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Spin-offs and Reverse Morris Trusts

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Editor's Note: Daniel Wolf is a partner at Kirkland & Ellis LLP focusing on mergers and acquisitions. This post is based on a Kirkland & Ellis *M&A Update* by Mr. Wolf, Sara B. Zablotney, and David B. Feirstein.

Even with the recent slowdown in M&A activity, spin-offs have been among the transactions of choice in the past year. With everyone from economic mainstays like ConocoPhillips and Kraft to high-profile new players like TripAdvisor engaging in separation deals in the latest round of deconsolidation, it is an opportune time for dealmakers to consider the general implications of a spin-off on transformational corporate merger activity and certain structures that may allow for a combination of the two.

Corporations engage in spin-offs for a variety of business and financial reasons. A corporation's goals can be accomplished without U.S. federal income tax to the distributing corporation and its stockholders so long as the transaction meets the requirements of Section 355 of the Internal Revenue Code.

Failure to meet these requirements either before or after the transaction can cause a spin-off to be taxable to the distributing parent company (in the form of corporate- level gain generally equal to the appreciated value of the spun-off subsidiary), to the distributing parent's stockholders (in the form of dividend income equal to the value of the spun-off business), or both. These taxes can be prohibitively or even catastrophically expensive.

Section 355(e) of the Internal Revenue Code is particularly relevant to M&A activity — under that section, if 50% or more of the vote or value of the distributing parent or the spun-off subsidiary is acquired as part of a "prohibited plan" with the spin-off, the spin-off is taxable to the distributing parent (but not to its stockholders).

Under these rules, there is a rebuttable presumption that any acquisition of the distributing parent's or the subsidiary's stock that occurs during the two years prior to, and the two years after, a spin-off transaction is part of a "prohibited plan". However, an acquisition that fits within one of several regulatory safe harbors is not treated as part of such a plan. The safe harbors most relevant to M&A activity generally require that there be no “agreement, understanding, arrangement or substantial negotiations” regarding the contemplated deal (or a similar transaction) within a specified time frame of the spin-off (which can range, depending on the safe harbor, from a two-year period ending on the distribution date, to a one-year period beginning on the distribution date). These safe harbors therefore put a premium on avoiding discussions with the potential counterparty regarding a deal during the relevant “black-out” periods. Determining whether an agreement, understanding, arrangement or substantial negotiations exist with respect to any particular transaction requires examination of all the contacts between the corporation involved in the spin-off (and its officers, directors, controlling stockholders and agents) and the potential counterparty. In particular, conversations regarding price or exchange ratios generally will disqualify a transaction from the relevant safe harbors.

The fact-specific nature of the safe harbor inquiry, the high stakes and the highly technical nature of the tax analysis present significant practical concerns for dealmakers advising a client involved in both a spin and a transformational acquisition. Though deals predicated on satisfying a safe harbor certainly occur, they may not be possible or practical.

An alternative to a so-called “safe-harbor deal” is a post-spin M&A transaction where former stockholders of the distributing parent continue to own more than 50% by vote and value of the corporation involved in the spin-off (or its successor) after the closing of the transaction. A Reverse Morris Trust transaction, or RMT, is one such structure (named after a 1966 case blessing the structure). In an RMT transaction, as part of a plan, a merger partner merges with the distributing parent or spun-off subsidiary immediately after the spin-off in a tax-free transaction. The key to the tax free nature of an RMT transaction is that immediately after the transaction, historic stockholders of the distributing parent own more than 50% of the stock by vote and value of the combined company. As a result, an RMT is only practical if the merger partner is approximately the same size as, or smaller than, the spun-off subsidiary (or distributing parent). Where the two companies are approximately the same size, the merger partner may “right-size” itself by, for example, borrowing money and distributing the cash to its stockholders. In addition, though the >50% test is a bright line, the parties do have some greater flexibility in allocating between the two merger partners the initial composition of the combined company’s board of directors and management team.

A potentially attractive feature of an RMT transaction is the ability of the distributing parent to partially monetize its interest in the distributed subsidiary on a tax-efficient basis. For example, prior to the distribution of the subsidiary, it is fairly common for the distributing parent to cause the subsidiary to borrow money and distribute the cash to the parent. In another common structure, as part of the internal reorganization of assets by the distributing corporation to create and prepare a subsidiary for a spin-off, the subsidiary issues debt securities to the parent, which in turn exchanges those securities for outstanding parent indebtedness. In both cases, the parent has received a benefit from the subsidiary's leverage (that is, receipt of cash or debt relief), but the distributed subsidiary, and not the parent, has the obligation to repay the indebtedness. There are tax-based limitations on both of these strategies as well as a potential practical obstacle created by further driving down the value of the distributed subsidiary while the parties are trying to stay above the 50% minimum.

A recent example of an RMT transaction is Procter & Gamble's plan to dispose of its Pringles brand (now troubled due to accounting issues at the merger partner, Diamond Foods). In the Pringles deal, after Procter & Gamble distributes the subsidiary holding its Pringles brand, the subsidiary will merge with a subsidiary of Diamond, with historic P&G stockholders receiving approximately 57% of the combined company. As part of the deal, P&G (a repeat RMT customer after combining its Folgers business with JM Smucker in 2008) expects to receive from Pringles approximately $850 million in cash on a tax efficient basis (subject to adjustment within a collar based on the trading price of Diamond's stock around the time that the exchange offer or distribution occurs), a substantial portion of which will be used to retire existing P&G debt. In another recent proposed RMT deal, Entergy has announced that it plans to distribute its electric transmission business, which thereafter will combine with ITC. Prior to the transaction, ITC will right-size itself by borrowing approximately $700 million and will either distribute the proceeds to its stockholders or engage in a stock buyback. In the combination of ITC and the Entergy subsidiary, former Entergy stockholders are expected to receive 50.1% of the combined entity's equity by vote and value. Because of the high stakes of failing to satisfy Section 355(e)'s 50% test, Entergy has requested a ruling letter from the U.S. Internal Revenue Service on the transaction. If Entergy does not receive certain of its requested rulings, the agreements for the separation of the electric transmission business and the merger with ITC include a complicated adjustment mechanism designed to ensure that former Entergy stockholders do in fact hold more than 50% of the combined company by vote and value post-merger. This unusual feature shows another path for right-sizing entities to satisfy the requirements for a tax-free RMT transaction.

Although generically referred to as spin-offs, the separation transactions we have described can be structured as either a pro-rata distribution of shares of the subsidiary to the stockholders of the distributing parent (a true spin-off) or a voluntary exchange of the distributing parent's securities for those of the subsidiary at a set exchange ratio (a true split-off).

Under the right circumstances, RMTs can be a powerful method for planning a tax-free spin -off followed by a transformational transaction. While a straightforward direct sale of the distributed business would be taxable to the distributing parent, an RMT facilitates such a sale (and potential associated leveraging) on a tax-free basis. If a split-off (as opposed to a spin-off) is successfully employed, the distributing company achieves the added benefit of “repurchasing” some of its outstanding stock, with a resulting increase in EPS. By combining the attractive elements of a spin- or split-off with the strategic benefits of a stock-for-stock combination, an RMT can provide stockholders with increased value and diversification, allow a distributing parent to streamline its business and even create a monetization opportunity.