

Demystifying Spinoffs: Complex “IPOs” With a Sophisticated Tax Overlay

Key considerations when spinning off a business
segment or division

June 2025



Contents

Introduction	3
Overview	4
Navigating the IPO	5
SpinCo's Growth Story and Market Opportunity	5
The Disclosure Regime	5
Corporate Governance — Key Considerations	6
Interacting With Equity Research Analysts	8
The When-Issued Trading Market	8
Successfully Executing SpinCo's IPO — Timeline and Key Dates	10
Sample Spinoff Timeline	11
Executing the Carveout	12
Defining SpinCo — What's In and What's Out?	12
Capital Structure	12
Separation and Distribution Agreement	12
Transition Services Agreement	13
The Management Team and Other Employee and Cultural Matters	13
Employee Matters Agreement	14
Duties of ParentCo's Board of Directors	15
Achieving the Tax Objectives	15
Qualifying as a Tax-Free Spinoff	15
Tax Matters Agreement	17
Conclusion	17
Contacts	18

Introduction

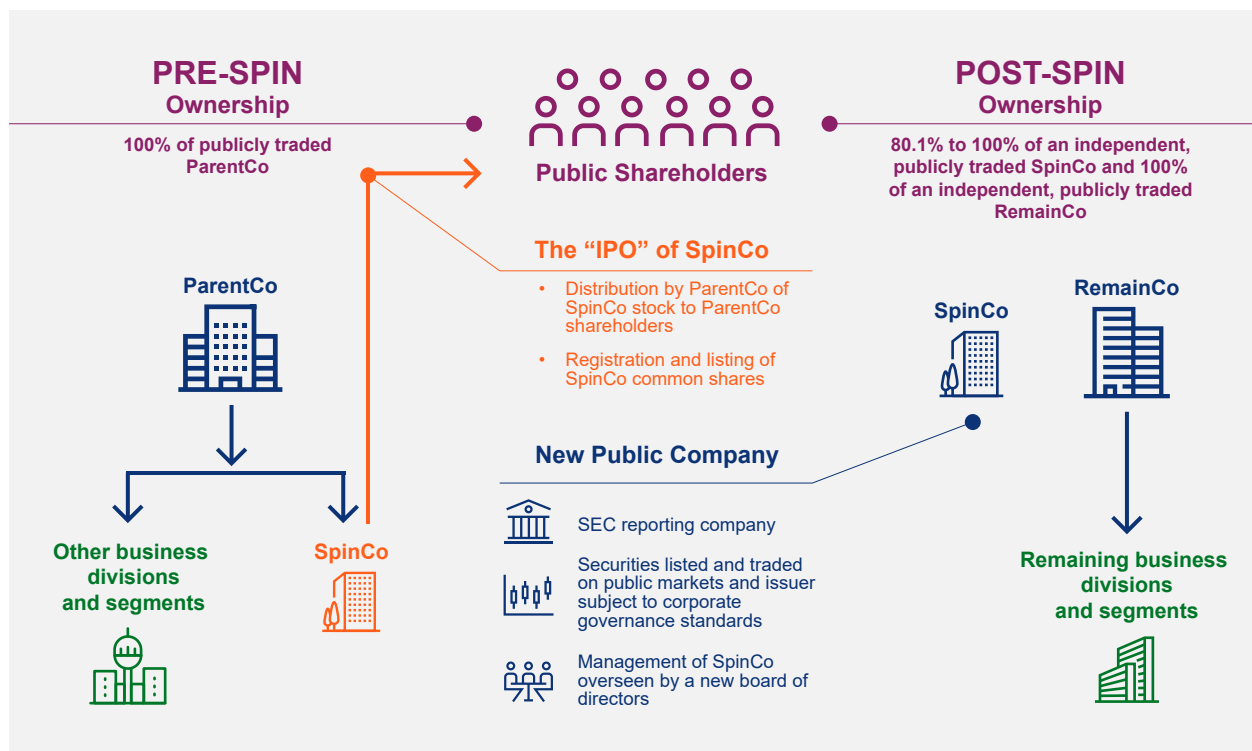
In a spinoff, a public company separates one or more of its businesses into a new, publicly traded company. For the public company that initiates it, a spinoff can achieve a number of critical business and financial objectives, including:

- Potentially achieving a greater valuation multiple and unlocking shareholder value by disposing of lower-valuation business segments
- Permitting investors to evaluate and make investment decisions based on the separate investment characteristics of each company
- Allowing the management teams of the separate companies to focus on their distinct core business, unhindered by the needs of the other business, leading to superior performance and results
- Providing each of the separate companies the flexibility to pursue distinct capital allocation strategies based on their respective business needs and priorities, and potentially achieving a more favorable cost of capital and greater access to the capital markets
- Providing each of the separate companies with its own public equity that can be used as an acquisition currency or to incentivize employees
- Allowing the divestment of a non-core business in a tax-efficient manner

A spinoff requires advanced planning across a number of disciplines, incorporating elements of capital markets, tax, finance, intellectual property, and mergers and acquisitions. This report identifies some of the primary considerations that companies may wish to take into account to help ensure a successful spinoff.

Overview

In a traditional spinoff transaction, the board of directors of the parent company (ParentCo) authorizes and declares a distribution of stock of the entity owning the assets and liabilities of the business that will be spun (SpinCo) to its stockholders on a pro rata basis to form a stand-alone, independent, publicly traded company. Often, ParentCo will distribute 100% of the SpinCo stock, but up to 19.9% can be retained in a spinoff that qualifies as tax-free, provided that certain additional requirements are satisfied.



Navigating the IPO

SpinCo's Growth Story and Market Opportunity

In essence, spinoff transactions are another form of taking a business public. Though no securities are being sold, the Form 10 registration statement can serve the same marketing purpose as an IPO S-1 registration statement. The Form 10 is an opportunity to tell SpinCo's growth story and to identify SpinCo's competitive strengths, strategy, position in the industry, and market opportunity. To create the most compelling story, SpinCo should involve investment bankers who are familiar with the relevant industry, peer companies, and market dynamics, as well as SpinCo's go-forward management team, who will sell the story to both existing and new investors during any non-deal roadshows and post transaction.

In addition to serving as a marketing document, the Form 10 will also provide the basis for future investor presentations and SpinCo's 1934 Act disclosure (i.e., Annual Report on Form 10-K), once SpinCo is a stand-alone public company. The Form 10 should not be viewed simply as a disclosure document that meets specified rule requirements, but rather as a marketing opportunity to sell SpinCo's story to the investment community.

In contrast to IPOs, one advantage of a spinoff transaction is that ParentCo does not need to time "market windows" because a spinoff is a distribution of stock as opposed to a capital raise. As a result, ParentCo can dictate timing and have greater certainty of execution. For example, during a relatively weak IPO market from 2022 to 2024, 90 spinoff transactions were announced by public companies.

The Disclosure Regime

Form 10 Registration Statement

Form 10 is a 1934 Act registration statement (unlike an IPO S-1, which is a 1933 Act registration statement) filed by SpinCo under SpinCo's name and EDGAR filing codes. Like an S-1 registration statement used in a pure IPO, a Form 10 may be confidentially submitted and will go through a full comment process with the SEC before being declared effective. Similar to the prospectus in an S-1, the information statement, which is filed as an exhibit to the Form 10 registration statement, is the primary disclosure document SpinCo will file with the SEC. The information statement will be mailed to all of ParentCo's stockholders in advance of the distribution and spinoff. While the formal rules applicable to Form 10 are less onerous than an S-1, common practice is to include fulsome disclosure and to mimic the structure of an S-1.

A key gating issue with respect to the Form 10 will be determining which financial statements are required; this can be a time-consuming process and should be one of the first issues the deal team addresses. The Form 10 must be filed publicly with the SEC at least 15 days prior to the requested effective date of the registration statement. To the extent SpinCo intends to issue bonds in connection with the transaction, as a practical matter for ParentCo to comply with Regulation FD, SpinCo will need to "flip to public" prior to commencing the bond offering. SEC comment letters and SpinCo's responses will be made publicly available on EDGAR no earlier than 20 business days after the effective date of the Form 10.

Notwithstanding the fact that legal opinions on the disclosure in a Form 10 are not given, and comfort letters are not provided by the accountants as in a traditional IPO, SpinCo will have liability on the Form 10 and will want to conduct a rigorous process to ensure accuracy of the disclosure. Treating the information statement in a similar manner to a capital markets offering document will also position the company for future offerings, in which they will be required to deliver legal opinions and comfort letters to underwriters.

The Separation and Distribution Agreement, Transition Services Agreement, Tax Matters Agreement, and Employee Matters Agreement discussed below are all traditionally filed as exhibits to the Form 10.

Corporate Governance — Key Considerations

After the bell at the exchange has been rung and the champagne has stopped flowing, SpinCo will need to be ready to operate as an independent, public company. In parallel with the Form 10 registration process, SpinCo must address a number of corporate governance matters and implement important governance policies and procedures. SpinCo's board composition must be decided, including assessing and identifying new directors who meet applicable independence requirements. While ParentCo and SpinCo may share certain of their directors and officers, too significant of an overlap can call into question whether there has been a genuine separation of the companies and risk the intended tax treatment of the spinoff. This is of particular concern if there are other significant connections between ParentCo and SpinCo following the spinoff, such as commercial arrangements or a retained equity stake.

SpinCo will also want to adopt a public company charter and bylaws with well-thought-out and appropriate takeover defense provisions (replacing the bare bones versions implemented at SpinCo's formation), and adopt and implement myriad corporate governance policies — including SEC- and exchange-compliant board committee charters, corporate governance guidelines, and insider trading and Regulation FD policies, among others.

Additionally, SpinCo will begin building effective internal controls over financial reporting and implementing disclosure controls and procedures. Typically, SpinCo will begin as a "non-accelerated filer" and, in connection with SpinCo's second Form 10-K annual report filing, SpinCo's management will be required to assess the effectiveness of SpinCo's internal controls over financial reporting, and, unless SpinCo is an emerging growth company (EGC), its auditor will be required to attest to, and report on, that assessment. However, if SpinCo leverages ParentCo's reporting history to facilitate immediate S-3 eligibility (provided certain financial statement requirements are satisfied), SpinCo will immediately be an "accelerated filer" and will be required to comply with the internal control over financial reporting requirements in connection with its first 10-K filing.

Naturally, ParentCo may be inclined to simply "dupe" ParentCo's well-worn governance structure at SpinCo, rather than consider specifically which governance structure is best suited to SpinCo as a new, stand-alone public company. ParentCo's governance structure is likely based on best practices for a mature, public company, having evolved over the course of ParentCo's history as a result of shareholder and board engagement and aligned with best practices advocated by proxy advisory firms such as ISS and Glass Lewis. However, best practice for a public company at ParentCo's stage of corporate life may not be desirable for a newly spun-off public company that may have a multiyear ramp to achieve profitability, execute on its business plan, or simply get its sea legs.

Newly spun-off companies regularly receive shareholder proposals on corporate governance matters one or two years following their debut as a public company. As a result, SpinCo should implement a governance structure that provides SpinCo with sufficient runway for its management team to execute on SpinCo's long-term business strategy and to prove themselves as an independent management team running a stand-alone business.

The need for a governance structure is particularly pressing for SpinCo's procedural and structural activism and takeover defenses. As a commercial matter, SpinCo is often "immature" on many levels at the point of separation and may face the following challenges:

- The equity markets will not have fully and efficiently valued SpinCo, as ParentCo's legacy shareholders may sell off shares due to differences in status with ParentCo (index inclusion, capitalization, sector, or geography)
- The management team is getting their bearings, both operationally and in interacting with institutional investors
- SpinCo will be burdened with the often high hurdles for future performance that ParentCo set when marketing the spinoff to its shareholders and analysts
- SpinCo's directors may have just joined the board and may be unfamiliar with SpinCo's operations and longer-term strategies, as well as with each other

Further, there is no "honeymoon period" for SpinCos with activists. This was exemplified by Trian's activism campaign at Solventum, announced only three months after their spinoff from 3M, and the intense activism from Cruiser Capital and AREX Capital at Enhabit, both of which announced campaigns within a year of Enhabit's spinoff from Encompass Health. Further, SpinCos have been subject to unsolicited tender and takeover offers shortly after a spinoff. As a consequence, providing SpinCo with both procedural and structural protections against unsolicited bids and activism during this vulnerable post-spin window will protect and enhance shareholder value at SpinCo, not diminish it.

Implementing many of the preferred protections in a spinoff is particularly easy — including a classified board, prohibitions on the calling of special meetings or actions by written consent by shareholders, and omitting majority vote, proxy access, and similar "shareholder friendly" mechanisms — as these protections are not likely to adversely impact "purchase" decisions by investors in the spinoff distribution paradigm. Similarly, employment agreements with market-level protections for executive officers and severance programs for other key employees often provide the comfort needed for leadership to focus on long-term value creation for shareholders.

SpinCo's full board is typically not constituted until the spinoff occurs, but that board will inherit the governance structure and transaction agreements put in place by ParentCo. As a practice point, ParentCo can consider holding an informal meeting of the to-be-constituted SpinCo board prior to the date of the spinoff to walk them through these agreements, including the Separation and Distribution Agreement, and to describe the governance structure in an effort to obtain "buy in" from the new SpinCo board.

Interacting With Equity Research Analysts

In a traditional IPO, companies host an analyst day to share management's financial model (including detailed, long-range projections) with the research analyst at each of its lead investment banks, to allow the research analyst to produce a proprietary model on the company prior to commencing the investor road show and closing the transaction. However, in a spinoff transaction, companies are not permitted to share management's model and projections with research analysts, as sharing that information would be in violation of Regulation FD, which broadly prohibits public companies from selectively disclosing material non-public information (MNPI). ParentCo is a public company subject to Regulation FD, and in most spinoff transactions the division or segment being spun off represents a material portion of ParentCo's business; therefore, projections regarding that division or segment constitute MNPI for ParentCo. As a result, analyst day meetings are typically not held in a spinoff transaction.

Consequently, some research analysts, including those who already cover ParentCo, may take a period of time post-closing before they initiate coverage on SpinCo. During this time, analysts will diligently SpinCo, wait for SpinCo to provide guidance to the Street, and build their own proprietary models.

When Is Guidance Provided?

In most spinoff transactions, SpinCo management often waits until SpinCo's first quarterly earnings call post-closing of the transaction before providing annual guidance. This timing allows SpinCo management to review its guidance policy and actual guidance figures with SpinCo's board of directors, which will be newly constituted at closing of the transaction. As an alternative, some SpinCos choose to publish their forecast guidance figures immediately prior to the closing of the spinoff transaction so they can discuss the guidance with investors during non-deal roadshows. These non-deal roadshows are typically held a couple of weeks prior to the closing, including during the "when-issued" trading period (discussed below). It is common practice for both ParentCo and (once the Form 10 is effective and SpinCo is a reporting company) SpinCo to file on a Current Report on Form 8-K the investor deck to be used at these non-deal roadshows to satisfy Regulation FD requirements.

When Does SpinCo's Stock Typically Trade at a Multiple That Represents Fully Distributed Value?

As a result of SpinCo's inability to provide research analysts with long-term projections and the typical timeframe in which SpinCo provides annual guidance to the Street, it often takes two to three quarters post-closing for SpinCo's stock to trade at a multiple that represents fully distributed value.

The When-Issued Trading Market

The when-issued trading market refers to the period of time after the spinoff has been authorized and a record date has been established, but prior to the actual issuance of shares of SpinCo's stock (which occurs on the distribution date), when SpinCo's stock trades on a conditional or when-issued basis. During this time, in addition to the when-issued market for SpinCo, two markets are established for ParentCo — a "regular-way" market, in which ParentCo shares trade along with the right to receive shares of SpinCo's stock on the distribution date, and an "ex-distribution" market, in which ParentCo shares trade without that right, representing what will remain of ParentCo following the spinoff (RemainCo).

Historically, the when-issued market would commence on the trading day immediately prior to the record date for the spinoff and would typically last for seven to 10 business days, with trading volume tending to be light until the day or two leading up to the distribution date. While Nasdaq still follows this approach, in recent years the NYSE revised its policy in response to the typical trading activity to provide for a shortened when-issued trading period, commencing three business days before the distribution date.

The last day of when-issued trading is the last full trading day prior to the commencement of regular-way trading. For Nasdaq, regular-way trading for SpinCo stock will commence on the first trading day following the distribution date (even if the distribution occurs pre-market on such day). For the NYSE, regular-way trading will commence on the first trading day immediately following the spinoff distribution itself (that is, on the distribution date if the distribution occurs pre-market).

The exchanges designate when-issued trading by adding the symbol “WI” to the end of SpinCo stock’s expected trading symbol (i.e., SPIN-WI) and, with respect to ParentCo’s ex-distribution trading, to the end of RemainCo stock’s expected trading symbol. The following is an example of the potential trades that investors can make during the when-issued trading market:

- ParentCo Ticker = ParentCo shares and right to receive SpinCo shares on the distribution date (equivalent to the combined company shares)
- RemainCo Ticker-WI = RemainCo shares without the right to receive SpinCo shares on the distribution date
- SpinCo Ticker-WI = The right to receive SpinCo shares on the distribution date

Investors who purchase RemainCo Ticker-WI or SpinCo Ticker-WI in the when-issued market prior to the distribution receive a “due bill,” and such trades are settled one day following the commencement of regular-way trading.

The benefits of a when-issued trading market are that it can indicate the demand for SpinCo and RemainCo stock and attract investors to SpinCo who don’t own ParentCo stock by allowing them to begin trading the right to receive shares in the spinoff on a when-issued basis. The when-issued trading market can also reduce volatility in SpinCo and RemainCo stock once the stocks trade on a regular-way basis, and can provide liquidity for the sale of fractional SpinCo shares by the transfer agent prior to the distribution date.

From a governance perspective, both the NYSE and Nasdaq consider “listing” to commence, and applicable governance requirements to take effect, at the time when-issued trading commences, although SpinCo can take advantage of controlled company accommodations during the when-issued trading period (as it will only have one stockholder, ParentCo). Consequently, at a minimum, SpinCo must have one independent director on its Audit Committee at the time when-issued trading commences. Companies should be mindful of this requirement to appoint an independent Audit Committee member in advance of closing the transaction as the go-forward SpinCo board of directors is typically not constituted until the distribution date.

Successfully Executing SpinCo's IPO — Timeline and Key Dates

Clearing a Form 10 with the SEC follows the same process as clearing an S-1, with the same 30-day window for initial comments and approximate 10- to 14-day window for subsequent comments. The end stages of a spinoff do offer more timing flexibility than a traditional IPO, however, certain considerations should be kept in mind.

Declaration Date

The declaration date is the date the spinoff is declared, when the ParentCo board formally approves the spinoff and sets the record date, distribution date, and distribution ratio. The two primary considerations when selecting the distribution date are the status of the SEC process and exchange notice requirements. Though the Form 10 does not have to be completely cleared with the SEC prior to the declaration date, ParentCo and SpinCo should have confidence by the declaration date (including conversations with their SEC examiner) that all comments from the SEC will be resolved prior to the intended record date, to avoid any date changes subsequent to board approval.

Additionally, both the NYSE and Nasdaq have a strict 10-calendar-day notice requirement in advance of the record date. Public notice should not be given until board approval is obtained, so the declaration date should be at least 10 calendar days prior to the intended record date. As the NYSE has clarified in recent years, only one small exception exists to this requirement — notice can be given to the public via press release eight calendar days prior to the record date if private notice has been provided to the NYSE at the requisite 10 calendar days (and the NYSE may permit this private notice to be conditional, pending board approval by the eighth day).

Form 10 Effective Date

Similar to a traditional IPO, any confidentially filed Form 10 must be publicly filed 15 days prior to going effective (since a spinoff does not involve an offering-related roadshow, the 15-day requirement relates to effectiveness of the registration statement instead of a roadshow launch). Upon expiration of that 15-day period, effectiveness can be requested any time after the Form 10 and information statement are in final form, though on occasion spin-related details like dates, distribution ratios, and share counts may still be open (in which case, the fully final information statement should be filed on a SpinCo 8-K).

Effectiveness is advisable, though not required, prior to printing the information statement for any stockholder mailing, as no changes should be made after printing has begun. Effectiveness is required prior to the commencement of when-issued trading, and is also required for the transfer agent to initiate eligibility conversations with DTC. Certain investment banks may also prefer effectiveness of the Form 10 prior to the commencement of any non-deal roadshow.

Record Date

As noted above, the record date should be at least 10 calendar days after the declaration date, but can be later. The record date will also impact logistics related to the dissemination of the information statement. In recent years, many SpinCos have chosen to use notice and access to distribute the information statement, rather than a full mailing. Similar to an annual meeting proxy statement, a notice card is mailed to record holders explaining how to access an electronic version of the information statement

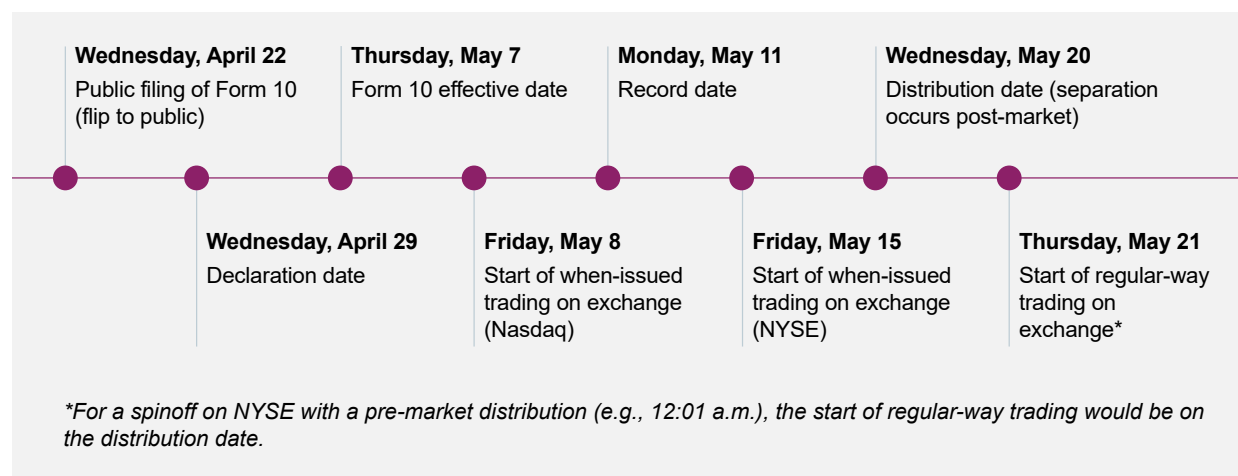
(though unlike an annual meeting proxy statement, there is no 40-day timing requirement for the notice). Broadridge, who will coordinate mailings of the notice cards or full information statements, as applicable, to all beneficial holders whose shares are held through DTC, requires approximately three business days following the record date to finalize the stockholder list and begin the mailing process.

Distribution Date

The amount of time between the record date and distribution date is usually driven by logistical considerations involving the exchange and transfer agent. Traditionally, the distribution date is seven to 10 business days after the record date, but at minimum a few business days are required. The distribution date is also driven in part by DTC. SpinCo's shares must be DTC-eligible by the distribution date, and DTC requests 10 calendar days' advance notice for eligibility (though occasionally they do not require the full amount of time).

Assuming notice and all required documents are sent to DTC on the effective date (see above), then the distribution date should be no earlier than 10 days after the effective date. Additionally, the notice cards or full information statements should at least be mailed to, but ideally delivered to, all stockholders prior to the distribution date.

Sample Spinoff Timeline



Executing the Carveout

Defining SpinCo — What's In and What's Out?

As an initial matter, ParentCo has the ability to define the scope of the business SpinCo will conduct. ParentCo will have two primary goals in this regard. First, ParentCo, in consultation with its financial advisor, will seek to delineate SpinCo's business in a manner that will create a compelling investment thesis for both SpinCo and RemainCo. Second, ParentCo will want to ensure that the nature of the business being spun off relative to the business being retained supports ParentCo's underlying rationale for conducting the spin. For example, if ParentCo desires to separate the two businesses in order to reduce ParentCo's cost of capital, it should demarcate SpinCo's business in a manner that is designed to achieve that goal.

Once ParentCo has identified the business that SpinCo will conduct, it will outline the structural steps needed to transfer that business into SpinCo. This process may involve moving ParentCo subsidiaries, transferring specific assets and liabilities (including contracts, intellectual property, and real estate), and selecting the employees who will support the SpinCo business. Once the spinoff steps have been defined, ParentCo will divide these steps a number of functional workstreams; these workstreams may require involvement from the treasury, tax, financial reporting, human resources, supply chain, and investor relations functions at ParentCo. ParentCo and its counsel also will begin preparing the legal documentation (i.e., the Form 10 and related transaction documentation) to effect the transfers that are required to establish SpinCo's business.

Additionally, ParentCo must analyze how the transfer of assets and liabilities to SpinCo and separation of SpinCo from ParentCo will impact ParentCo's existing bank debt and any outstanding indentures as well as its other material contracts, whether any third-party consents will be required, and whether the transfers will result in any material tax liabilities.

Capital Structure

Along with identification and transfer of SpinCo's business and the implications of the spinoff for its own capital structure, ParentCo will consider the appropriate initial capital structure of SpinCo. In particular, ParentCo must determine both the nature and amount of debt at SpinCo at the time of the spinoff, which will depend in large part on the nature of SpinCo's business and the reasons for ParentCo's desire to undertake the spinoff. If ParentCo is seeking to conduct the spinoff as a means of de-levering itself, for example, it may seek to either transfer debt to SpinCo or cause SpinCo to incur new debt and distribute the borrowings to ParentCo. Whether SpinCo's new debt takes the form of a credit facility, newly issued bonds, or assumed debt from ParentCo also will depend on SpinCo's ability to access new bank debt or debt capital markets around the time of the spinoff. Alternatively, ParentCo could de-lever itself by retaining SpinCo equity in the spinoff and exchanging the equity for ParentCo debt.

Separation and Distribution Agreement

The Separation and Distribution Agreement establishes the framework for the separation of SpinCo as an independent company and the relationship between ParentCo and SpinCo post-transaction. This agreement will define the business to be spun and allocate assets and liabilities between ParentCo and SpinCo. In some transactions, this agreement can provide an opportunity for ParentCo to offload

unwanted liabilities to SpinCo, though ParentCo should keep in mind SpinCo's solvency requirements. To the extent restructuring steps are required in order to position those assets and liabilities with the appropriate entity, this agreement will also traditionally outline such steps, and can include their completion as a closing condition to the spinoff.

The agreement includes a number of other conditions to close, such as the satisfaction of regulatory requirements, the listing of SpinCo with the applicable exchange, receipt of a tax opinion from a law firm or ruling from the IRS on the intended tax treatment of the spinoff, effectiveness of the Form 10 registration statement, and more. The Separation and Distribution Agreement also will contain indemnification provisions between the parties that often survive indefinitely post-closing and can be the subject of post-closing disputes between ParentCo and SpinCo.

Though the actual negotiation of the Separation and Distribution Agreement commonly occurs later in the process to minimize the impact of oft-challenging dynamics between ParentCo and SpinCo, the parties will identify the allocation of assets and liabilities early in the process. Doing so will allow sufficient time to determine the often-complicated mechanics of the separation and facilitate drafting of the Form 10 and the creation of its required financial statements. As ParentCo's board and management team control the spinoff, the terms of the separation are typically established by ParentCo and inherited by SpinCo and its board.

Transition Services Agreement

In most spinoff transactions, ParentCo provides certain transition services to SpinCo for a period of time post-closing. The breadth and length of these services often depends on how intertwined the two businesses were pre-closing, and typically most transition services last between three and 18 months. The Transition Services Agreement is the agreement pursuant to which ParentCo and SpinCo agree on the transition services, and parties usually schedule the scope of services to be provided, as well as the term and pricing. This schedule is typically excluded from the version of the Transition Services Agreement that is filed as an exhibit to the Form 10.

Understanding which transition services will be needed, how they will be provided, and how long the services will last can be a long lead-time item in the process. In general, any arrangements between ParentCo and SpinCo that are intended to persist beyond a transitional period should be negotiated on and should reflect arm's-length terms.

The Management Team and Other Employee and Cultural Matters

The ultimate outcome of a spinoff transaction is to create a stand-alone, independent, publicly traded company, with SpinCo having its own board of directors, management team, employees, and corporate headquarters. At some point in the transaction it will be necessary to determine who will form the leadership of SpinCo (including Chair of the board, CEO, and CFO), which officers and employees are joining SpinCo, and which are remaining with RemainCo. Sometimes, it is obvious when the business being spun off is a segment or division that has operated largely independently with a clearly identifiable management team, and other times it is not so clear cut when the business being spun is intertwined to a meaningful degree with the overall business. Particular challenges may arise across shared corporate functions and with regional or international leadership teams, in particular if the combined organization typically engaged with government officials or ministries as a "single face" for the organization.

The timing for making and announcing these decisions is important, as inevitably once the “teams” are selected, a dynamic of “us versus them” can begin to develop, leading to potential conflicts of interest and cultural issues. In addition, from a change management perspective, it is important to recognize that, for many individuals, the separation into teams impacts long-standing personal and professional relationships or may present a meaningful change to career development planning. There may also be a perception of “winners” and “losers” that will need to be managed from a retention and incentive perspective.

To ensure a successful execution of the transaction for both SpinCo and RemainCo, both companies will benefit from everyone rowing in the same direction. ParentCo’s board and senior management team must balance the need to make decisions that will position SpinCo to operate successfully as a stand-alone company with ensuring that decisions are not made too early, potentially impacting deal dynamics and the company’s culture.

ParentCo often names SpinCo’s Chair, CEO, and CFO earlier in the process (often coinciding with announcing the intention to spin off the business) to enable pre-planning for SpinCo’s financial profile and strategic and cultural frameworks, with decisions on the broader management team and employee base coming later. While this approach effectively maintains business continuity, if the allocation of employees between RemainCo and SpinCo is unclear, a gap in communication may create unnecessary anxiety and potential retention issues among the employee base. One potential mitigation for this risk is to make decisions on a staged, leveled basis, determining layers of leadership one at a time, from most senior to junior. This method enables each management level to engage in the allocation of headcount to best preserve high-performing teams and ensure equitable allocation of talent to set up both companies for success. Regardless of the process selected, consistent communication to employees is critical — even if only to communicate that no decisions have been made yet — as employees will fill an information void with their own predictions or suspicions.

Once employee allocation decisions have been made and communicated, having a formal process in place to manage inevitable appeals of placement decisions and “back room” recruiting efforts is vital. A dedicated talent management committee (with representation from both RemainCo and SpinCo) may be useful in managing these activities, but a clear decision-making process with a near-zero tolerance for exceptions is crucial to maintaining order and focus among the employee base.

Employee Matters Agreement

The Employee Matters Agreement governs ParentCo’s and SpinCo’s compensation and employee benefit obligations relating to current and former employees of each company, and generally allocates liabilities and responsibilities relating to employee compensation and benefit plans and arrangements. This agreement will specify how outstanding ParentCo equity-based compensation awards are treated in connection with the separation. For example, ParentCo awards may “follow” the employee, with ParentCo awards held by employees of SpinCo converted into SpinCo awards and ParentCo awards held by employees remaining with ParentCo continuing to represent ParentCo awards.

Alternatively, all employees may be treated the same, regardless of which entity will be the holder’s employer after the separation, in which case either (i) all awards may be split into two awards, one representing an award in ParentCo and one representing an award in SpinCo, or (ii) all awards may continue to represent a ParentCo award.

Irrespective of which approach is adopted, the aggregate intrinsic value of the award immediately prior to the separation will be preserved immediately after the separation through adjustments to the awards that reflect the change in value of ParentCo resulting from the separation and, if applicable, the new value of SpinCo.

Duties of ParentCo's Board of Directors

ParentCo's board must satisfy its duties of care and loyalty to ParentCo and its stockholders in making the decision to distribute SpinCo's stock to its stockholders and satisfy itself that the distribution is a permissible dividend. In determining to distribute SpinCo's stock and effectuate the distribution and separation, under Delaware law, ParentCo's board of directors and executive officers do not owe any fiduciary duties to SpinCo or its future stockholders. As a consequence, the directors of ParentCo are free, as a fiduciary matter, to consider the interests of only ParentCo's shareholders in establishing the terms of the spinoff and separation arrangements. However, as ParentCo's shareholders will receive the SpinCo shares, setting up SpinCo for commercial failure, or establishing a capitalization under which SpinCo cannot practically operate (or might even lead to its insolvency), could lead to a breach of fiduciary duty claim by ParentCo shareholders or possible claims of fraudulent conveyance.

A traditional spinoff transaction is a distribution, or dividend, under state law and, therefore, must comply with the requirements of the law of the state in which the parent company is organized. For Delaware corporations, boards of directors must determine that ParentCo has sufficient "surplus" (the amount by which net assets exceed capital) from which to pay the dividend of SpinCo stock. In the case of a spinoff, the dividend is composed of the value of the equity interests in SpinCo being distributed.

For purposes of this calculation, actual current value, not book value, should be used, which ordinarily results in a substantial increase in surplus relative to book. In Delaware, a board may utilize third-party experts to validate the calculation of assets (defined as the amount by which total assets exceed liabilities) in calculating adequate surplus; as directors can bear personal liability for an improperly declared dividend, use of third-party advisors or reasonable reliance on well-founded management analysis of net assets and solvency is recommended. Stockholder approval of the dividend is typically not required under the laws of most states.

Achieving the Tax Objectives

Qualifying as a Tax-Free Spinoff

The benefit of a tax-free spinoff is that there is no tax at either the ParentCo level (with respect to the appreciation in SpinCo) or the shareholder level (with respect to the value of the SpinCo stock received). In order for a spinoff to qualify as tax-free, the transaction must meet a number of requirements. A detailed description of all the requirements is beyond the scope of this report, but the principal tests in brief are as follows:

- **Active Business Test.** Each of the ParentCo business and the SpinCo business must have been actively conducted by ParentCo and/or SpinCo for at least five years, and must not have been acquired in a taxable transaction within the past five years unless such acquisition qualified as an "expansion" of an existing business.

- Corporate Business Purpose. The spinoff must be motivated by a corporate-level business purpose (other than the saving of federal taxes) that cannot be efficiently achieved through any other nontaxable transaction. Note that shareholder-level business purposes (e.g., to increase shareholder value) are not sufficient, though they may provide a basis for demonstrating a valid corporate business purpose. Examples of common business purposes include:
 - To facilitate access to capital for either ParentCo or SpinCo
 - To enhance “fit and focus” of the ParentCo and SpinCo businesses
 - To provide an equity interest in either the ParentCo or SpinCo business to current or prospective employees
 - To facilitate the use of equity as an acquisition currency (where spinoff is expected to increase equity value and thereby reduce dilution)
 - To facilitate a tax-free acquisition of ParentCo or SpinCo such as a “Morris Trust” or “Reverse Morris Trust” transaction
- Distribution of Control. ParentCo must distribute at least an 80% interest in SpinCo to ParentCo shareholders. ParentCo’s retention of any SpinCo stock or securities following the spinoff would generally require a ruling from the IRS, although if recently proposed regulations are finalized in their current form, they would establish retention criteria that, if satisfied, would eliminate the need for a ruling. The retained stock or securities are generally used in a tax-free debt-for-debt or debt-for-equity exchange to de-lever ParentCo in a tax efficient manner, but they can also be distributed to ParentCo shareholders or sold for cash in a taxable exchange.
- Device Test. The spinoff cannot be used principally as a device to distribute earnings and profits. A taxable sale of ParentCo stock or SpinCo stock subsequent to the spinoff is evidence of device. The larger the percentage of stock sold and the nearer in time to the spinoff, the stronger the evidence.
- Limitations on Acquisitions of ParentCo or SpinCo Stock as Part of a “Plan” With the Spinoff. If one or more persons acquire 50% or more of either ParentCo or SpinCo as part of a “plan” with the spinoff, the spinoff will be taxable to ParentCo but not ParentCo shareholders. Any acquisition that occurs from two years before the spinoff to two years after the spinoff is presumed to be part of a “plan,” but the presumption is rebuttable, and there are several helpful safe harbors.

A related consideration is whether to seek a ruling from the IRS on the tax-free nature of the spinoff, which can take several months, or to instead rely on an opinion of counsel. Unless ParentCo plans to retain SpinCo equity following the spinoff or there are other novel issues at play, companies generally rely on an opinion of counsel (which eliminates the timing variable of waiting to obtain an IRS ruling).

Tax Matters Agreement

The Tax Matters Agreement has two basic functions. The first is to govern ParentCo's and SpinCo's respective rights, responsibilities, and obligations after the spinoff with respect to tax liabilities and benefits arising in the ordinary course of business during the pre-spinoff period, including the division of tax attributes, the preparation and filing of tax returns, the control of audits, and other tax matters. The second is to safeguard the tax-free treatment of the spinoff and to allocate responsibility for the resulting taxes should the spinoff ultimately be found to be taxable. In particular, the Tax Matters Agreement typically lists a number of post-spin transactions (e.g., disposition of assets, acquisition or issuance of SpinCo stock) that SpinCo cannot engage in within two years after the spinoff without first obtaining an opinion of counsel acceptable to ParentCo. The agreement also imposes an indemnification obligation on SpinCo should it cause the spinoff to be taxable regardless of whether it obtains an opinion. The agreement typically does not have a symmetrical set of restrictions on ParentCo, since ParentCo is already incentivized not to cause the spinoff to be taxable given that ParentCo is the liable party vis-à-vis the IRS for any tax liabilities resulting from the spinoff being taxable.

Conclusion

Spinoffs require many of the same business and legal preparations as an IPO — with the added complexity of separating a business in two. ParentCo must not only register SpinCo with the SEC and successfully market SpinCo stock to investors and analysts, it must also prepare SpinCo to operate as a stand-alone public company and address employee, cultural, and business changes that go along with separating a business unit. This complex method of taking public a new company benefits from legal advice that pairs technical sophistication with a deep understanding of the strategic, commercial, legal, tax, and regulatory hurdles that could arise. Latham combines premier capital markets and transactional tax practices with many years of experience advising on spinoff transactions to offer clients market-tested, practical advice on how to navigate the spinoff process successfully.

Contacts

Capital Markets



Alexa M. Berlin
alexam.berlin@lw.com
+1.312.777.7201
Chicago



Cathy A. Birkeland
cathy.birkeland@lw.com
+1.312.876.7681
Chicago



Kenneth (KC) Sands
kenneth.sands@lw.com
+1.312.777.7162
Chicago

M&A



Ryan J. Maierson
ryan.maierson@lw.com
+1.713.546.7420
Houston

Transactional Tax



Jared W. Grimley
jared.grimley@lw.com
+1.713.546.7403
Houston



Pardis Zomorodi
pardis.zomorodi@lw.com
+1.424.653.5565
Century City