

# ***SPIN- OFFS***



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## For companies evaluating their strategic options, the spin-off of a subsidiary or division may be a viable alternative.

In light of continued weak economic and financial performance and forecasts, lagging stock market valuations and significant regulatory changes and uncertainty, many companies are engaged in a continuous or episodic process of evaluating their strategic alternatives. While it may not be suitable in all cases, the spin-off of a subsidiary or a division into a stand-alone public company should be considered among these strategic options.

In a typical spin-off transaction, the parent company (Parent) "spins off" its subsidiary by distributing all of that subsidiary's stock to Parent's stockholders. After the transaction, both Parent and the spun-off entity (SpinCo) have separate and independent existences with the stockholders of Parent owning the stock of Parent and, initially, the stock of SpinCo.

The following article explains:

- Key reasons why companies engage in spin-offs.
- The timing, process and documentation of a typical spin-off.
- Considerations regarding the allocation of assets and liabilities between Parent and SpinCo.
- Important tax considerations when structuring the transaction.

- US federal securities law requirements and issues.
- Required corporate approvals and significant director liability considerations.
- Corporate governance issues.

As used in this article, the term "spin-off" does not include a:

- Split-off, which involves Parent offering stock in a subsidiary in exchange for a specified number of Parent's shares held by Parent's stockholders.
- Subsidiary offering, which occurs when Parent makes a public offering of its subsidiary's stock.
- Split-up, which involves Parent distributing stock in its subsidiary to its stockholders after which Parent dissolves.

>> This article is based on a Practice Note available on [practicallaw.com](http://practicallaw.com). For this continuously maintained resource, search [Spin-offs: Overview](#) on our website.

### REASONS FOR A SPIN-OFF

Some of the key reasons why companies decide to engage in spin-offs are to:

- Enable management to focus its attention on its core business, while

allowing non-core businesses the resources and management attention to develop and realize full stockholder value.

- Incentivize officers and employees of disparate business lines by allowing management of those lines to implement appropriate employee compensation packages without the friction and administrative burden created by having differing employee compensation metrics within the same organization.
- Separate a subsidiary from Parent in preparation for that subsidiary's sale to a third party.
- Maximize stockholder value in high-growth business lines that may be undervalued due to their performance being obscured by their attachment to slower-growth businesses.
- Shed businesses that are no longer wanted and no longer fit within Parent's business plan but that either are illiquid or do not have a current market valuation that Parent believes to be fair.
- Allow Parent and SpinCo to raise capital and seek financing separately which may allow either entity (or both) to do so more effectively and efficiently.

- Establish a takeover defense. Spinning-off a subsidiary may make Parent less attractive as a takeover target without destroying value for existing stockholders (as those stockholders get the stock of the subsidiary).
- Avoid regulations. Following a spin-off, Parent and/or SpinCo may not be subject to the same regulatory regime post-transaction as they were pre-transaction and, depending on the cost and administrative burden of the regulations, may unlock stockholder value that would otherwise be suppressed.
- Reduce costs. Although spin-offs may in certain circumstances have the potential to increase costs through loss of synergies, in certain scenarios costs may be reduced. For example, before the spin-off, the subsidiary may have been subjected to extraordinary costs by virtue of its affiliation with a particular Parent business.
- Eliminate conflicts between Parent and SpinCo business lines.

## TIMING, PROCESS AND DOCUMENTATION

### TIMING AND PROCESS

A typical spin-off transaction can be completed in about six months: two months of pre-announcement preparation followed by four months primarily focused on the SEC and distribution process. For a general list of the key process tasks that should be taken when conducting a spin-off, see *Box, Conducting a Spin-off* and for a detailed sample timeline of the principal steps involved in a spin-off, see *Box, Spin-off Transaction Timetable*.

### PRIMARY DOCUMENTATION

The distribution agreement (also referred to as the separation agreement) sets forth the basic terms and conditions of the spin-off, including:

- The assets and liabilities to be allocated to SpinCo.
- Cross-indemnifications of historical liabilities.

- Representations and warranties regarding the assets and liabilities to be transferred.
- Tax-related covenants and indemnifications.
- The mechanics of the distribution.

Other agreements typically necessary to document the allocation of assets and liabilities and employees between Parent and SpinCo, post-spin-off services and other operational relationships between Parent and SpinCo or other aspects of a spin-off include:

- Tax allocation agreement.
- Employment and benefits agreement.
- Intellectual property agreements.
- Insurance agreement.
- Environmental agreement.
- Legal proceedings agreements.
- Transitional services agreement.
- Leases.
- Supply agreements.
- Management services agreement.

## ASSET AND LIABILITY ALLOCATION

In any spin-off, Parent must transfer the relevant assets and liabilities to SpinCo unless the assets and liabilities already reside in SpinCo. Many of the considerations and issues involved in this transfer are similar to the issues and considerations involved in any sale of a business or division to a third party.

### GENERAL CONSIDERATIONS

The allocation of assets and liabilities between Parent and SpinCo generally tracks the underlying businesses being retained by Parent and those being spun-off with SpinCo. Therefore, assets related to, or liabilities arising from, businesses that are being spun-off generally would be transferred to SpinCo.

This allocation becomes difficult when various assets, services or personnel are used before the transaction by both Parent and the business to be spun-off. In addition, if both Parent's business and

that of SpinCo are operated in an overlapping manner, it can be difficult to trace certain known or contingent liabilities (such as environmental or litigation liabilities). In such cases, it is important to pay careful attention to identifying those assets and liabilities that are staying with Parent and those that are being transferred to SpinCo in the distribution agreement (for example, through use of qualifiers such as "primarily related to" or schedules of specifically enumerated assets and liabilities).

### PRE-EXISTING SPINCO

For a spin-off involving a pre-existing SpinCo, conduct due diligence early to determine which assets and liabilities to be spun-off already reside in SpinCo and which ones must be transferred to SpinCo.

### ASSIGNMENT AND CHANGE OF CONTROL ISSUES

Review all contracts to which SpinCo is a party (or is intended to be a party following the transfer from Parent) in the context of the contemplated transaction (including the assignments, transfers, contributions, dividend and other corporate actions planned to effectuate the spin-off) to identify anti-assignment and change of control provisions that may necessitate obtaining third-party consents.

### SOLVENCY AND FRAUDULENT TRANSFER

Ensure that no transfer of assets or liabilities between Parent and SpinCo in connection with a spin-off subsequently may be voidable as a fraudulent conveyance. Similar to the ultimate spin-off dividend of the shares of SpinCo, such asset and liability transfers generally are not made in return for "reasonably equivalent value." Therefore, the transfers may constitute fraudulent conveyances if, at the time of or following the transfers, the transferring and transferee entities do not meet applicable solvency and capital requirements. See below *Fraudulent Conveyance and Solvency Issues*.

## LIABILITIES TO THIRD PARTIES AND INDEMNITIES

The assignment of a liability in a spin-off transaction generally does not absolve the assigning party of its obligations to a third party with respect to such liability absent the consent of the third party. Consequently, distribution agreements generally contain cross-indemnities between Parent and SpinCo for the liabilities intended to be assumed by each party.

## ADDITIONAL CONSIDERATIONS

In addition to the general asset and liability allocation considerations highlighted above, intellectual property (IP) assets, employee benefits and executive compensation assets and liabilities, and environmental liabilities need to be considered.

### Intellectual Property

A spin-off may pose particular concern for a company's IP assets. To a much greater degree than real or tangible property, IP rights may be owned by one entity and used by others, and shared throughout the corporate organization by affiliates, with those rights often not being fully understood. Carefully identifying and allocating rights to any shared IP is therefore a critical element of a spin-off.

### Employee Benefits and Executive Compensation

If the spin-off involves the transfer or spin-off of employees, the parties must consider what that means to former Parent's employee benefit and executive compensation plans. For example, potential issues may involve:

- Continuation of benefits.
- Separation of plan assets and liabilities.
- Consequences of termination or change in control events.
- Requirements under collective bargaining agreements.
- Equity-based compensation.

# CONDUCTING A SPIN-OFF

The key tasks in a spin-off:

- ❑ Identify and draft a comprehensive description of the business purposes for the spin-off, the businesses to be spun-off with SpinCo and the businesses to remain with Parent. These descriptions will be helpful in drafting the agreements implementing the spin-off and in ensuring that structural issues are identified at the beginning of the process.
- ❑ Form SpinCo (unless it already exists), draft its post-spin-off governing instruments and identify its post-spin-off directors and officers (taking into account the requirements under the Sarbanes-Oxley Act of 2002 (SOX) and any applicable securities exchanges).
- ❑ Determine and prepare required audited historical financial statements for SpinCo and pro forma financial statements (this should be done as early as possible in the spin-off process).
- ❑ Draft the Information Statement, and Form 10 under Section 12(b) or Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act), for the shares to be registered and issued by SpinCo. The Information Statement must include audited financials of SpinCo. Upon completion of the draft Form 10, register SpinCo's shares.
- ❑ Determine the allocation of assets and liabilities and employees between Parent and SpinCo and identify and analyze required third party consents, waivers and other issues related to effecting the allocation.
- ❑ Identify assets that Parent and SpinCo must share and any services or other operating relationships that must remain in place between Parent and SpinCo following the spin-off.
- ❑ Analyze the contemplated transactions for potential tax consequences, and ensure that they are structured so as to qualify as a tax-free distribution.
- ❑ Analyze the contemplated transactions for consent, waiver and funding requirements under debt instruments and other material contracts of Parent and its subsidiaries.
- ❑ Analyze the expected financial viability of Parent and SpinCo following the spin-off, and examine the contemplated transactions under applicable laws and governing instruments relating to permissibility of dividends, fraudulent conveyance and stockholder voting and engage appropriate experts (for example, to provide fairness or solvency opinions).
- ❑ Draft the necessary agreements (see *Primary Documentation*).
- ❑ Effect Parent's and SpinCo's board of directors' approval of the contemplated transactions, including the distribution of SpinCo's stock to Parent's stockholders, and the setting of a record date and distribution date.
- ❑ Prepare a communications strategy for stockholders, customers, suppliers, financing sources, unions, employees and other constituencies.

For a more detailed list of steps, see *Box, Spin-off Transaction Timetable*.

### Environmental

Environmental considerations often can be qualitatively different from other legal concerns in a spin-off because:

- Environmental liabilities often may be of significant magnitude and have significant contingencies, uncertainties and long gestation periods.
- Management and remediation of environmental issues often involves judgments that may have substantial

effects on the magnitude of liabilities as well as ongoing operations of a business.

Therefore, in a spin-off transaction where environmental liabilities may exist, particularly if Parent or SpinCo operates in an environmentally sensitive industry, it becomes crucial to allocate known and contingent environmental liabilities as well as rights and responsibilities for identifying, managing and remedying environmental issues.

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# SPIN-OFF TRANSACTION TIMETABLE

The following is a sample timetable of the principal steps involved in a spin-off. Although this timetable is not exhaustive or targeted to any specific transaction, it highlights many of the matters and issues that might be considered by a company and its advisors prior to, and while proceeding with, a spin-off transaction.

## PARTIES

Parent Company	Parent
Spin-Off Entity	SpinCo
Parent Counsel	PC
Parent Financial Advisors	PFA
Counsel to Financial Advisors	FAC
Parent Accountants	A

## PRELIMINARY CONSIDERATIONS AND PRE-DISTRIBUTION MATTERS

ACTION/EVENT	RESPONSIBILITY
<b>MONTHS 1 AND 2</b>	
Identify businesses to be spun-off with SpinCo and businesses to remain with Parent	Parent, PFA
Examine financial viability of SpinCo and Parent as independent entities	Parent, PFA
Parent board authorization to proceed	Parent
Kick-off meeting	All
Review "business purpose" for spin-off with tax counsel <ul style="list-style-type: none"> <li>▪ consider applying for IRS ruling</li> </ul>	Parent, PC
Determine assets and liabilities to be transferred to SpinCo <ul style="list-style-type: none"> <li>▪ determine method of transfer (including in applicable foreign jurisdictions)</li> <li>▪ commence legal and financial due diligence</li> <li>▪ begin solvency opinion/fairness opinion process</li> <li>▪ determine allocation of contingent liabilities and claims</li> </ul>	Parent, PC, PFA, A
Prepare strategy for contacting: <ul style="list-style-type: none"> <li>▪ stockholders</li> <li>▪ customers</li> <li>▪ suppliers</li> <li>▪ financing sources</li> <li>▪ unions</li> <li>▪ employees</li> <li>▪ other constituencies</li> </ul>	Parent, SpinCo
Establish disclosure policies: <ul style="list-style-type: none"> <li>▪ press comments</li> <li>▪ SEC comments</li> <li>▪ stock exchange</li> <li>▪ other third parties</li> </ul>	Parent, PC

ACTION/EVENT	RESPONSIBILITY
Commence audit/preparation of financials for SpinCo	Parent, A
Determine and prepare required financial statements <ul style="list-style-type: none"> <li>■ historical audited financial statements of SpinCo on an independent basis</li> <li>■ pro forma financial statements</li> </ul>	A
Consider fraudulent conveyance/solvency issues <ul style="list-style-type: none"> <li>■ engage solvency opinion firm</li> <li>■ draft solvency opinion</li> </ul>	Parent, PC, PFA, solvency firm
Review Parent's and its subsidiaries' public and private debt instruments, loans, secured interests, patents, leases, governmental contracts, customer agreements, supplier contracts, collective bargaining agreements, other contracts, etc. for contractual limitations, successor problems, antidilution adjustments <ul style="list-style-type: none"> <li>■ identify need for consents or waivers</li> <li>■ determine timing and process for obtaining necessary consents or waivers</li> <li>■ review employee benefit and severance plans for the same</li> <li>■ identify limitations (e.g., no sale or transfer)</li> </ul>	Parent, PC, PFA
Review governance and state and federal laws <ul style="list-style-type: none"> <li>■ legal dividend?</li> <li>■ charter or by-law vote requirement or limitations?</li> <li>■ sale of substantially all of the assets?</li> <li>■ consider need to register spin-off under '33 Act (unlikely if all shares are spun; retention of shares by Parent may require seeking no action relief from '33 Act registration)</li> </ul>	Parent, PC
Draft SEC No-Action Letter re: absence of registration under '33 Act, if necessary	PC
Resolve SpinCo and Parent stand-alone management needs <ul style="list-style-type: none"> <li>■ treasury/financial staff</li> <li>■ investor relations</li> <li>■ SEC reporting function</li> <li>■ labor relations</li> <li>■ other shared functions, if any</li> </ul>	Parent
Determine whether there are any needs to allocate employees/corporate personnel	Parent
Determine whether division of pension plans assets are necessary	Parent
Determine how existing Parent stock options will be treated	Parent
Review impact on Parent shareholder rights plan (if applicable)	Parent, PC
If contemplating Parent retaining a portion of SpinCo stock <ul style="list-style-type: none"> <li>■ consider continuity of ownership and DGCL §203</li> <li>■ registration rights?</li> <li>■ lock up?</li> </ul>	Parent, PC
Begin drafting Form 10 and Information Statement (for registration of securities under Exchange Act)	Parent, PC
Prepare communications for employees and customers	Parent
Prepare board presentation	Parent, PFA
Present spin-off, Form 10 and creation of SpinCo or amendment of existing Certificate of Incorporation of SpinCo, for board approval	Parent
Announce intention to effect spin-off to press and other interested parties	Parent
File Form 8-K (with press release and related materials)	Parent, PC
File IRS ruling request	Parent, PC

ACTION/EVENT	RESPONSIBILITY
<b>MONTH 3</b>	
Meet with customers, suppliers, unions and financing sources	Parent, SpinCo
Draft assets and liabilities transfer documentation	Parent, SpinCo, PC
Seek any required consents	Parent, SpinCo
Coordinate with securities exchange for listing of SpinCo stock <ul style="list-style-type: none"> <li>■ draft listing application</li> <li>■ confirm listing eligibility</li> <li>■ select and reserve trading symbol</li> <li>■ check requirements re: printing of stock certificates</li> </ul>	Parent, SpinCo, PC
Form SpinCo <ul style="list-style-type: none"> <li>■ Certificate of Incorporation (or amendment of existing Certificate of Incorporation of pre-existing subsidiary) (draft and file with applicable Secretary of State)</li> <li>■ by-laws</li> <li>■ organizing resolutions</li> <li>■ shareholder rights agreement (if desirable)</li> <li>■ create corporate organization chart</li> <li>■ determine board of directors and executive officers</li> <li>■ identify prospective outside directors</li> <li>■ consider dividend policy of SpinCo</li> </ul>	Parent, SpinCo, PC
Identify agreements to be entered into between SpinCo and Parent; draft term sheets; draft agreements <ul style="list-style-type: none"> <li>■ distribution agreement</li> <li>■ tax allocation agreement</li> <li>■ employment and benefits agreement</li> <li>■ intellectual property agreements</li> <li>■ insurance agreement</li> <li>■ environmental agreement</li> <li>■ legal proceedings agreements</li> <li>■ transitional services agreement</li> <li>■ leases</li> <li>■ supply agreements</li> <li>■ management services agreement</li> </ul>	Parent, SpinCo, PC
Coordinate financing arrangements for SpinCo	Parent, SpinCo, PFA
Draft benefit plans for SpinCo <ul style="list-style-type: none"> <li>■ health and welfare plans</li> <li>■ SpinCo stock option plan and other SpinCo management incentive plans</li> <li>■ employment contracts</li> <li>■ treatment of existing Parent stock option for SpinCo and Parent employees</li> <li>■ 401(k) plan and other pension plans</li> <li>■ Other</li> </ul>	Parent, SpinCo, PC
Blue sky review	Parent, PC
SpinCo board resolutions <ul style="list-style-type: none"> <li>■ approve or ratify Form 10 and Information Statement</li> <li>■ adopt stock exchange resolutions and listing application</li> <li>■ appoint transfer agent and registrar</li> <li>■ authorize execution and delivery of spin-off agreements</li> <li>■ adopt rights plan</li> <li>■ approve SEC filings</li> </ul>	SpinCo, PC

ACTION/EVENT	RESPONSIBILITY
<ul style="list-style-type: none"> <li>■ adopt amended Certificate of Incorporation and By-laws</li> <li>■ adopt stock certificate</li> <li>■ appoint independent public accountants</li> <li>■ adopt compensation and benefit plans</li> <li>■ elect new officers</li> <li>■ establish board committees and chairman</li> <li>■ establish board and committee schedules</li> <li>■ adopt board governance policy</li> <li>■ authorize Form S-8 filings</li> <li>■ adopt banking, borrowing and investment resolutions</li> <li>■ adopt board approval limits</li> </ul>	
<b>END OF MONTH 3</b>	
File Form 10 along with Information Statement with SEC (pursuant to Rule 12-b(10); the SEC has 30 days after the date of filing to comment but, in practice, Form 10 notification is not effective until cleared by SEC)	Parent, PC
<b>MONTHS 4 AND 5</b>	
Designate distribution agent	Parent
Meet with transfer agent and registrar	Parent, SpinCo
Select financial printer	Parent
Coordinate logistical details of separating SpinCo <ul style="list-style-type: none"> <li>■ facilities</li> <li>■ benefits</li> <li>■ insurance</li> <li>■ stock certificates</li> <li>■ corporate policies</li> </ul>	Parent
Prepare press release re: spin-off (filing of Form 10) and file 8-K	Parent, PC
Prepare Form S-8 for SpinCo	Parent, PC
Prepare Form 3s for SpinCo officers and directors	Parent, PC
Prepare a spin-off road show (if desirable) <ul style="list-style-type: none"> <li>■ draft presentation</li> <li>■ revise presentation</li> <li>■ final rehearsal</li> <li>■ actual road show</li> </ul>	Parent, PFA
File Form 8-K with Information Statement as an exhibit	Parent
Meeting with and presentation to ratings agencies	Parent, SpinCo, PFA
Receive, respond to and resolve SEC comments on Information Statement	Parent, SpinCo, PC
File Form ID with SEC to get CIK and CCC code for SpinCo	SpinCo, PC
Respond to IRS comments and obtain private letter ruling	Parent, SpinCo, PC
<b>MONTHS 5 AND 6</b>	
Form 10 declared effective	N/A
Section 13D filings <ul style="list-style-type: none"> <li>■ Must be filed by holders of more than 5% of SpinCo common stock (if any)</li> <li>■ File when Form 10 is declared effective</li> </ul>	Parent, SpinCo



ACTION/EVENT	RESPONSIBILITY
Complete filing of listing application	SpinCo, PC
Obtain CUSIP number for stock	SpinCo
Meeting of Parent board of directors held if not already done so (typically 2 to 4 weeks before completion of spin-off) <ul style="list-style-type: none"> <li>▪ spin-off dividend declared</li> <li>▪ record date set (typically less than 2 weeks before distribution date)</li> <li>▪ distribution date set (date that spin-off is consummated and shares distributed to Parent shareholders)</li> <li>▪ notify stock exchange of record date</li> <li>▪ authorize the entry into and execution of all spin-off agreements, if not done so already</li> <li>▪ issue press release</li> <li>▪ fairness, solvency and tax opinions</li> </ul>	Parent, PC, PFA
Meeting of SpinCo board of directors held, approve all agreements, declare rights (if any)	SpinCo
Issue press release and file Form 8K	Parent
Begin mailing Information Statement to common stock shareholders (Parent's transfer agent will continue to mail the Information Statement to new holders through the record date of the spin-off)	Parent
Begin spin-off road show	SpinCo, PFA
SpinCo begins trading on "when-issued" basis (typically one to three days before the record date)	N/A
Record date for spin-off	Parent
Spin-off: Mail stock certificates to Parent holders of record as of record date	Parent
Provide shareholders with information as to allocation of tax basis between Parent and SpinCo	Parent, SpinCo, PC
Execute agreements	Parent, SpinCo
Distribution date of SpinCo shares to Parent shareholders as of record date	N/A
SpinCo stock begins trading "regular-way" (typically the day after distribution date)	N/A

## POST-DISTRIBUTION MATTERS

ACTION/EVENT	RESPONSIBILITY
File Form 8-K regarding consummation of the spin-off	Parent, SpinCo, PC
File Form S-8 Registration Statement for SpinCo stock option plan (required to register exercise of options under the '33 Act)	SpinCo, PC
Make any necessary filings (e.g., Form 3 for directors, officers and 10% beneficial owner) for SpinCo	Parent, PC
Allocate costs incurred by Parent on behalf of SpinCo <ul style="list-style-type: none"> <li>▪ listing fee</li> <li>▪ Form 10 filing fee</li> <li>▪ printing costs</li> <li>▪ legal and audit fees</li> <li>▪ D&amp;O insurance premium</li> </ul>	Parent

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For a more detailed examination of the considerations related to asset allocation, search [Spin-offs: Overview](#) on our website.

## TAX CONSIDERATIONS

One of the key advantages of a spin-off is that it can be structured as a tax-free distribution under Section 355 of the Internal Revenue Code (IRC). To be considered a tax-free distribution, the spin-off must generally satisfy the requirements set out below.

### GOOD CORPORATE BUSINESS PURPOSE

The parties must establish that the transaction is motivated by a proper corporate business purpose. For example, a desire to save on US federal taxes is not considered a good corporate business purpose. The following business purposes have been expressly approved by the IRS:

- Providing an equity interest to employees.
- Facilitating a stock offering.
- Facilitating borrowing.
- Saving significant costs.
- Improving performance by changing fit and focus.
- Resolving competitive concerns.
- Facilitating acquisitions generally.
- Facilitating acquisitions of others.
- Insulating one business from the risks of another business (see *Rev. Proc. 96-30*).

### ACTIVE CONDUCT OF A TRADE OR BUSINESS

Both Parent and SpinCo must have conducted an active trade or business within the five-year period before the distribution and must conduct an active trade or business immediately after the distribution. The two businesses existing after a corporate division must also be five years old before the time of the distribution or exchange. In general, this means that a business acquired in a transaction in which gain or loss was recognized less than five years ago does not qualify for this requirement.

### NO “DEVICE”

Another element necessary to achieving a tax-free corporate division is to establish that the transaction was not used principally as a device for the distribution of the earnings and profits of either Parent or SpinCo. This test was designed to prevent stockholders from converting dividend income to capital gain by selling the shares of either Parent or SpinCo after the distribution. This test applies only at the stockholder level. The avoidance of corporate gain at the parent level is not evidence of a device.

### DISTRIBUTION OF “CONTROL”

Parent must distribute a sufficient amount of stock of SpinCo to its stockholders to place the stockholders in control of SpinCo. For purposes of this requirement, the term “control” is defined as ownership of stock possessing at least both:

- 80% of the total combined voting power of all classes of stock entitled to vote; and
- 80% of the total number of shares of each other class of stock of the corporation.

### CONTINUITY OF INTEREST

The continuity of interest requirement requires that the historic stockholders of Parent have some continuing proprietary interest in both Parent and SpinCo after the transaction. It is not necessary for each stockholder of Parent to have a continuing proprietary interest if one or more of the stockholders of Parent maintain that interest.

### NO DISTRIBUTION OF “HOT STOCK”

Subsidiary stock that was acquired by Parent in a taxable transaction during the five-year period preceding the spin-off is considered “hot stock.” The hot stock does not qualify as a tax-free distribution in the spin-off and is taxable to both Parent and the receiving stockholders (the taxable hot stock is referred to as boot). The policy for taxing hot stock is apparently to prevent Parent from using excess cash to purchase shares of the subsidiary and distributing such shares

to stockholders as an in-kind but tax-free dividend.

Failing any of the previous requirements could cause the distribution to be taxable to Parent as well as the stockholders. In addition, Parent (but not the stockholders) can be subject to tax if it fails to meet either of the following two requirements:

- No “purchase” of 50% or more of the stock which is being distributed in the spin-off within the five years preceding the distribution (see *IRC § 355(d)*).
- No acquisition of 50% or more of an equity interest in either Parent or SpinCo under a plan involving the distribution (see *IRC § 355(e)*). Whether an otherwise tax-free distribution and an acquisition are part of a plan (or series of related transactions) depends on all of the facts and circumstances. The statute presumes that an acquisition occurring during the four-year period beginning two years before the corporate division is part of a plan that involves the distribution. However, regulations under Section 355(e) establish a number of safe harbors which most parties to a spin-off rely on.

In general, the requirements listed above are motivated by a desire to ensure that the division would result in a true separation of businesses and to prevent it from being a vehicle for a disguised dividend or a disguised sale of a subsidiary.

>> For a more detailed discussion of tax considerations, search [Spin-offs: Overview](#) on our website.

## SEC REGISTRATION AND DISCLOSURE

Spin-off transactions implicate a number of US federal securities laws. An important question to consider at the outset of the transaction is whether the spin-off must be registered under the Securities Act of 1933, as amended (Securities Act). In addition, it will be important to consider the form and content of disclosure that must be delivered to stockholders.

## REGISTRATION REQUIREMENTS

The SEC staff takes the position that a conventional spin-off transaction, made for a valid business purpose, does not involve a “sale” and may generally avoid registration of SpinCo’s stock under Section 5 of the Securities Act if the following conditions are met:

- **No consideration.** The distribution must be free, which means that Parent’s stockholders must not provide any consideration for the spun-off shares. If Parent transfers SpinCo’s securities for value, the transaction will be viewed as a “sale” under the Securities Act and must be registered.
- **Pro rata distribution.** The spin-off must be pro rata, which means that Parent’s stockholders must have the same proportionate interest in Parent and SpinCo, both before and after the spin-off. Otherwise, certain stockholders would give up value for the spun-off shares, which ordinarily triggers a registration requirement.
- **Adequate information.** Primarily driven by anti-fraud concerns, Parent must furnish adequate information about the spin-off and SpinCo to both its stockholders and the trading markets (see below *Filing and Disclosure Obligations*).
- **Valid business purpose.** The spin-off must be undertaken for a valid business purpose, which depends on the facts of the particular situation.
- **Two-year holding period for restricted securities.** If the securities to be spun off are “restricted securities” as defined in Rule 144(a)(3) of the Securities Act, Parent must have held the securities for at least two years before the spin-off. This condition does not apply where Parent formed SpinCo, rather than acquired SpinCo from a third party.

(See *SEC Staff Legal Bulletin No. 4 (Corporation Finance) (September 16, 1997) (Spin-offs)*.)

If the conditions described above are not satisfied, the spin-off will be treated as

the offer and sale of securities to Parent’s stockholders and must be registered under the Securities Act. Parent, as selling stockholder, and SpinCo, as issuer, must file a registration statement with the SEC, typically on Form S-4 (or, if a public offering is contemplated as part of or in connection with the transaction, on Form S-1). The registration statement consists of the prospectus that will be delivered to investors, as well as other required disclosures included in Part II of the registration statement.

>> For more information on registering securities on Form S-4 or Form S-1, search [Registration Statement: Form S-4 and Business Combinations](#) or [Registration Process: Overview](#) on our website.

## FILING AND DISCLOSURE OBLIGATIONS

Although most parent companies will seek to structure the transaction to avoid SEC registration, SEC registration will have little impact on timing. Even if the spin-off is structured to avoid registration under the Securities Act, SpinCo still must:

- Register the securities to be spun-off on Form 10 under Section 12 of the Securities Exchange Act of 1934, as amended (Exchange Act).
- Furnish its stockholders with an information statement that substantially complies with Regulation 14A (if a proxy statement is required) or Regulation 14C under the Exchange Act (if no proxy statement is required).

The disclosures that SpinCo is required to make in these Exchange Act filings are similar to disclosures it would be required to make in a registration statement under the Securities Act. Specifically, Parent and SpinCo must provide, among other information:

- A full set of risk factors.
- Description of SpinCo’s business.
- Management’s discussion and analysis.
- Description of the securities.
- Financial statements and pro forma financial information.

## CORPORATE APPROVALS AND DIRECTOR LIABILITY

A spin-off transaction will require approval by the board of directors of Parent and SpinCo, respectively. The significant considerations relevant to such approvals and related potential director liability are set forth below.

### BOARD APPROVAL

Spin-off transactions are considered dividends and may only be declared by the board of directors of Parent. In addition, the many other corporate transactions required to effect a spin-off require board approval of both parties. There are significant issues that each board must consider when approving the transactions, including:

- Fiduciary duties of the directors.
- Potential director liability arising from the payment of dividends.
- Fraudulent conveyance and solvency issues.

### FIDUCIARY DUTIES OF DIRECTORS

In approving a spin-off, the directors must act in accordance with their fiduciary duties. Generally speaking, directors approving a spin-off are entitled to the presumption under the business judgment rule that they acted on an informed basis, in good faith and in the honest belief they were acting in the best interests of the corporation. Stockholders are permitted to sue the directors for breach of the directors’ duties, but would have the initial burden of proving the directors acted improperly. The directors are protected if they rely in good faith on opinions or reports of officers or outside experts selected with due care and reasonably believed to have been acting within their professional competence. In exercising their business judgment, the board should consider the:

- Business purposes of the spin-off.
- Nature of the businesses being spun-off.
- Anticipated financial and operational consequences of the spin-off to Parent and SpinCo.

- Tax consequences to stockholders of the dividend.
- Other terms of the transaction, such as the manner in which Parent and SpinCo will operate together in the future.

>> For more information on the fiduciary duties of the board of directors, search [Fiduciary Duties of the Board](#) on our website.

## DIVIDENDS AND DIRECTOR LIABILITY

A spin-off transaction typically involves the declaration and payment of a dividend. Section 170 of the Delaware General Corporation Law (DGCL) provides that a company may pay dividends either out of its “surplus” (defined as the amount by which total assets exceed the sum of total liabilities plus the par value of outstanding capital stock) or the net profits for the fiscal year in which the dividend is declared and/or for the preceding fiscal year.

Notably, while no single objective standard of asset valuation exists, when determining the availability of surplus, the directors should “evaluate the assets on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present values” (see *Morris v. Standard Gas & Elec. Co.*, 63 A.2d 577, 582 (Del. Ch. 1949)). In other words, the surplus determination should be based on current rather than historical or book values.

Parent’s directors may be held personally liable under Section 174 of the DGCL if the directors are determined to have acted negligently in connection with the approval of an unlawful dividend. Fortunately, Section 172 of the DGCL protects directors from liability for unlawful dividends made in reliance on the reports of employees, committees of the board of directors or experts as to the availability of surplus or other funds from which a distribution may be made. Therefore, it is advisable for the board of directors to consider engaging a financial advisor or an appraisal firm to assist in valuation.

## FRAUDULENT CONVEYANCE AND SOLVENCY ISSUES

Federal bankruptcy law and state fraudulent conveyance law provide, in general, that any transfer made or obligation incurred for less than “reasonably equivalent value” may be set aside by creditors or a bankruptcy trustee if at the time of the transfer or because of the transfer any of the following are true:

- The debtor’s liabilities would be greater than its assets (balance sheet test).
- The debtor intended or believed that it would incur debts beyond its ability to pay as they matured (cash flow test).
- The property remaining in the hands of the debtor was unreasonably small for the conduct of its business (capital adequacy test).

This issue arises in the context of a spin-off transaction because dividends are not sales or transfers for “reasonably equivalent value.” In addition, many of the asset and liability transfers between a parent and spin-off subsidiary will not be for “reasonably equivalent value.” Accordingly, a spin-off distribution and related asset and liability transfers should be scrutinized to determine whether Parent and SpinCo satisfy the federal and state law tests of solvency. In this regard, Parent should consider obtaining opinions regarding the solvency of Parent and SpinCo from a financial advisor. A solvency opinion will provide protection to directors under Section 141(e) of the DGCL similar to the protection under Section 172 of the DGCL referenced above.

If the directors approve a transaction that is subsequently found to be a fraudulent conveyance, it is unlikely that they will be sued directly under the applicable fraudulent conveyance statutes unless they engaged in willful misconduct or benefited personally. The fraudulent conveyance statutes in Delaware do not create a cause of action against the directors or officers of a company that engages in a fraudulent conveyance, but the directors can be sued on the theory that the

transaction constituted a breach of their fiduciary duties. Carefully reviewing the fraudulent conveyance issues and obtaining expert advice can materially assist in defending any such action.

## CORPORATE GOVERNANCE CONSIDERATIONS

Because SpinCo will have a separate existence and be a public company, the parties must put in place a proper corporate governance structure. Significant corporate governance issues that need to be addressed include:

- Incorporating SpinCo.
- Selecting the directors and officers.
- Determining the role of the independent audit, compensation and nominating committees.
- Complying with the SEC’s periodic reporting and disclosure requirements.

## INCORPORATION AND CHARTER DOCUMENTS

If SpinCo is a newly formed entity, Parent must determine the state in which to incorporate it. Although Delaware is the most commonly selected state of incorporation, the parties should consider if there are business, tax, regulatory, social or other reasons to select another state, such as the state in which the company primarily does business, or that serves as the company’s primary regulator. Even if SpinCo is an existing subsidiary, the reasons for selecting its jurisdiction of incorporation should be revisited and the parties should determine whether to reincorporate SpinCo in another jurisdiction.

>> For more information on forming a new entity, search [Forming and Organizing a Corporation](#) on our website.

When forming a new entity or spinning off an existing subsidiary, counsel should ensure that the charter documents are appropriate for a public company. It is much easier to make any necessary changes to SpinCo’s charter and by-laws before the spin-off. If an existing subsidiary is being

used as SpinCo, the charter and by-laws should be reviewed to ensure they include appropriate provisions for a public company. For example, it is likely that the charter of a wholly-owned subsidiary would not contain the flexibility on issuing capital stock, including blank check preferred stock, which may be desirable for a public company. In addition, the charter and by-laws of a wholly-owned subsidiary are likely drafted to provide for expansive stockholder control (such as the right of stockholders to act by written consent) to ensure administrative ease within the consolidated entity. These provisions may not be desirable once SpinCo has a broad stockholder base.

Public companies typically also have charter and by-law provisions that are designed to ensure that, if the company is the target of a hostile takeover, the board of directors is in a position of power to negotiate with a potential acquiror to ensure the protection of stockholders' interests. When determining which takeover defenses to implement, the intention to protect the company from undesirable takeover attempts must be balanced against the valid interests that stockholders have in avoiding inappropriate entrenchment of the board and management and of having a voice in corporate decisions and strategy.

>> For more information on forming typical takeover defenses, search [Defending Against Hostile Takeovers](#) on our website.

## SELECTION OF DIRECTORS AND OFFICERS

It is critical that those persons charged with managing SpinCo have the requisite qualifications and background. The most natural choice would be to select individuals who have past associations with, and knowledge of, the businesses being spun-off to serve as directors and officers of the new company. However, Parent also must consider the stock exchange requirements that apply to public companies. The New York Stock Exchange (NYSE) and NASDAQ Stock Market (NASDAQ) each have implemented stringent corporate governance

standards relating to the board of directors of listed companies. The NYSE and NASDAQ rules provide that companies listing in connection with a spin-off transaction have one year from the spin-off to satisfy these requirements.

>> For information on the independence requirements of the NYSE and NASDAQ, search [Corporate Governance Standards: Board of Directors](#) on our website.

However, as discussed below, the company must have at least one independent director on its board at the time of the spin-off and multiple independent directors within 90 days to satisfy independent committee standards. In the case of a spin-off, independence requirements of the exchanges (which contain three-year look-back provisions) may serve as an obstacle to appointing too many directors with past affiliations with Parent, its affiliates or entities with which it has done business.

In addition, as a state corporate law matter, the extent to which directors of SpinCo will have conflicts of interest with the business of SpinCo must be considered. Individuals serving as directors or officers of both Parent and SpinCo also may face difficult decisions concerning corporate opportunities that arise and that may be of interest to both entities as well as with regard to ongoing contractual relationships and indemnification obligations between Parent and SpinCo. While these conflicts can be managed with appropriate disclosure and procedures, it may be prudent to avoid extensive overlaps between the directors and officers of Parent and SpinCo.

## INDEPENDENT BOARD COMMITTEES

As a listed company, SpinCo must have independent audit, compensation and nominating committees. Under SEC and stock exchange rules, the directors on these committees must be "independent" under both the relevant stock exchange definition and under Rule 10A-3 of the Exchange Act. However, stock exchange and SEC rules permit a company listing in connection with a spin-off to phase in the independence requirements. The

company must have one independent member on the relevant committee as of the spin-off, a majority (for example, two out of three) independent committee within 90 days of the spin-off and a fully independent committee within one year of the spin-off (although, under NASDAQ rules, compensation and nominating decisions can be made by independent directors).

The parties structuring the spin-off transaction should ensure that the audit committee of SpinCo has, at the time of the spin-off, the opportunity to develop a sufficient relationship with the outside and inside auditors and an understanding of the company's financial reporting obligations and internal controls to minimize unnecessarily steep learning curves or other difficulties post-spin-off. As for the compensation arrangements for SpinCo, in many cases these will, to some extent, be inherited or derived from the arrangements at former Parent. However, it is important that the compensation committee at the SpinCo level take the necessary steps to review and approve executive compensation plans and make compensation determinations in accordance with stock exchange requirements, and to support the necessary disclosure that will need to be made under the SEC proxy rules.

Notably, the recently enacted US finance reform legislation calls for the SEC to establish new independence standards for compensation committees (for more information on this reform legislation, search [Road Map to the Dodd-Frank Act](#) on our website). Finally, although the initial directors of SpinCo will be appointed pre-spin-off by Parent, the nominating committee must be in a position to recommend their re-election (as appropriate) when they are next up for election, and so presumably should be comfortable with their qualifications.

The parties structuring the spin-off should ensure that these committees (and the SpinCo board more broadly) have an appropriate level of participation in the formation and spin-off transactions. Before the spin-off, the directors of SpinCo

owe their fiduciary obligations only to Parent (as the sole stockholder), but immediately upon the effectiveness of the spin-off, the directors will owe fiduciary duties to the stockholders of SpinCo, and must be in a position to discharge their oversight responsibilities in a responsible and well-informed manner.

>> For other stock exchange requirements and important corporate governance considerations for public companies, search [Corporate Governance Standards: Overview](#) on our website.

## PUBLIC COMPANY REQUIREMENTS UNDER US SECURITIES LAWS

As a public company, SpinCo must also comply with the many periodic reporting and disclosure requirements that arise under the SEC's rules and regulations, including the considerable requirements of the Sarbanes-Oxley Act of 2002 (SOX). The parties structuring the spin-off should consult with counsel to review the operations and governance of SpinCo to confirm compliance with all applicable requirements of SOX.

### Disclosure controls and procedures

The company must establish, and periodically assess the effectiveness of, disclosure controls and procedures

which are designed to ensure that information required to be disclosed by the issuer in its Exchange Act reports (including quarterly and annual reports, Form 8-Ks and proxy statements) is processed and reported in a timely manner. This includes certifying as to the effectiveness of its disclosure controls in its first Form 10-Q or 10-K following the spin-off. Before the spin-off, the businesses in SpinCo will have been covered by Parent's disclosure controls and procedures, but as part of the spin-off preparations the parties must adapt and, as appropriate, modify these procedures so they work at the level of SpinCo.

### Internal control over financial reporting

Internal control over financial reporting is more narrowly focused than disclosure controls in that it relates specifically to financial reporting, but it generally presents a more significant burden on the issuer. Internal controls must provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

For a newly spun-off company, the management report and (as applicable) auditor

attestation on internal controls are generally not required until the company's second annual report on Form 10-K. However, getting to this stage inevitably involves substantial testing and remediation of systems throughout the company. This process should be discussed among management, outside and inside auditors and the audit committee at the earliest possible stage.

### Prohibitions on loans

SOX prohibits issuers from extending or arranging extensions of credit in the form of personal loans to its directors or executive officers. As a general matter, this does not prohibit ordinary course business-related advances and similar arrangements, and certain other exceptions are available. Because there is no grandfathering of transactions that were in place pre-spin-off, it is important to examine any existing arrangement that could be seen as an extension of credit to a prospective director or executive officer to determine whether any exception is available or whether the arrangement needs to be unwound.

*Article illustrations by Jennifer Casey of Practical Law Company.*

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## SPIN-OFFS: OVERVIEW

This article is based on Spin-offs: Overview, a continuously maintained Practice Note available on our website (search [Spin-offs: Overview](#) on [practicallaw.com](#)). The Practice Note was contributed by the following attorneys at Sullivan & Cromwell LLP:

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