior IPO), there are a number of documents required to establish the relevant arrangements between spin-co and parent, including the following:

- **Separation Agreement** (allocating assets and liabilities between spin-co and parent)
- **Employee Matters Agreement** (dividing up employee liabilities and potentially requiring certain commitments)
- **Tax Matters Agreement** (allocating historic tax liabilities and containing the arrangements that would apply in the event that the spin-off fails to maintain “tax free” treatment)
- **Litigation Matters Agreement** (allocating responsibility for litigation)
- **Transition Services Agreement** (providing for post-spin-off services until the companies can fully separate)
- **Intellectual Property Matters Agreement** (usually containing cross-licenses for intellectual property, potentially on only a transition basis)
- **Other necessary commercial arrangements**

Do my shareholders need to approve a spin-off?

Under Delaware law, the generally accepted view is that a spin-off is not a “sale, lease or exchange” of property or assets of the parent that may implicate the requirement to obtain shareholder approval. In contrast, it is likely that a split-off would be viewed as involving an “exchange” under Delaware law and would, therefore, require shareholder approval if spin-co constitutes all or substantially all of parent’s assets.

In other jurisdictions, the relevant corporations statutes and case law may require shareholder approval of a spin-off or a split-off if spin-co constitutes all or substantially all of the assets of parent.
Do I need to be worried about breaching any contracts to complete the spin-off?

A spin-off may have a variety of contractual implications. Contracts assigned to spin-co may require the counterparty’s consent to the assignment. To the extent that parent and spin-co both require rights under a contract, new contracts with third parties providing for the separation of contractual rights may be required.

Contracts that are assigned to spin-co, as well as those to which spin-co is already a party, need to be reviewed to determine whether they contain change-of-control provisions that may be implicated. Parent’s credit facilities, indentures, leases, severance agreements, IP licenses and other agreements must be reviewed to determine whether they contain restrictions or other provisions (such as financial covenants or restrictions on material asset sales, dividends or related party transactions) that are implicated by the spin-off, the restructuring activities conducted in contemplation of the spin-off or the relationships between parent and spin-co following the spin-off.

What are the implications of announcing a plan to spin-off spin-co on the ability to negotiate with a third party that may be interested in acquiring parent or spin-co after the spin-off?

In order to preserve the tax-free nature of the spin-off, it is generally critical that discussions regarding an acquisition of parent or spin-co do not occur until after the spin-off is completed to ensure that the acquisition is not considered part of the same “plan” as the spin-off. If discussions have already occurred before the spin-off, it is generally necessary that discussions do not resume for six months or one year after the spin-off.

In contrast, a potential acquirer that had not engaged in such discussions with parent or spin-co for at least 2 years prior to the spin-off could generally begin discussions immediately following the spin-off, but should proceed with caution. These limitations do not generally apply to a so-called “Reverse Morris Trust” or RAT transaction if the consideration for the acquisition is solely acquirer stock that represents more than 50% of the acquirer’s outstanding common stock (i.e., if the acquirer is smaller than the company, whether parent or spin-co, that it is acquiring). In that limited situation, the acquisition could be completed as part of the same plan as the spin-off without affecting the tax-free nature of the spin-off. Acquirers are generally likely to be advised regarding these restrictions and (absent use of the RMT structures) are likely to defer approaching parent or spin-co to discuss an acquisition until after completion of the spin-off.

In addition, the tax sharing agreement between parent and spin-co will typically allocate responsibility for spin-off taxes to the party that breached such “plan” requirements, thus imposing the appropriate incentives for the parties to comply. It is typical (but not universal) in such arrangements that parent consent (or an IRS ruling or an unqualified opinion of counsel) is required before spin-co can be acquired within the 2-year period after the spin-off.
## Practice Contacts

<table>
<thead>
<tr>
<th>Name</th>
<th>Location</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Francis J. Aquila</td>
<td>New York</td>
<td>+1-212-558-4048</td>
<td><a href="mailto:aquilaf@sullcrom.com">aquilaf@sullcrom.com</a></td>
</tr>
<tr>
<td>Audra D. Cohen</td>
<td>New York</td>
<td>+1-212-558-3275</td>
<td><a href="mailto:cohenas@sullcrom.com">cohenas@sullcrom.com</a></td>
</tr>
<tr>
<td>Ronald E. Creamer Jr.</td>
<td>New York</td>
<td>+1-212-558-4000</td>
<td><a href="mailto:creamerr@sullcrom.com">creamerr@sullcrom.com</a></td>
</tr>
<tr>
<td>Scott B. Crofton</td>
<td>New York</td>
<td>+1-212-558-4682</td>
<td><a href="mailto:croftons@sullcrom.com">croftons@sullcrom.com</a></td>
</tr>
<tr>
<td>Joseph B. Frumkin</td>
<td>New York</td>
<td>+1-212-558-4101</td>
<td><a href="mailto:frumkinj@sullcrom.com">frumkinj@sullcrom.com</a></td>
</tr>
<tr>
<td>Brian E. Hamilton</td>
<td>New York</td>
<td>+1-212-558-4000</td>
<td><a href="mailto:hamiltonb@sullcrom.com">hamiltonb@sullcrom.com</a></td>
</tr>
<tr>
<td>Matthew G. Hurd</td>
<td>New York</td>
<td>+1-212-558-4000</td>
<td><a href="mailto:hurdm@sullcrom.com">hurdm@sullcrom.com</a></td>
</tr>
<tr>
<td>Eric Krauthheimer</td>
<td>Los Angeles</td>
<td>+1-310-712-6678</td>
<td><a href="mailto:krauthheimere@sullcrom.com">krauthheimere@sullcrom.com</a></td>
</tr>
<tr>
<td>Stephen M. Kotran</td>
<td>New York</td>
<td>+1-212-558-4963</td>
<td><a href="mailto:kotrans@sullcrom.com">kotrans@sullcrom.com</a></td>
</tr>
<tr>
<td>Keith A. Pagnani</td>
<td>New York</td>
<td>+1-212-558-4000</td>
<td><a href="mailto:pagnanik@sullcrom.com">pagnanik@sullcrom.com</a></td>
</tr>
<tr>
<td>John L. Savva</td>
<td>Palo Alto</td>
<td>+1-650-461-5610</td>
<td><a href="mailto:savvaj@sullcrom.com">savvaj@sullcrom.com</a></td>
</tr>
<tr>
<td>George J. Sampas</td>
<td>New York</td>
<td>+1-212-558-4945</td>
<td><a href="mailto:sampasg@sullcrom.com">sampasg@sullcrom.com</a></td>
</tr>
<tr>
<td>Melissa Sawyer</td>
<td>New York</td>
<td>+1-212-558-4243</td>
<td><a href="mailto:sawyerm@sullcrom.com">sawyerm@sullcrom.com</a></td>
</tr>
<tr>
<td>Krishna Veeraraghavan</td>
<td>New York</td>
<td>+1-212-558-7931</td>
<td><a href="mailto:veeraraghavank@sullcrom.com">veeraraghavank@sullcrom.com</a></td>
</tr>
<tr>
<td>Davis J. Wang</td>
<td>New York</td>
<td>+1-212-558-4000</td>
<td><a href="mailto:wangd@sullcrom.com">wangd@sullcrom.com</a></td>
</tr>
</tbody>
</table>
S&C Offices Worldwide

WWW.SULLCROM.COM

New York
Telephone: +1 212 558 4000
Facsimile: +1 212 558 3588
125 Broad Street
New York, NY 10004-2498
U.S.A.

Washington, D.C.
Telephone: +1 202 956 7500
Facsimile: +1 202 293 6330
1701 New York Avenue, N.W.
Washington, DC 20006-5215
U.S.A.

Los Angeles
Telephone: +1 310 712 6600
Facsimile: +1 310 712 8800
1888 Century Park East
Los Angeles, CA 90067-1725
U.S.A.

Palo Alto
Telephone: +1 650 461 5600
Facsimile: +1 650 461 5700
1870 Embarcadero Road
Palo Alto, CA 94303-3308
U.S.A.

Beijing
Telephone: +86 10 5923 5900
Facsimile: +86 10 5923 5950
Suite 501
China World Trade Center Tower 1
No. 1, Jianguo Menwai Avenue
Beijing 100004
China

Hong Kong
Telephone: +852 2826 8688
Facsimile: +852 2522 2280
28th Floor, Nine Queen's Road
Central
Hong Kong

Tokyo
Telephone: +81 3 3213 6140
Facsimile: +81 3 3213 6470
Otemachi First Square East Tower
16F
5-1, Otemachi 1-chome
Chiyoda-ku, Tokyo 100-0004
Japan

London
Telephone: +44 20 7959 8900
Facsimile: +44 20 7959 8950
1 New Fetter Lane
London EC4A 1AN
United Kingdom

Paris
Telephone: +33 1 7304 1000
Facsimile: +33 1 7304 1010
24, rue Jean Goujon
75008 Paris
France

Frankfurt
Telephone: +49 69 4272 5200
Facsimile: +49 69 4272 5210
Neue Mainzer Strasse 52
60311 Frankfurt am Main
Germany

Brussels Conference Facility
Telephone: +32 2 789 5055
7 Rue Joseph II, 1st Floor
1000 Brussels
Belgium

Melbourne
Telephone: +61 3 9635 1500
Facsimile: +61 3 9654 2422
101 Collins Street
Melbourne, Victoria 3000
Australia

Sydney
Telephone: +61 2 8227 6700
Facsimile: +61 2 8227 6750
Level 27, The Chifley Tower
2 Chifley Square
Sydney, New South Wales 2000
Australia