Fordham Journal of Corporate & Financial Law

Volume 1 | Issue 1 Article 8

1996

M&A: Survival of the Fittest in the 21st Century, Strategic Positioning in the Banking and Communications Industries - Corporate Restructuring & Spin-offs

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CORPORATE RESTRUCTURING & SPIN-OFFS *

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INTRODUCTION

Today, I will discuss spin-offs,[1] capital restructurings of troubled companies and business restructurings through divestitures.

I THE GROWTH OF SPIN-OFFS

The quantity of restructuring activity, particularly divestitures, did not change much from 1991 to 1993. (See Exhibit 1) However, the dollar amount of divestiture activity increased dramatically in 1994 and then decreased from that level in 1995. The interesting trend is the high percentage of spin-offs as compared to other divestiture activity. Spin-offs represented nine percent of divestiture activity in 1991, fifteen percent in 1994 and forty percent in 1995.

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* This speech was part of a symposium held at Fordham University School of Law on March 12, 1996 entitled **M & A: Survival of the Fittest in the 21st Century, Strategic Positioning in the Banking and Communications Industries.**

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[1] BLACK'S LAW DICTIONARY 974 (6th ed. 1991), A spin-off is defined as:

> [a] form of corporate divestiture that results in a subsidiary or division of a corporation becoming an independent company. Spin-off occurs where part of assets of corporation is transferred to a new corporation and stock of transferee is distributed to shareholders of transferor without surrender by them of stock in transferor. (citation omitted) A type of reorganization wherein, for example, A Corporation transfers some assets to B Corporation in exchange for enough B stock to represent control. A Corporation then distributes the B stock to its shareholders.

Id.

Ten years ago, there were many reasons for the significant increase in restructuring activity: the market's preference for investments which were "pure plays"; management's desire to improve the corporation's focus while achieving a better fit with other lines of business; reduction of reinvestment risk (i.e., eliminating cross subsidies and subject strategies and investments to market scrutiny); and capital improvements for a higher price to earnings ratios. Today, a new force, shareholder activism, accounts for the dramatic increase in restructuring activity.[2]

A. *Shareholder Activism*

The primary goal of corporate management has evolved over the past few years and is now geared towards satisfying the interests of shareholders. Increased shareholder activism has caused management of corporate America to work harder to enhance shareholder value.[3] Shareholders are exerting pressure on corporate management. For example, the Teamster's pension fund has recently assembled a list of directors who, in its opinion, are not serving the shareholders properly and should be removed from their respective boards.[4] Previously, only CEO's had been targeted, but today, directors are just as vulnerable. In response to this pressure, management has moved towards acquisition activity and divestiture in certain industries.

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[2] Richard Siklos, *"New Breed" Targets Woolworth: Zealous Shareholders Demand 117-Year-Old Giant Retailer Spin-off its FootLocker Chain and Related Stores*, FIN. POST, Jan. 23, 1996, at 4 (explaining how a new surge of shareholder activism, led by shareholder activists such as Carl Icahn and Bennet LeBow, has forced companies to sell off divisions and whole companies).

[3] *Id.* (indicating that investors are using hardball techniques to force what they consider entrenched boards and managers to maximize shareholder value); *see also Leader; Flip-Flop*, INV. RELATIONS, Mar. 1, 1996. The article states that:

> [t]he market distinguishes between good, bad and indifferent reasons for restructuring companies; and where it sniffs out an attempt to jump on a bandwagon, instead of addressing fundamental concerns, it will make its judgment felt. Markets are pragmatic: in the end, their only consistent preference is for maximization of shareholder value.

Id.

[4] Judith H. Dobrzynski, *Board Members, Too, Are Getting Investor Scrutiny*, N.Y. TIMES, Mar. 12, 1996, at D1 (stating that the International Brotherhood of Teamsters' pension fund has prepared a list of the 23 least valuable directors in corporate America).

II RESTRUCTURING METHODS

There are a number of restructuring methods: Letter Stock/Targeted Stock; Private Sale; Leveraged Recapitalization; Joint Venture; Initial Public Offering ("IPO"); Spin-off; and Tax-Free Split-Off.

Letter stock is a class of stock issued by the parent which allows an investor to participate in the growth and risks of one specific business without being tied down to other businesses.[5] The recapitalization of the parent company gives the class of stock a body of rights which is usually viewed by the investing community as roughly equivalent to direct investment in a specific subsidiary or division. This so-called poor man's spin-off serves many of the same functions as a spin-off, but, is not at all identical.[6] For example, General Motors issued class E stock when it acquired EDS in 1984 and class H stock when it acquired Hughes Electronics and Data Systems Units. More recently, U.S. West did a targeted stock deal, issuing two types of stock, one for its local telephone business, the other for its cellular and wireless business.[7] These issued classes of stock were tied to the subsidiary not the parent companies.

A private sale of a subsidiary or division to a single buyer is still the most common form of divestiture, particularly for the numerous smaller transactions. The sale may be to a company in the same industry as the subsidiary -- a trade buyer -- or may be to one of the many leveraged buyout groups -- the so-called financial buyer. Increasingly, companies have found that some kind of auction process is best suited to obtaining the highest possible price for the subsidiary. This process, coupled with lofty valuations

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[5] Robert W. Wood, *Current Trends And Transactions: Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings: 1995*, (PLI Tax Law and Estate Planning Course Handbook Series No. 378 1995).

[6] *Id.* According to the article, companies are currently attracted to target stock plans because, "there is no spin-off, there are no regulatory issues, and certainly no difficulties with obtaining a favorable ruling from the IRS." *Id.*

[7] Steven Lipin & Leslie Cauley, *US West Plans Two Classes of Stock, Splitting Phone Holdings, New Ventures*, WALL ST. J., Apr. 10, 1995, at A3. According to the article, "US West, dissatisfied with its stock's performance and eager to expand in Cable TV, plans to create two new classes of stock to reflect the differing values of its cable and wireless holdings and its local telephone business...." *Id.*

in the public stock market, has made it increasingly difficult for financial buyers to close deals without reducing expected rates of return to their investors.

The leveraged recapitalization is a variation on the private sale to a financial buyer. It is essentially a leveraged buyout where the parent company retains an equity interest in the leveraged subsidiary. It serves a number of purposes, not the least of which involves financial accounting. When a subsidiary undergoes a leveraged buyout, the balance sheet of the purchased company is written up to reflect the amount paid, often with a large amount attributed to goodwill. This goodwill must be written off against earnings over some period of time, not to exceed 40 years. In most cases, depending on the nature of the business, the write off period is much shorter.

This goodwill amortization has no effect on the cash flow of the acquired business, but for a financial buyer anticipating a subsequent public offering of shares in the company, every dollar of earnings reduction due to goodwill amortization will mean several dollars (depending on the price:earnings multiple) of reduction in the IPO price of the company. Where, instead of a complete LBO, the divestiture transaction takes the form of a leveraged recapitalization, the subsidiary's balance sheet will not be written up to reflect the "purchase price"; instead, the historical balance sheet will remain, reflecting only the effect of the leveraged dividend to the parent company. The book net worth of the former subsidiary will look pretty awful as a result, but the IPO market will not discount the stock price for goodwill amortization.

The joint venture represents an interesting means of divestiture in a gradual way. A company seeking to divest a subsidiary may find that the trade buyer best situated to reap the maximum value from the subsidiary may benefit from a gradual transition of control rather that the immediate transfer that accompanies the typical sale. One example is the joint venture between Philips, the Dutch electronics company, and Whirlpool. In the late 1980s, Philips wished to divest its $1.55 billion major domestic appliances division.[8] It negotiated a joint venture with Whirlpool enabling the latter to greatly expand its appliances business into Europe in a way that retained the best elements of the Philips business and integrated them with Whirlpool's worldwide operation.[9] Ultimately, in 1991, Whirlpool exercised its option to buy out Philips at a price that exceeded the value of the business in 1989.[10]

The three major on-line services are performing four different types of restructuring activity.[11] H&R Block, owner of CompuServe, is going to do an IPO of twenty percent of CompuServe and then spin-off the remaining eighty percent to its shareholders.[12] Sears has announced that it is looking to sell its fifty percent interest in Prodigy,[13] while America On-Line is doing strategic joint ventures with AT&T and Netscape Communications.[14]

A. Why Spin-offs?

The reason why a spin-off is so terrific and should be used is best proven through an example. If a hypothetical parent company identifies a non-core subsidiary, it can divest it. Assume book value and tax basis of the subsidiary is $200 million, while the fair market value is $1 billion. (See Exhibit #2). The most basic divestiture is a cash sale. (See Exhibit #3). In a cash sale, one billion dollars of cash is

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[8] *See* Ashish Nanda & Peter J. Williamson, *Use Joint Ventures to Ease the Pain of Restructuring*, HAR. BUS. REV., Nov.-Dec. 1995, at 119.

[9] *Id.*, at 120.

[10] *Id.*, at 119.

[11] Lauren R. Rublin & Eric J. Savitz, *The Unsinkable Dow Continues To Defy Gravity and the Skeptics*, BARRON'S, Feb. 26, 1996, at 3 (indicating that the three major on-line services are America Online, CompuServe and Prodigy).

[12] *Id.*, (announcing H&R Block's intention to sell off 20% of CompuServe in the IPO and distribute the rest within a year, either as a spin-off to H&R Block shareholders or as a split-off in which holders could trade in H&R Block shares for stock in CompuServe).

[13] *Id.*, (stating that IBM owns the other half of Prodigy and would be the obvious buyer for Prodigy except for the fact that IBM hired investment bankers to consider what to do with its holdings and announced its new internet strategy which did not involve Prodigy).

[14] Peter H. Lewis, *America Online in Alliances With AT&T and Netscape*, N.Y. TIMES, Mar. 12, 1996, at D1 (stating that these two new major alliances were intended to help America Online take fuller advantage of the internet's growing popularity).

$800 million of taxable gain is recorded and a tax of $320 million is due at the corporate level. This leaves only $680 million in proceeds. However, if the corporation decides to distribute the proceeds to the shareholders, these funds will be taxed again at the shareholder level as dividend income.

An IPO is subject to a similar tax regime as a cash sale. The IPO occurs within the parent company and it will ultimately create a number of taxable sales which can only be deferred from the corporate level for a limited time period.

A spin-off, meeting the requirements of Section 355 of the Internal Revenue Code (the "Code"), is entirely tax free to the corporation and shareholders.[15] This allows $1 billion of value associated with the subsidiary to be placed directly into the hands of the shareholders. However, if any of the requirements under Section 355 are not met, the corporation and the shareholders will be subject to tax at the same level as a cash sale.

B. Requirements for a Tax-Free Spin-off

There are six requirements for a tax-free spin-off:

(1) Parent must distribute 80% control of Sub (80% of voting power and 80% of each class of nonvoting stock);
(2) Parent and Sub must each carry on an active trade or business that has been carried on continuously for at least five years;
(3) The spin-off must have a compelling business purpose;
(4) The transaction may not be a device to distribute the company's earnings and profits;
(5) There must be continuity of shareholder interest in each of the continuing entities;
(6) There is a five year holding period requirement in Parent under certain circumstances.[16]

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[15] 26 U.S.C. § 355 (1996) (stating that a corporation may distribute to its shareholders the stock of a "controlled corporation" without any tax consequences to the shareholders, provided that the requirements of § 355 are met).

[16] 26 U.S.C. § 355 (1996).

Tax advisors can objectively analyze most of the above requirements by looking at the data and history of the company as well as the details of the proposed transaction. One requirement that does not lend itself to this kind of objective analysis, but which is crucial to the conclusion that a spin-off will qualify under Code Section 355, is the business purpose requirement. Any sort of tax-free reorganization requires some bonafide business purpose in order to qualify for nonrecognition treatment. The way the tax law has developed, however, the business purpose requirement for a spin-off is raised to a significantly higher level, both in terms of the extent of the extenuating circumstances necessary to meet the test and the level of proof necessary to satisfy the Internal Revenue Service that the test has been met.

Substantially all of the recent spin-offs of public companies have been driven by the goal of enhancing shareholder value. Nevertheless, the position of the IRS is clear: enhancing shareholder value is not an acceptable business purpose to support a tax-free spin-off.[17] As a result, accountants, tax attorneys and the I.R.S. spend a lot of time forming an acceptable corporate business purpose from the overall circumstances and motivations of the corporation.

There are several commonly employed business purposes: equity financing through a successful public offering; debt financing to increase the credit rating; key employee plans for private companies and employee stock option plans ("ESOP") for public companies; regulatory relief; "fit and focus" for the needs of non-core business; and merger facilitation through a "Morris Trust" transaction.[18]

Equity financing is the closest relative of the pure shareholder value concept. Assume the combined stock price of two companies post spin-off will exceed the stock total market capitalization of the pre spin-off parent company. The IRS will analyze this act as a taxable transaction. However, if you take

[17] *See, e.g.*, Roger Lowenstein & Clare Ansberry, *Icahn Plan for USX Faces Steely Scrutiny,* WALL ST. J., Apr. 25, 1990, at C1. According to Robert Willens, a Shearson Lehman Hutton analyst, "a spin-off must be for a specific corporate purpose in order to be tax-free. Merely increasing the value of the stock is not in and of itself a corporate business purpose." *Id.*

[18] Commissioner of Internal Revenue v. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

this transaction and couple it with a desire on the part of either of the two companies, parent or subsidiary (post spin-off) to go to the equity markets for new capital, you have a business purpose. In other words, by taking advantage of the enhanced trading value of the stock and employing those funds for valid corporate business purposes, such as acquisitions or paying down debt, you can avoid being taxed.

Relief from regulatory constraints has traditionally been available for the communications industry. A few years ago, Pacific Telesis spun-off Air Touch Communications[19] and Sprint is currently spinning-off Sprint Cellular.[20] Due to the recent changes in communications legislation, it will likely be more difficult to demonstrate that a spin-off is necessary to enable a phone company to pursue new lines of business.

"Fit and focus" is a business purpose which focuses on the needs of the non-core business rather than upon those of the strong one. Non-core businesses, either de facto non-core businesses or businesses that have been explicitly given that mark of Cain by management, do very poorly by virtue of that label. They can not compete for corporate allocation of resources. These businesses, during the 1980's, were the best candidates for very successful leveraged buy-outs, however, today many are candidates for successful spin-offs.[21]

Finally, the Morris Trust transaction is an acceptable business purpose for facilitating a merger.[22] (See Exhibit #4). Basically, in this situation, there is an acquirer, a parent, and a subsidiary. The acquirer and parent want to merge, but, a subsidiary or division which does not fit exists. The parent is permitted to spin-off the subsidiary to the shareholders and then merge with the acquirer in a tax-free reorganization. A

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[19] Stuart Elliott, *The Media Business: Advertising; A Campaign for a New Telecommunications Company Tries to Burst the "Techno-Babble" Bubble*, N.Y. TIMES, Apr. 11, 1994, at D6.

[20] *In Brief; Sprint Sheds Cellular Unit*, COMM. WEEK, Mar. 11, 1996, at 8.

[21] *See, e.g.*, Robert Johnson, *Kelly and Kohlberg Kravis are in Talks that Could Lead to Spin-off at Beatrice*, WALL ST. J., Feb. 2, 1988, (stating that KKR took Beatrice private in a leveraged buyout in 1986 and was considering a spin-off in 1988). According to analysts at the time, "[t]he most likely spin-off candidates [were] the Swift Meat lines and Tropicana Juices." *Id.*; *A Review of the Leveraged Buyout Market*, MERGERS & ACQUISITIONS IN CANADA, July 1, 1993; Allen Kaufman and Ernest J. Englander, *Kohlberg Kravis Roberts & Co. and The Restructuring of American Capitalism*, BUS. HIST. REV., Mar. 22, 1993.

[22] Morris Trust, *supra* note 18.

Morris Trust transaction allows a post-spin-off sale by the shareholders which before now was contra to the requirements of device and continuity of interest.[23]

C. IPO/Spin-off

An IPO spin-off transaction takes twenty percent of the subsidiary public, brings cash in to the parent company and then establishes a trading market for the subsidiary.[24] (See Exhibit #5). For this type of transaction, all formalities of an IPO must be carried out, including underwriting. This is followed with a spin-off through a distribution of the remaining eighty percent of the stock of the subsidiary to the shareholders. A few years ago, Sears used this method to spin-off its Dean Witter Financial Services Group, most of its Caldwell Banker real-estate holdings and twenty percent of its Allstate insurance unit.[25] H&R Block has indicated it will spin-off its CompuServe subsidiary in this way as well.[26]

One advantage of an IPO/Spin-off is that during the pre-spin-off period the parent and the subsidiary can continue to file a consolidated return. Although a more appealing transaction for management would be a sale, in order to bring cash into the company, a spin-off brings the greatest value to the shareholders. Some question whether all the value must be sent out of the company instead of making acquisitions or retiring debt.

D. Pre-Spin Leverage

A pre-spin leverage is a combination of a leveraged buy-out or a leveraged recapitalization with a tax-free spin-off. (See Exhibit #6). Using the base model of a subsidiary with a fair market value of one

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[23] *Id.*

[24] Gregory A. Patterson & Francine Schwadel, *Back in Time: Sears Suddenly Undoes Years of Diversifying Beyond Retailing Field*, Wall ST. J., Sept. 30, 1992, at A1.

[25] *Id.*

[26] Rublin & Savitz, *supra* note 11.

billion dollars which has tax bases of only $200 million, the parent wants to leverage it to $800 million and hold on to the cash. This spin-off will trigger a gain of $600 million to the parent and a cash tax cost of $240 million.

Another option is to have the subsidiary borrow the $800 million and distribute it to the parent. (See Exhibit #7). The parent company then contributes the cash and all of its other assets and liabilities to a new entity called "new parent." The parent company then spins off "new parent" to the shareholders tax free. Although this sounds too good to be true, it is one of the many instances in which the tax law is governed almost exclusively by form, notwithstanding a lot of dictum to the effect that the tax law looks to substance and not form.

E. Tax-Free Split-off

The tax-free split-off is a transaction in which the subsidiary is distributed non-pro-rata.[27] (See Exhibit #8). The parent company takes the subsidiary public, establishes a trading price for the stock, then subsequently offers an exchange to the parent's shareholders. The shareholders can keep the parent stock or exchange it for stock in the subsidiary. This is a tax-free transaction, provided all the other requirements under Section 355 are met.

Three advantages are: shareholders have a choice to swap one investment for another on a tax-free basis, parent can report a gain on the disposition of the subsidiary for book purposes and there will be a

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[27] BLACK'S LAW DICTIONARY 974 (6th ed. 1991), A Split-off is defined as follows:

> When a corporation sets up and funds a new corporation and gives the shares of this new corporation to the old corporation's stockholders in exchange for some of their shares in the old company, this new company is a 'split-off' and the process is a split-off. A type of reorganization whereby, for example, A Corporation transfers assets to B Corporation in exchange for enough B stock to represent control. A Corporation then distributes the B stock to its shareholders in exchange for some of their A stock.

Id.

diminution in the number of shares outstanding and a more favorable earnings per share comparison as compared with a straight pro-rata spin-off.

CONCLUSION

Corporate America is undergoing a restructuring of its business holdings to an extent not seen in recent times. Influential investors are sending a message to CEOs and directors that they must establish a vision for the company and pursue it; if you do not have a vision, get one. In the vast majority of cases, the pursuit of a corporate vision has resulted in widespread divestitures of businesses identified as non-core. In other cases, companies have pursued aggressive acquisition strategies to build up and upon their core businesses.

Of the various means of divesting businesses, the spin-off has become extremely popular. One important reason for this is that it represents the most efficient means of placing the enhanced stock value directly in the hands of the stockholders without reduction for corporate taxes. The tests for achieving tax-free status for a spin-off are rigorous, with the business purpose requirement being the most problematic. In the absence of ill-advised changes to the tax laws, we can expect the spin-off to continue to be an important tool for restructuring U.S. businesses for many years to come.

Spin-offs/Total Divestitures

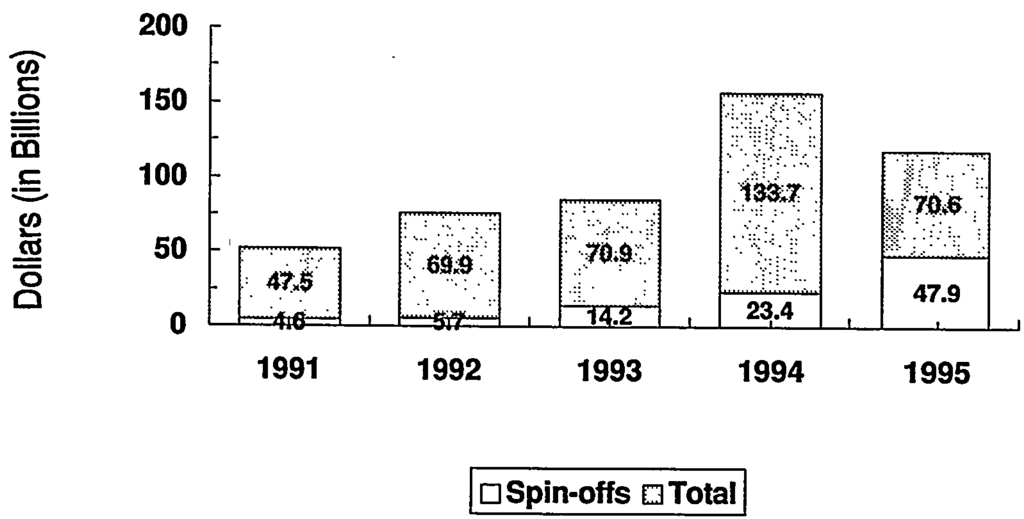


EXHIBIT 1

What's so great about Spin-offs?

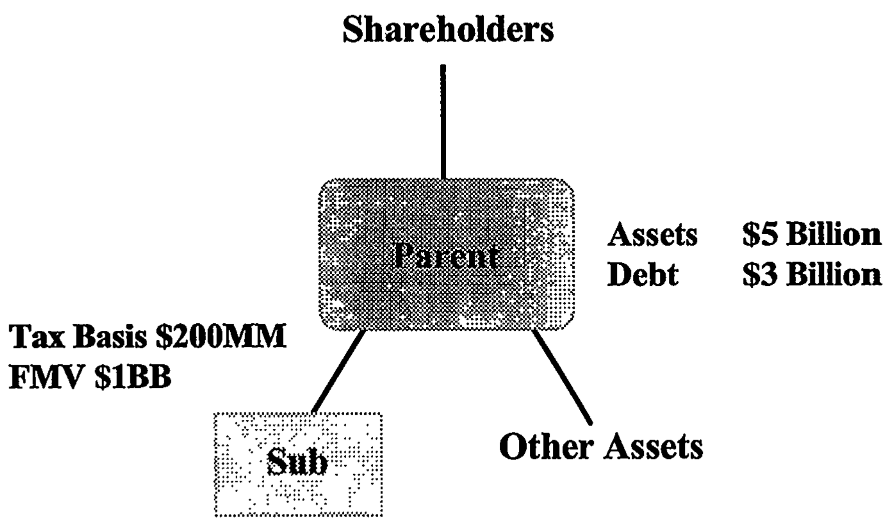


EXHIBIT 2

Spin-off versus Sale and IPO

Sale of Sub

Proceeds		1,000
Tax Basis	(200)	
Taxable gain	800	
Tax @ 40%		(320)
Net Proceeds		680

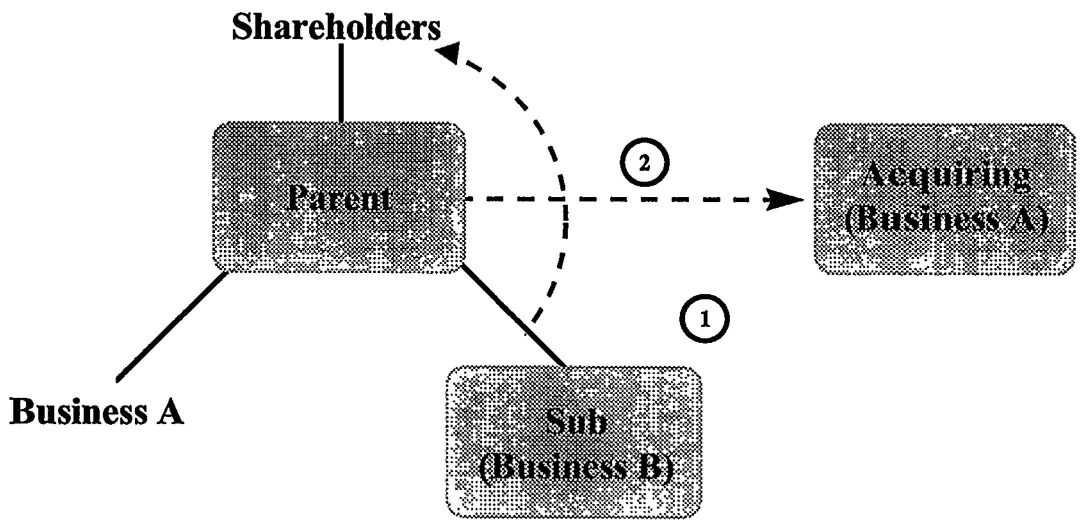
IPO

Less cash up front
Same tax cost as sale

Spin-off

Tax-Free to Parent and Shareholders if it meets the requirements of Section 355
If any requirement is not met, Parent recognizes gain and pays $320 tax; Shareholders pay full tax on receipt of "dividend"

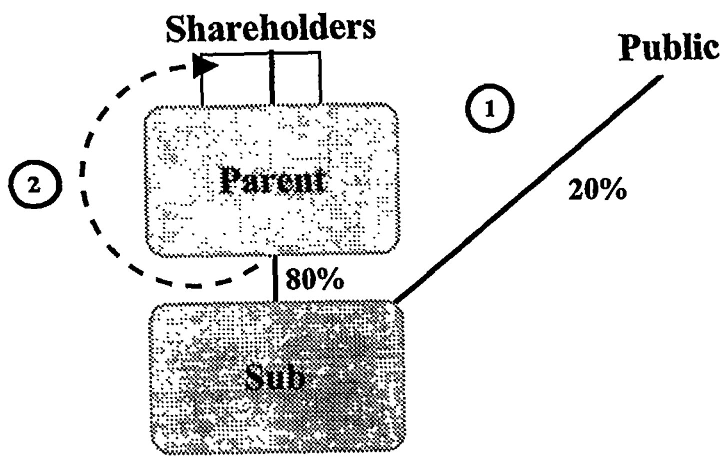
Morris Trust Transaction



- Acquiring wishes to merge with Parent, but does not wish to acquire Business B. Therefore, Parent spins off Sub to the Shareholders, and then merges with Acquiring in a tax-free reorganization

EXHIBIT 4

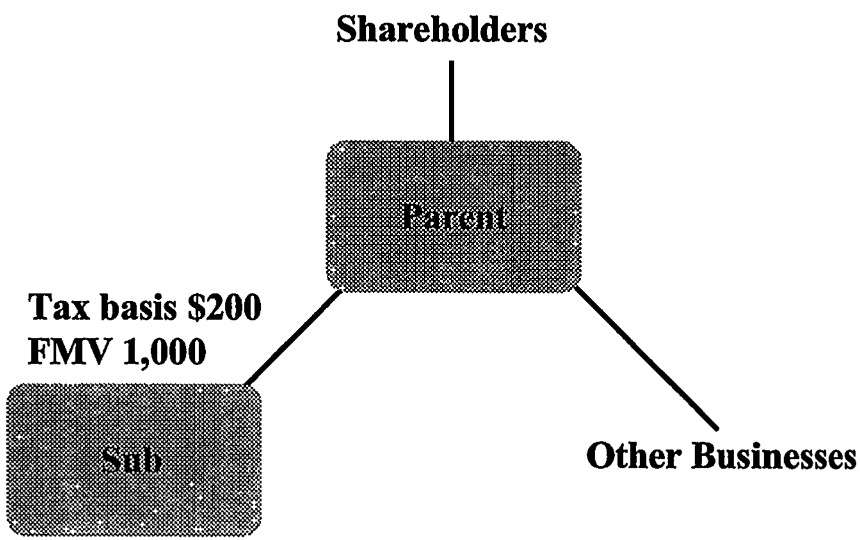
IPO/Spin-off (e.g., Sears/Allstate, Sears/Dean Witter-Discover)



(1) IPO of Sub 20% stock issuance

(2) Parent spins off 80% of Sub to Shareholders

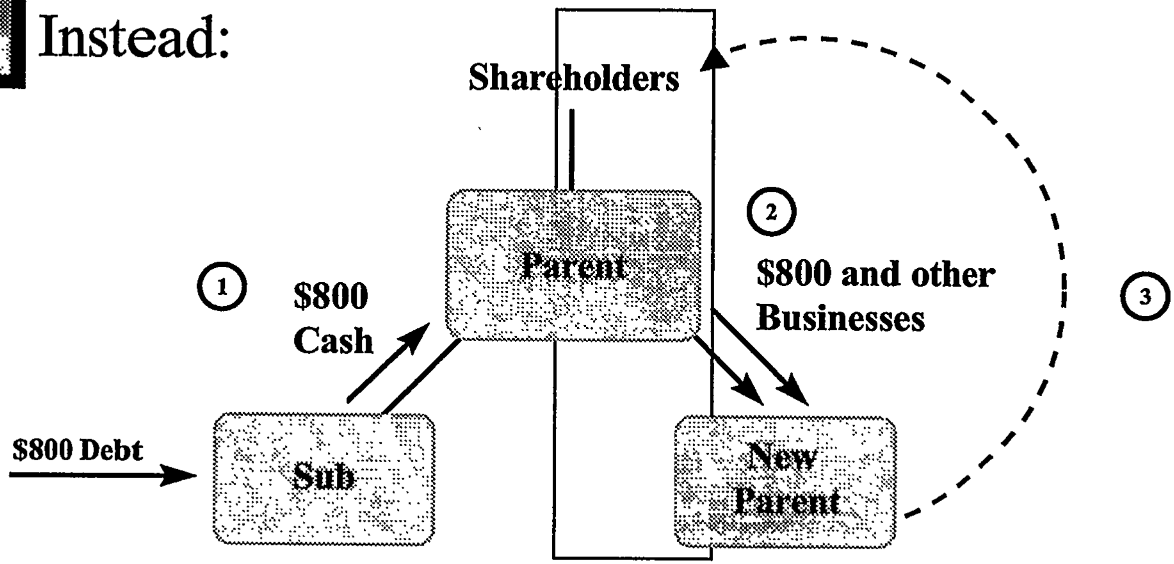
Pre-Spin Leverage



- Parent wishes to push $800 debt down to Sub. This triggers $600 gain/$240 tax upon spin-off

EXHIBIT 6

Instead:



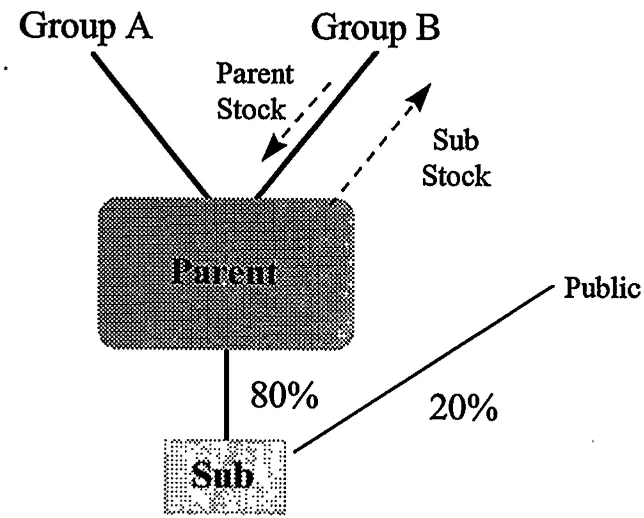
(1) Sub borrows $800 and distributes cash to Parent

(2) Parent contributes $800 and all other assets and liabilities to New Parent

(3) Parent spins off New Parent to Shareholders

EXHIBIT 7

Tax-Free Split-off



- Parent distributes Sub stock non-pro rata to certain Shareholders, who surrender Parent shares in exchange. Usually preceded by 20% IPO of Sub.

<u>Advantages</u> (1) Shareholders have choice to swap one investment for another
(2) Parent reports a gain on "disposition" of Sub for book purposes
(3) Parent reduces number of shares for EPS purposes (same result as stock buyback, rather than spin-off or reverse stock split)

EXHIBIT 8