Weil Alert

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IPOs, Spins and Split-Offs: Capturing the Value of a Separate Business Unit

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Public and private companies (including PE owned portfolio companies) enjoy many alternatives to capture and maximize value for stakeholders by separating one or more business units that are capable of operating as an independent company.

Below is a brief summary of:

- reasons why companies and PE sponsors may consider the separation of a business unit,
- basic deal structures,
- steps that companies and PE sponsors might take now to create optionality for or facilitate a potential separation in the future, including anticipated challenges and pitfalls to avoid, and,
- important tax issues to keep in mind.

Why consider separating a business unit?

There are many reasons why parent companies and PE sponsors seek to maximize or unlock value for their stakeholders by separating a business unit. These include:

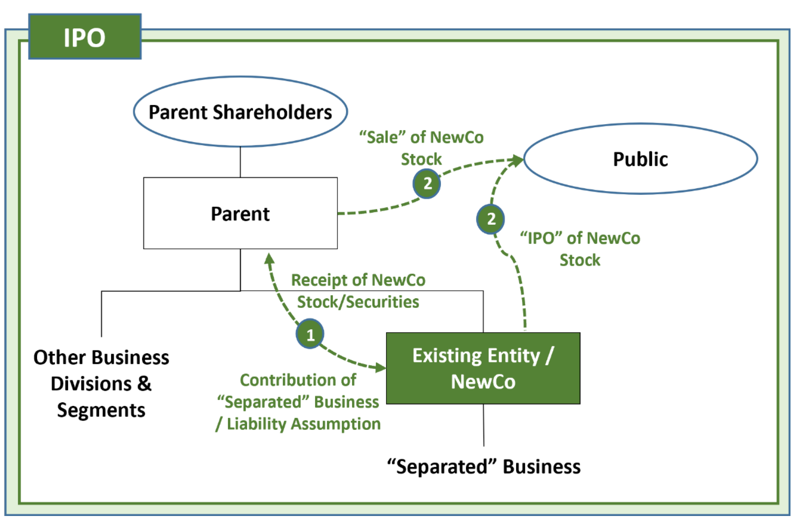
- ***Trading multiples and valuations.*** The business unit may be in an industry that typically trades at higher multiples than the parent company of which it is a part, and therefore the business unit is undervalued as a part of the parent;
- ***Drag on the parent.*** On the other hand, the business unit may "drag down" the valuation of the parent company as a result of differing financial characteristics (*e.g.*, slower growth rates than the overall business, lower margins, higher capital requirements, regulatory burdens, lower trading multiples of industry, etc.);
- ***Inability to value.*** The market may not give sufficient value of the business unit, because the business unit's financial characteristics are masked or overwhelmed by the overall financial picture of the parent, preventing investment analysts of the parent from "giving credit" and attention to the value of the unit;
- ***Operational and strategic benefits.*** The business unit may grow and focus on its core business and compete more effectively as a streamlined independent company, if for example, the business unit is constrained by the strategic, operational or capital funding priorities of its parent, or if key potential customers of the business unit are also competitors of the parent and therefore inhibited from transacting with the business unit;

- ***Ability to monetize the business.*** The separation of the business unit can be used to monetize the parent's investment in the business unit, right size the parent's capital structure or de-lever the parent; for example, the business unit may assume debt of the parent company that comes off the parent's balance sheet upon separation, the parent may use cash proceeds generated by the separation to pay down parent debt, or the parent may use the retained equity of the separated business unit as currency to repurchase parent equity or debt in exchange transactions;
- ***Tax efficiencies.*** The separation may be structured in a way that permits value to be returned to parent company stakeholders on a tax-free or tax-efficient basis; and
- ***Incentivizing Management.*** The separation of the business unit, and the granting of equity the value of which is tied solely to the performance of that business unit can be a useful tool to incentivize the management team of that business unit to focus on its success, particularly in circumstances where the business unit and the parent have different financial characteristics or valuation, competing considerations, or where they are in different growth stages.

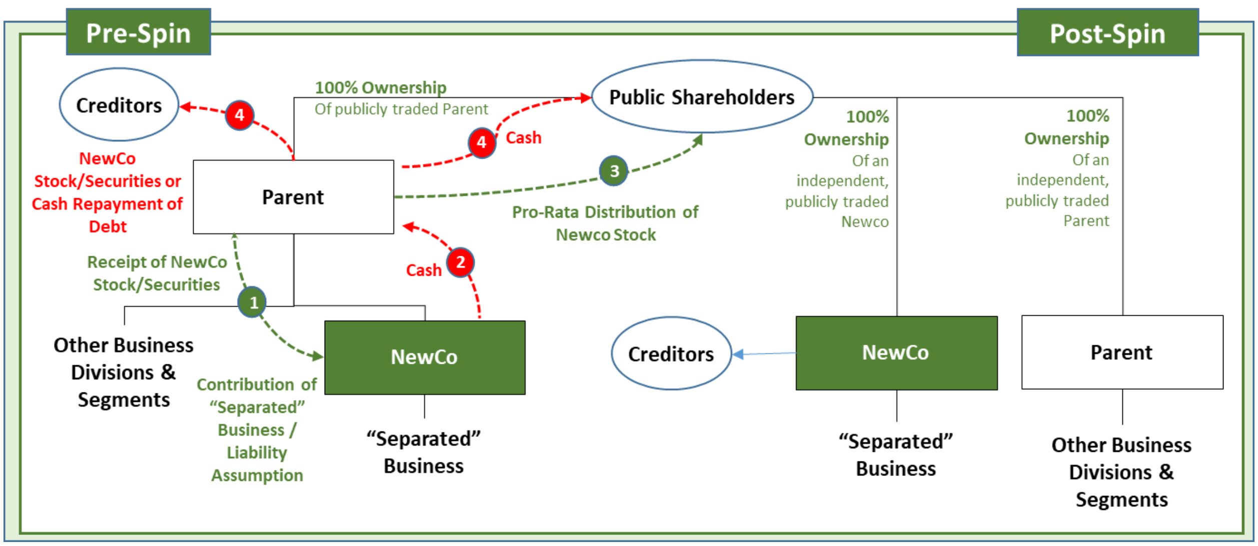
What are the primary deal structures?

The following are basic deal structures that may be used to separate a business unit. These deal structures are in addition to the potential sale of a business unit through an M&A transaction, and in fact, it is not uncommon to explore one or more of these alternative deal structures on a "dual track" basis with a potential M&A sale.

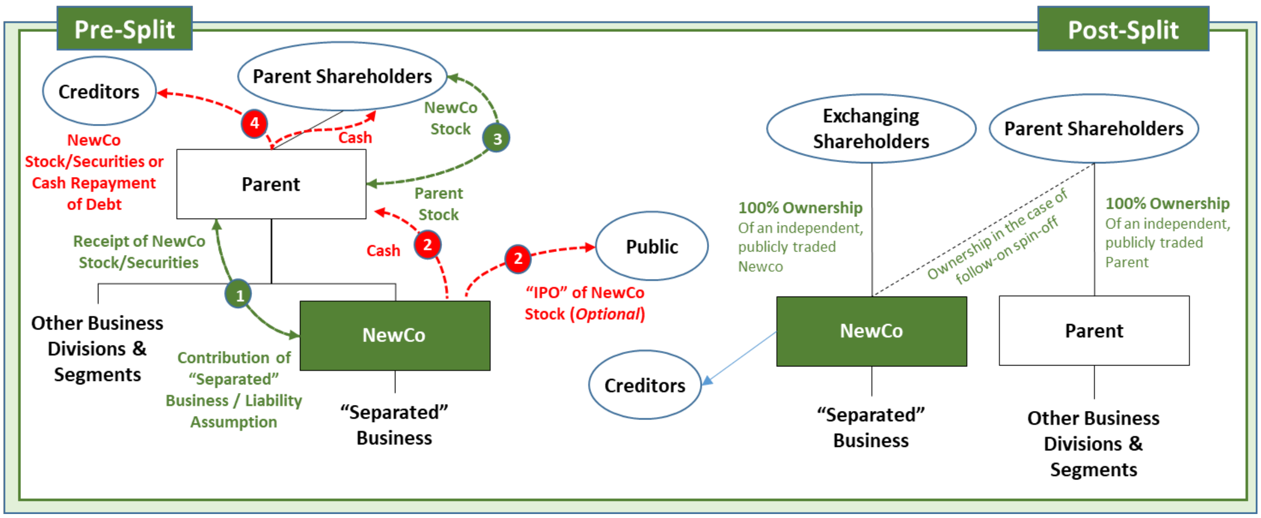
- ***IPO***. In an initial public offering, or IPO, the parent (Parent) will stand up the business to be separated under either an existing corporate entity or a newly formed entity (Newco), and will execute a public offering of the entity's equity on either a primary basis (where Newco issues new shares for cash) or a secondary basis (where Parent sells a portion of the shares it owns in Newco for cash). Even in a primary offering, the cash proceeds are often used to satisfy intra-company liabilities owed by Newco to Parent, thus indirectly benefitting Parent. Typically, only a portion of the equity is issued/sold in an IPO in order to establish a separate trading market for Newco's equity. Immediately following the IPO, Parent typically retains a significant percentage of Newco's equity (e.g., greater than 80% where Parent contemplates engaging in a subsequent transaction on a tax-free basis, as further explained below). If Parent intends to continue to sell down its Newco equity for cash, it will normally do so in a series of follow-on secondary offerings, with the timing dictated by market conditions and lock-up arrangements agreed with the underwriters.



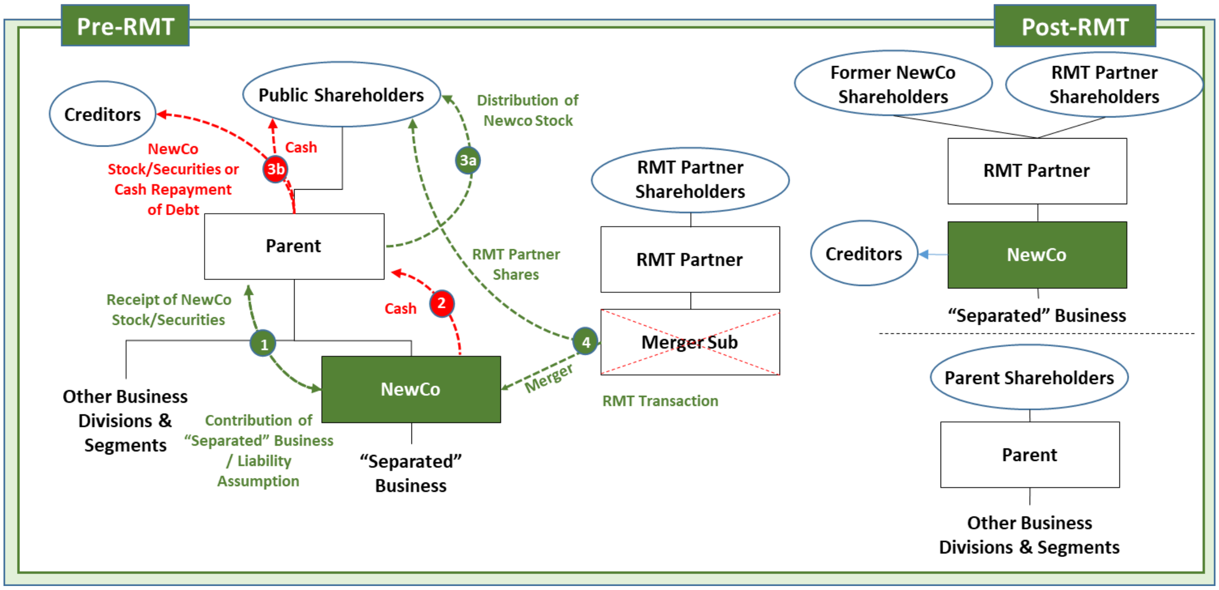
- ***Spin-Off.*** In a spin-off, Parent again combines one or more business units or other assets into a separate legal entity (Newco) and then distributes all or a portion (generally at least 80%) of the equity of Newco as a dividend on a pro rata basis to Parent's shareholders. As such, Parent receives no cash consideration. Provided various requirements are satisfied (as discussed further below), the distribution of Newco stock is normally expected to be executed on a tax-free basis for both Parent and its shareholders. Frequently, a spin-off is accompanied by a simultaneous listing of Newco's equity in order to create a liquid secondary market for that equity, or it follows a partial IPO through which a trading market for Newco equity has already been established. Although the spin-off itself does not generate proceeds for Parent, there are structures that allow Parent to receive value in connection with the spin-off. For example, prior to the spin-off, Newco may assume Parent debt or, alternatively, may incur new debt or engage in a partial IPO and distribute the cash proceeds of such borrowing/IPO to Parent, in each case, potentially on a tax-free basis; provided, however, Parent (i) has sufficient tax basis in Newco to support the liability assumption and/or cash distribution and (ii) distributes any such cash proceeds to its shareholders and/or creditors as part of the transaction. In addition, Parent can potentially de-lever above and beyond its tax basis in Newco through the implementation of: (i) a debt-for-equity exchange, in which Parent uses a portion of its Newco equity to retire its own debt, or (ii) a debt-for-debt exchange, in which Parent retires its own debt by exchanging it for Newco debt "securities" received by Parent as part of the "dropdown" of business assets.



- ***Split-Off.*** In a split-off, Parent typically starts with a partial IPO of Newco (to establish a separate trading market for Newco's equity), retaining at least 80% of the Newco equity. Then, after a period of time, Parent will consummate one of several alternative transactions. Parent may simply spin-off its remaining interest in Newco as a pro rata dividend to Parent stockholders, as described above. Alternatively, in a traditional split-off, Parent will commence an "exchange offer" whereby Parent offers its remaining interest in Newco equity to Parent stockholders in exchange for a surrender by participating stockholders of all or a portion of their equity in Parent. Parent stockholders thus must choose between continuing to hold shares in Parent or exchanging some or all of their equity in Parent for equity in Newco. This then allows Newco equity to be delivered exclusively to those shareholders who actively elect to tender for such Newco equity. Viewed differently, Parent will commence an offer to repurchase its own equity and, in lieu of using cash, will use the remaining Newco equity it holds as the currency. This exchange offer often includes a premium to encourage existing Parent stockholders to participate in the offer (e.g., Parent may offer its shareholders $11 worth of Newco stock in exchange for $10 worth of Parent stock). If the exchange offer is oversubscribed (meaning that more Parent shares are tendered than Newco shares offered), the exchange is conducted on a pro-rata basis. If the exchange offer is undersubscribed (meaning that too few Parent shareholders participate in the offer), Parent will typically distribute any remaining unsubscribed Newco shares pro-rata via a spin-off. As a result, in the case of a separation of a business unit that is or could be in a different industry than Parent, a split-off can be a useful tool to ensure that only Parent stockholders who wish to hold Newco stock participate in the transaction. A split-off transaction (including, if applicable, any follow-on spin-off) is usually structured to obtain tax-free treatment to Parent and its shareholders. Furthermore, the various types of monetization strategies and debt exchanges described above in the spin-off context are potentially available in the case of a transaction structured as a split-off.



- ***Reverse Morris Trust Transactions.*** In its most common form, a Reverse Morris Trust transaction, or RMT, involves Parent and another publicly traded company, referred to as RMT Partner, entering into a series of interrelated agreements whereby Parent contributes the business to be divested into a new or existing company (Newco), with Parent distributing all of the stock of Newco to its stockholders (taking the form of either a spin-off or split-off). Immediately after the distribution of the Newco equity, Newco combines with the RMT Partner – typically through a reverse subsidiary merger – with Newco stockholders receiving shares of RMT Partner stock (representing at least 50.1% of the combined entity) in exchange for their shares of Newco stock. Other variations of the RMT may also include transactions where RMT Partner is not publicly traded, where RMT Partner acquires Parent (as opposed to Newco), or where Newco or Parent acquires the RMT Partner. One of the advantages of the RMT structure is that the separation, distribution and subsequent merger are generally implemented on a tax-free basis, provided, however, that various requirements are satisfied. Stated differently, if the relevant tax requirements are satisfied, Parent generally is able to divest a business with significant built-in gain without the typical tax drag associated with a straight sale. Furthermore, because an RMT involves a spin-off or split-off, the various types of monetization strategies and debt exchanges described above can potentially be implemented as part of the RMT transaction.



What steps can companies take now to preserve the optionality for and facilitate a potential separation in the future?

It is very rare that the business to be separated already operates completely independently from its parent as a distinct legal entity. Often, the most difficult challenges and the cause of many of the delays in preparing a business to be separated involve the processes undertaken to disentangle the business from its parent and stand up the business within the legal entity to be separated. This requires significant advanced planning across a number of disciplines, incorporating elements of capital markets, tax, finance, human resources, intellectual property, and mergers and acquisitions.

In addition, at a practical level, any of the separation transaction structures described above require the new company to publish audited and interim historical (so-called "carve-out") financial statements for the business, which in turn requires that the operations, assets and liabilities of the business be clearly defined. The preparation and audit of these financial statements requires a significant amount of lead-time and is often a key gating item. These financial statements may even be required before the separation transaction if, for example, the new company is going to raise public or private debt to fund any pre-separation distribution or payment to the parent.

There are several steps companies can take to facilitate the process and maintain flexibility to pursue a separation in the future. These include:

- ***Financial and accounting separation.*** While maintaining a completely separate financial reporting and accounting system prior to separation may be neither cost efficient nor desirable, the ability at a minimum to identify and separately track the assets, revenues and expenses of the business well in advance of a potential separation will prove to be a significant benefit in reducing the lead times required to prepare and audit the necessary separate financial statements.
- ***Transition services.*** It is frequently the case that immediately upon separation, the new company continues to rely on the parent company for certain services (legal, accounting, HR, IP, IT, IR, insurance, benefit of vendor arrangements, etc.). Understanding well in advance what these dependencies are (and mapping out the points of interconnectedness) will help define needs going forward (which are typically memorialized in a transition services agreement) and provide a roadmap for understanding the steps and costs of achieving complete independence for the separated business. Because these costs of "de-synergizing" may be one of the key disadvantages to a separation, understanding these costs with greater specificity and preparedness will also help in

making a final decision about separation. For tax reasons, there is generally an “outside date” by which the transition services arrangements should be completed.

- ***Legal and contractual separation.*** Proactively analyzing contractual arrangements in advance and taking care when entering into new arrangements will facilitate any future separation. For example:
  - Can the relevant operating or IP assets be grouped under a separate legal entity?
  - If not, is there an executable plan under which operating assets could be transferred to the new entity in a tax-efficient manner?
  - Do parent debt covenants permit the separation under relevant asset sale or “all or substantially all” sale provisions?
  - Can important vendor and customer contracts be transferred or assigned to the new entity without consent? If any of them are shared contracts with the parent, would separating them have significant economic consequences?
  - Do contracts have change of control provisions or parent guarantees that preclude assignment to the new entity without consent or amendment?
  - Can ownership or licenses of important intellection property be transferred or allocated to the new entity through new licenses or cross-licenses?
  - Are there bars to transferring leases or real property required by the new entity?
  - Are there plant assets or other shared facilities that are currently used by both the business to be separated and the parent’s other businesses?
  - Are there contingent liabilities resulting from existing or threatened litigation relating to the business that need to be allocated?
  - Are there contingent liabilities resulting from potential tax issues relating to the business that need to be allocated?
- ***Employee matters.*** Employee matters typically occupy a significant focus in the separation. Apart from the additional management and employees that may be required by the new company to operate independently, there are a myriad of issues that the parent must confront to prepare for a potential separation. These include, among others, identifying management of the separated business, allocating employees whose roles are shared by both the business to be separated and the parent’s other businesses, adjustments to any equity awards, determining the level and continuity of benefits, and allocating the costs of accrued benefits for prior service (which may or may not be directly related to the business to be separated).
- ***Tax structuring and due diligence***. The ability to obtain tax-free treatment for a spin-off transaction is conditioned upon full compliance with a myriad of requirements. Some of these requirements can be difficult to interpret and apply in particular factual circumstances, and may be retrospectively impacted by a wide range of post-spin transactions or events involving Parent, Newco, or their shareholders. Parent and its advisors, therefore, must perform comprehensive tax due diligence and structuring analysis from an early stage to identify and carefully assess the potential tax risks and costs of implementing the transaction. Establishment of the transaction structure, and identification of associated tax issues and risks, will serve as the basis for determining whether the transaction can be implemented by way of tax opinion or, alternatively, whether a private letter ruling from the IRS may be warranted (which requires significant lead time to obtain).

What are common pitfalls to avoid?

The separation of a business unit can be challenging and represents significant upheaval for a company, its people, its counterparties and its culture. Being able to avoid these pitfalls will help smooth the process.

- ***Lack of effective communications plan.*** Separations are potentially very disruptive to employees, supplier/vendor relationships and customer relationships, and even a public rumor of a potential separation or a non-committal statement regarding the exploration of "strategic alternatives" can have a negative impact on both the parent business and the unit that may be separated. Employees accustomed to being associated with the parent business may face with trepidation the prospect of being with a smaller, separate company or worse, the fear they will have no job at all. Having in place an effective communications plan that may be executed in conjunction with any public announcement or leak (keeping in mind any securities laws restrictions, such as "gun-jumping" in an IPO) can help address potential concerns and mitigate this disruption. Clear communication can also help the parent and the separated business retain critical employees.
- ***Lack of Effective Steering Process***. Undertaking both the separation itself and the related IPO, spin-off or split-off is a complex process with many steps to execute and coordinate, and many stakeholders (owners, employees, customers, suppliers, regulatory bodies and financial, accounting and legal advisors). Failure to establish early on an effective steering process that is able to solicit directly or indirectly the required feedback from stakeholders and identify and resolve issues will likely result in significant delays as unanticipated issues come to the forefront.
- ***Us vs. Them – Dealing with Conflicts.*** As plans for a potential separation advance from a theoretical possibility to a specific actionable plan, and management for the business to be separated is selected, a change in group dynamics often occurs as employees once united under a common employer recognize that that their interests following separation may no longer be aligned. Ultimately the balance of power typically remains with the parent prior to separation, which allows the parent, subject to tax or other restrictions, to frequently dictate the terms of the post-separation relationship. Failure, however, to be sensitive to potential conflicts going forward and address them thoughtfully will sow the seeds of a rocky post-separation relationship. Areas of particular sensitivity include non-compete arrangements, parent consent rights, the scope, service levels and costs of transition services, and any ongoing costs or restrictions imposed by tax requirements. Investors may be concerned about the prospects of the newly separate business, especially if it inherits liabilities from the parent company, such as underperforming segments or increased debt.
- ***Failure to Anticipate.*** One of the most significant pitfalls in separation transactions is simply the failure to anticipate the challenges that arise in the separation process itself or in the post-separation period. This may include the failure to properly identify and estimate the costs of operating as an independent company, delays resulting from the failure to plan for the multiple and interconnected workstreams that must be carefully choreographed to effect the separation, the failure to understand the level of interconnectedness between the parent's business and that of the business to be separated, the failure to anticipate the magnitude and cost of stand-alone financing, or the failure to anticipate how the market or other key stakeholders will respond to the separated business. Careful planning, analysis and the experience of advisors can help mitigate these risks.

What are some of the key tax considerations?

The benefit of a tax-free spin-off, split-off, or RMT transaction is that there is no tax at either the parent level (with respect to the appreciation in Newco) or at the shareholder level (with respect to the value of the Newco stock received). However, for such a transaction to qualify as tax-free, it has to meet a number of requirements. While a detailed description of all of the requirements is beyond the scope of this article, we have highlighted some, but not all, of the core requirements below:

- ***Active Trade or Business Test***. Parent and Newco must have each actively conducted a business for at least five years, and not have acquired such business in a taxable acquisition within this period (subject to certain exceptions).
- ***Corporate Business Purpose***. The transaction must be motivated by a corporate-level business purposes that could not be efficiently and effectively achieved through any other nontaxable transaction. Examples of common types of business include, but are not limited to: (i) facilitation of access to capital; (ii) enhanced “fit and focus” of business lines; (iii) facilitation of an RMT transaction; (iv) facilitation of the use of equity as acquisition currency; and (v) facilitation of more targeted equity compensation for employees.
- ***Distribution of Control***. Parent must distribute stock possessing at least 80% of Newco’s voting interest to its shareholders.
- ***Device Test***. The transaction cannot be used principally as a device to distribute earnings and profits. For example, a pre-planned or intended taxable disposition of either Parent or Newco following the transaction may cause an otherwise tax-free transaction to be taxable. This rule must be examined closely, particularly in the context of private equity sponsor ownership of Parent.
- ***Limitations on Acquisitions of Parent or Newco that are Part of a “Plan” with the Spin-Off***. One or more persons generally cannot acquire 50% or more of either Parent or Newco as part of a “plan” with the spin-off (taking into account certain look-through rules that continue to treat Newco shareholders as owing Newco stock by virtue of their ownership in the acquirer), or else the spin-off is taxable to Parent (although the spin-off may remain tax-free for Parent’s shareholders).

Tax considerations play a fundamental role in separation transactions. If the desire is to conduct a spin-off, split-off, or RMT transaction on a tax free basis, then tax considerations will drive the structure of the initial transaction (such as the requirement that the parent retain 80% of voting control following the initial IPO), and the structure of the subsequent spin-off or split-off. Tax considerations will also regulate important aspects of the post-separation relationship between Parent and the separated company, as well as place certain limitations on transactions that can be carried out by the separated company for a specified period following separation. These restrictions and the consequences of a loss of tax-free status will be set forth in a tax matters agreement. Furthermore, the structuring steps and the related restrictions designed to preserve a tax-free transaction will serve as the basis for either a tax opinion or an IRS private revenue ruling.

In certain cases, it may be preferable to structure the transaction in a manner that is taxable to the parent, for example, in a situation where the parent has a high taxable basis in the business to be separated and desires to engage in an RMT transaction that does not comply with the no 50% acquisition rule described above.

Given the importance of tax considerations, integrating sophisticated tax counsel closely in all aspects of the transaction is critical.

Why Weil?

Weil has led some of the largest and most complex IPOs, spin-offs, split-offs and RMT transactions that have occurred in recent years. Weil is one of the few firms in the world that can combine within a single firm the market-leading M&A, capital markets, PE, tax, corporate governance, employment and IP practices required to execute these types of transactions.

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If you have any questions regarding IPOs, spin-offs or split-offs, do not hesitate to reach out to any of your normal Weil contacts or any of the below.

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