To Our Clients and Friends:

Spin-offs continue to be a prominent feature of the deal landscape; new transactions are announced on an almost weekly basis. For example, Barnes & Noble recently said that it plans to spin off its Nook business, eBay said that it would spin off PayPal, and Hewlett Packard announced that it would spin off its printer and computer business. A total of approximately 51 separation transactions have been announced so far this year. The tally was not quite as high in 2013, but still robust; approximately 42 transactions were announced.

When market analysts seek to explain this apparently never-ending stream of separation transactions, they reason that the stock market rewards pure-play companies focused on a single line of business with higher stock prices than conglomerates. They also observe that activists have added momentum to the transaction flow by encouraging companies that operate several lines of business to consider separation opportunities. In addition, they observe that separation transactions can result in improved management focus, enable the implementation of more efficient capital structures and compensation programs, and result in the creation of a new equity currency.

Another important feature of spin-off transactions that receives less attention, but that can make these transactions very attractive, is the opportunity for parent companies to raise capital, monetize their interest in the companies being spun off, and reduce indebtedness. Although spin-offs, by themselves, do not generate cash for the parent or its stockholders, the transaction planners can use a variety of techniques to achieve monetization and recapitalization goals.

Some of the monetization and recapitalization techniques are relatively straightforward, while others are quite exotic, involving complicated tax planning. To take some simple examples, the subsidiary might borrow money, distribute the borrowing proceeds to its parent, and then complete the spin-off transaction. Alternatively, the parent might cause the subsidiary to engage in an initial public offering and then spin-off its stock in the subsidiary. Or it might structure a sponsored spin, in which a financial sponsor invests in the subsidiary at the time of the spin-off. The sponsor's investment might be coupled with the payment of cash to the parent.

Examples of other, more complex structures include transactions in which the spin company and the parent company undertake a debt-for-debt or debt-for-equity exchange. These transactions typically require extensive involvement from investment banks. Alternatively, the parent might couple a spin-off with an M&A transaction and a monetization transaction using so-called "Morris Trust" or "Reverse Morris Trust" structures.
The choice among these alternatives will depend significantly on the pre-spin capital structure of the parent and the subsidiary to be spun off, the financial health of the parent and the subsidiary, the tax attributes of the parent's investment in the subsidiary, and conditions in the equity and debt markets. The transaction planners must also consider the post-transaction solvency of the parent and the subsidiary, each company's ability to generate sufficient capital to satisfy its business needs post-spin, and a range of other business, accounting, tax and legal questions.

The balance of this client alert describes the principal alternatives in more detail and identifies some of the critical issues that the transaction planners must address.

**Distributions by spin-off company following borrowing.** One of the most straightforward techniques involves a structure in which the company to be spun off borrows money, either in a bank financing, a bond offering or a combination of both, and then uses the proceeds of the borrowing to satisfy an intercompany payable or pay a dividend to the parent. As an alternative, the company to be spun off might assume some portion of the parent's debt.

The usefulness of either technique may depend in part on the parent's tax basis in the subsidiary. A dividend by the subsidiary to the parent will be taxable to the parent to the extent the dividend exceeds the parent's tax basis in the subsidiary (or in some cases, its basis in the assets transferred to the subsidiary in exchange for subsidiary stock), unless, under certain circumstances, the dividend is distributed by the parent to its stockholders pursuant to the plan of reorganization. The subsidiary's assumption of parent debt similarly may be taxable to the parent. Thus, if the parent's tax basis is low, the opportunities for tax-free monetization may be limited or more complex structures may be required.

The parent and the spin company must take into account the impact of any distribution on their respective capital structures and their ability to operate after the spin-off. Dividend rules may prohibit the payment if the subsidiary's assets post-dividend are less than its liabilities. The transfer may be viewed as a fraudulent conveyance under creditors' rights rules if payments to the parent are not made in return for reasonably equivalent value and leave the spin-off company insolvent.

There are many examples of transactions that use these techniques. When Timken spun off Timken Steel earlier this year, Timken Steel borrowed under a credit facility and paid a dividend to its parent. Similarly, when Sears Holdings spun off Lands' End, Lands' End used the proceeds of a term loan to pay a dividend to a subsidiary of Sears Holdings.

**Initial public offering by subsidiary.** Spin-off transactions are sometimes coupled with initial public offerings. Subsidiary stock is sold to the public in an underwritten offering. The parent then distributes the balance of its shares in the subsidiary to its stockholders. If the offering is structured as a primary offering, in which the subsidiary sells shares directly to the public, the subsidiary uses the offering proceeds to pay a dividend to the parent or retire intercompany payables. If the offering is structured as a secondary offering, in which the parent sells its shares in the subsidiary to the public, the parent receives the proceeds directly. Subject to the basis limitations described above, the
transaction planners may be able to increase the size of the payment to the parent if the subsidiary also incurs new debt or assumes parent indebtedness.

In addition, to ensure that the spin-off is tax-free to the stockholders and the parent under Section 355 of the Internal Revenue Code, the parent must possess at least 80% of the voting power of the subsidiary stock and 80% of each class of non-voting stock prior to the spin-off. This requirement has the effect of limiting the size of the offering. Parent companies sometimes structure around the 80% obstacle by creating two classes of subsidiary stock – a class with ordinary voting power and a class with super-voting power. The parent and the spin-off company sell the low vote stock to the public; the parent retains the high vote stock to ensure that it continues to control the subsidiary for purposes of the tax-free spin-off rules.

The transaction planners must also consider the capital structure, solvency and financing issues that they would take into account in creating a monetization structure that relies on borrowing. In particular, they must take steps to ensure that both the parent and the spin-off company will be solvent going forward, and will have sufficient access to financing to meet their capital needs. In addition, the transaction planners must take into account the state of the IPO market; in these transactions, much more than the traditional spin-off, they must manage market risk. And they must consider what governance arrangements they will establish during the period between the IPO and the distribution of any shares that remain in the hands of the parent following the IPO.

Transaction planners have been linking IPOs with spin-offs for many years. An example includes the 2011 IPO of Sunoco subsidiary SunCoke Energy. At the same time that SunCoke completed the IPO, it used the proceeds of a long term borrowing to repay indebtedness to its parent. Sunoco later spun off all of its remaining shares of SunCoke Energy stock. Another example is the IPO of GECC subsidiary Synchrony Financial in 2014. As part of the financing arrangements, Synchrony paid off all of its outstanding intercompany indebtedness to GECC and entered into a new term loan facility with GECC. GECC has indicated that it plans to distribute the balance of its shares in Synchrony Financial to GECC's stockholders in 2015.

**Sponsored spin-off.** The transaction planners might structure a deal in which a private equity firm or other financial sponsor buys a portion of the spin-off company's equity or parent equity or debt. Depending on the specifics, the sponsor may invest in the spin company before or after the spin-off. The sponsor could also invest in the debt or equity of the parent, which could be exchanged in the spin-off for spin-off company equity. As in the case of an IPO, the parent receives some or all of the proceeds from the sponsor's investment, for example, because it sells a portion of its subsidiary stock directly to the sponsor, because the subsidiary sells newly issued shares and then pays some or all of the proceeds to the parent in the form of a dividend or to satisfy an intercompany payable, or because parent debt is exchanged or retired. The sponsor investment and spin-off may also be coupled with other monetization or recapitalization transactions.

The parent and the subsidiary must structure the deal so that they do not run afoul of the tax rules. As noted above, the parent must possess "control" of the spin-off company prior to the spin-off. In addition, in order for the spin-off to be tax free to the parent, the sponsor's stake in the spin-off
company must be less than 50%. Depending on whether the sponsor invests before, after or simultaneously with the spin-off, other tax planning issues will need to be addressed.

The sponsor and the parent must negotiate the terms of the sponsor's investment. Will the sponsor receive common stock or preferred stock? Is the sponsor subject to a standstill? When will it be permitted to transfer its shares? The parties must also address governance questions. A sponsor is likely to want a seat on the board of directors, and the right to provide input regarding the business' future. Negotiating these issues can be difficult and time-consuming.

Sponsored spin-offs involving a public company parent and a private equity firm investor are relatively unusual. Examples include a 2006 transaction in which Alberto Culver spun off Sally Beauty, with buyout firm Clayton Dubilier & Rice acquiring a 47.5% interest in Sally Beauty. Another example is a 2007 transaction in which Marshall Ilsley Corporation spun off Metavante Corporation, with financial sponsor Warburg Pincus acquiring a roughly 25% stake in the spin-off company.

Partial spin-off. The transaction planners might also consider a partial spin-off, in which they distribute some but not all of the subsidiary shares. They might couple the partial distribution with subsidiary borrowings to generate cash for the parent. Then, at a later stage, the parent could generate additional proceeds by selling the balance of its shares in the spun-off company. Partial spin-offs raise tax concerns as generally the rules require the distribution of all stock and securities of the spin-off company held by the parent unless the parent can establish that the retention of spin-off company stock or securities was not to avoid federal tax.

Partial spin-offs are also relatively unusual, but there are a few examples. Ralcorp spun off approximately 80% of its interest in Post Holdings in 2012. In connection with this transaction, Post Holdings borrowed approximately $175 million in term debt and delivered a portion of the proceeds to Ralcorp. Ralcorp later distributed the balance of its shares in Post Holdings to its stockholders.

Debt-for-debt exchange. As the foregoing examples suggest, monetization opportunities are limited by the tax rules which provide that any proceeds received by the parent in excess of its basis in the subsidiary will be taxed. Various structures have been devised to avoid the effect of these rules. In a typical debt-for-debt exchange, an investment bank purchases parent debt securities in the market. It then exchanges them in return for spin-off company debt securities. In a subsequent step, the investment bank sells the spin-off company debt securities as part of a public offering or other transaction. The parent company also engages in a spin-off transaction, in which it distributes spin-off company shares to its stockholders. The net effect is that the parent's debt burden goes down, the subsidiary's debt burden increases, and the subsidiary operates as an independent company. The transaction may also be combined with the payment of cash by the subsidiary to the parent and other monetization transactions.

The beauty of the debt-for-debt exchange is that the parent may be able to reduce its debt by an amount that exceeds its basis in the subsidiary without triggering tax. To ensure appropriate tax treatment, the transaction planners must take into account IRS positions regarding the timing of the subsidiary debt issuance, the debt exchange and the sale of the spin-off company debt securities. The transactions are
complex, and require the parent and the investment bankers that act as exchange parties to assume some market risk. Adjustments to the structure may be necessary to take into account each company's tax attributes and other factors.

The Ralcorp-Post Holdings spin-off involved a debt-for-debt exchange in which Post Holdings issued debt to Ralcorp, which then exchanged this Post Holdings debt for Ralcorp debt that was held by a third party investment bank. The bank later sold the Post Holdings debt to the public.

**Debt-for-equity exchange.** Another variation involves an exchange of parent debt for subsidiary equity. Under this structure, an investment bank acquires parent debt in the market, and then swaps the parent debt with the parent in return for subsidiary equity. Following the debt-equity exchange, the investment bank sells the subsidiary equity in an IPO. The parent may also distribute subsidiary shares it continues to hold to its stockholders. The transaction may be combined with other monetization transactions, including debt-for-debt exchanges. The net effect is that the parent's debt is reduced and the subsidiary becomes an independent company.

As is the case with the debt-for-debt exchange, this structure may enable the parent to reduce its debt by an amount that exceeds its basis in the subsidiary. The transactions require careful attention to IRS guidance regarding the timing of the exchange and other matters. The structure also requires the parent to work closely with its investment bank, and as in the case of the debt-for-debt exchange, both the parent and the bank must assume market risk.

An example of a transaction involving a debt-for-equity exchange is the Sunoco-SunCoke Energy transaction. An investment bank affiliate acted as the debt exchange party. It swapped Sunoco debt obligations with Sunoco in return for SunCoke Energy shares, and then sold the SunCoke Energy shares to the public in the IPO.

**Morris Trust and Reverse Morris Trust transactions.** Spin-offs are often completed as part of a so-called *Morris Trust* or *Reverse Morris Trust* transaction, in which the spin-off is coupled with the sale of a business to a third party acquirer. In a *Morris Trust* transaction, the parent company creates a subsidiary that will operate the business that will continue to be owned by the parent company stockholders. The parent company retains the assets that the third party wants to acquire. The parent company then spins off the subsidiary to the parent company stockholders, and the third party combines with the parent company. In a *Reverse Morris Trust* transaction, the parent company spins off the assets that the third party wants to acquire. The third party then acquires the spun-off company, and the parent continues to operate as a streamlined entity.

*Morris Trust* and *Reverse Morris Trust* transactions raise considerable tax planning complexities. In general, unless a strict set of IRS requirements can be satisfied, the spin-off will be treated as taxable to the parent. Among other things, as a general matter, after the merger, the stockholders of the parent should continue to hold more than 50% of the stock of the companies that are combined in the merger.

If the parent's transaction planners and the third party acquirer can solve the structuring issues, *Morris Trust* and *Reverse Morris Trust* transactions do unlock value. They give the parent stockholders the
opportunity to benefit from a combination with a third party. In addition, they can be combined with other monetization and debt restructuring opportunities.

Examples of M&A transactions that were accomplished through a spin-off include Georgia Gulf’s acquisition of PPG’s commodity chemicals business. Another example is a deal in which Disney spun-off ABC Radio, which was then acquired by Citadel Broadcasting. In both the PPG and ABC Radio deals, the spin-off company paid a dividend to the parent as part of the transaction.

**Split-up.** As an alternative to a spin-off, transaction planners sometimes consider split-up transactions. In these deals, the parent company gives its stockholders an opportunity to exchange parent company stock for subsidiary stock, rather than distributing subsidiary stock as a dividend. As in the spin-off, the end result of the split-up transaction is the creation of two public companies, the parent company and the former subsidiary. Split-up transactions offer similar opportunities for monetization, recapitalization and capital raising. A recent example includes a 2013 transaction in which Pfizer took its veterinary products company Zoetis public in an IPO and then completed a split-up coupled with a debt-for-debt exchange.

**Conclusion.** This memo, of necessity, does not seek to describe all of the tax planning complexities associated with the different deal structures. Nor does it attempt to analyze in detail the pros and cons of each of the structures. The planning considerations are complex and depend crucially on the facts and circumstances of the particular deal. But transaction planners, working closely with their advisers, should be able to devise transaction structures that result in meaningful monetization and debt restructuring opportunities.

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**Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work or any of the following:**

- **Stephen I. Glover** - Washington, D.C. (202-955-8593, siglover@gibsondunn.com)
- **David B. Rosenauer** - New York (212-351-3853, drosenauer@gibsondunn.com)
- **Benjamin H. Rippeon** - Washington, D.C. (202-955-8265, brippeon@gibsondunn.com)
- **Alisa Babitz** - Washington, D.C. (202-887-3720, ababitz@gibsondunn.com)
- **Alexander L. Orr** - Washington, D.C. (202-887-3565, aorr@gibsondunn.com)

Please also feel free to contact any of the following practice group leaders:

**Mergers and Acquisitions Group:**

- **Barbara L. Becker** - New York (212-351-4062, bbecker@gibsondunn.com)
- **Jeffrey A. Chapman** - Dallas (214-698-3120, jchapman@gibsondunn.com)
- **Stephen I. Glover** - Washington, D.C. (202-955-8593, siglover@gibsondunn.com)

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