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CORPORATE SPIN-OFFS AND FEDERAL SECURITIES LAW

By **James R. Hagan, Esq.**

Recently, several major corporations have used the method of "spinning-off" a new subsidiary in order to create new and additional value for the parent shareholders. Historically, "spin-offs" were used by established corporations to divest themselves of an underperforming division or a part of the business which was incompatible with the core focus of the parent. A good example of this tactic is exhibited most recently in the spin-off of the Alamo and National car rental chains from the parent, AutoNation, Inc. The parent is "separating" the lack luster rental unit to allow investors "to better recognize and evaluate the strengths and growth prospects of (our) automotive retail operations." The spin-off is an attempt to boost the lagging stock price.

However, in today's high-tech, high-growth environment, the "spin-off" has taken a new twist. Parent companies are carving out high profile divisions eager to have such "spin-outs" independently valued by the marketplace and in an effort to exploit current market conditions. Such internet and tech "spin-offs" create an independent company with an independent stock which may be publicly traded and which creates wealth for the parent company shareholders. In fact, five of the most lucrative IPO's of all time were spin-offs: AT&T spun off Lucent for \$3 billion, News Corporation spun-off Fox Entertainment for \$2.8 billion, CBS carved out Infinity Broadcasting for \$2.8 billion, Sears realized \$2.1 billion for Allstate, and DuPont sold off Conoco for \$4.4 billion.

Small, as well as large, corporations can use spin-offs to create additional value for shareholders. However, many aspects of federal securities laws apply to spin-offs and corporations must be careful to comply with all such laws.

A spin-off occurs when a parent corporation distributes to its stockholders the stock of a wholly owned or partially owned subsidiary. Such a distribution raises several federal securities law questions. In Corporate Finance Staff Legal Bulletin No. 4 dated September 16, 1997, issued by the Division of Corporate Finance of the Securities and Exchange Commission, the SEC staff considered the legal issues related to spin-offs. This article is based upon material discussed in that Bulletin.

The basic law regarding securities is simple. Under section 5 of the Securities Act of 1933

(hereinafter referred to as the "Securities Act") every sale of securities must be registered unless it is exempt. Accordingly, there are three legal questions to consider. Is a spin-off a "sale?" Is a spin-off sale exempt from registration? After a spin-off, may shareholders trade the stock?

Is a Spin-Off a Sale?

In most cases, a spin-off is not a sale. Normally, a spin-off occurs as a dividend to the shareholders of the parent. In order not to be a sale, the spin-off shares must be distributed on a pro rata basis to all shareholders of the parent without any consideration. In that case, the spin-off is not a sale and may be accomplished without registration. A pro rata distribution also exempts the spin-off shares from the short-swing profits provision of Section 16 of the Securities Act.

Securities Act Rule 145 can sometimes change the result described above. Rule 145 requires that certain exchanges of securities are equivalent to sales and therefore must be registered. Under Rule 145, if assets are transferred by the parent to the subsidiary, and the subsidiary is only partially owned by the parent, and shareholders of the parent approve the transaction, the spin-off is an exchange which requires registration. However, on the same facts, if the subsidiary is wholly-owned, the transaction is not an exchange and the spin-off may be accomplished without registration.

Is a Spin-Off Exempt from Registration with the SEC?

Sections 3 and 4 of the Securities Act provide several exemptions from the requirement for the registration of securities. Section 3 exemptions do not apply to spin-offs. The exemptions which apply to a spin-off are contained in Sections 4(1) and 4(2) of the Securities Act. Section 4(1) exempts from registration sales of securities by a person other than an issuer, underwriter, or dealer. Section 4(2) exempts from registration sales of securities by an issuer not involving any public offering. (The other two statutory exemptions in Section 4 of the Securities Act do not apply to spin-offs. Section 4(3) exempts from registration transactions by dealers, and Section 4(4) exempts from registration brokers transactions for customers which are accomplished on a stock exchange.) In the ordinary case of a spin-off, so many shareholders will be involved that the distribution of shares will constitute a public offering. Accordingly, the Section 4(2) exemption will not apply and the legal question will be whether or not the parent is an underwriter under Section 4(1) of the Securities Act.

The parent is not an underwriter if two conditions are met:

(a) The first condition is that the spin-off must be done for a valid business purpose. This requirement is not difficult to meet.

(b) The second condition concerns restricted securities.

(i) Restricted securities are defined in SEC Rule 144 as securities obtained from an issuer in a private transaction, securities acquired from an issuer that are subject to certain

resale limitations, and securities acquired as specified in Rule 144A, Regulation CE, or Regulation S. Securities involved in a spin-off will almost always be restricted securities which the subsidiary issued to the parent in a private offering.

(ii) If the business to be spun off has been acquired by the parent instead of originally created by the parent, the parent must have held the restricted securities for at least two years. If the parent has not held the restricted securities for that period of time, the parent is an underwriter and registration is required.

(iii) If the parent originally created the business, there is no two year holding period for the restricted securities, and the spin-off may be accomplished without registration.

Are Spin-off securities restricted?

The securities issued in the spin-off are not restricted securities under Rule 144 if there is adequate public information about the spun-off subsidiary.

(a) In most cases, adequate public information may be provided in one of two ways.

(i) Not later than the date of the spin-off, the parent may provide an Information Statement under Regulation 14A or 14C to the shareholders who receive the spin-off shares, and the subsidiary may register the spin-off shares, usually by means of an SEC Form 10.

(ii) In the alternative, the subsidiary may become a reporting company under the Exchange Act at least 90 days before the date of the spin-off, and the parent, not later than the date of the spin-off, may provide shareholders with information about the distribution ratio and fractional shares and about the expected tax consequences of the spin-off

(b) Under Rule 144, affiliates of the subsidiary may only rely on Rule 144 for the resale of the subsidiary's stock after the subsidiary has been a reporting company under the Exchange Act for at least 90 days.

USE OF A SUBSIDIARY TO SPIN-OFF

One example of how to effect a quick and inexpensive spin-off and stay in compliance with the various securities laws, rules, and regulations is as follows:

1. In order to avoid having the parent corporation determined to be an underwriter, Company A (the parent) may form a subsidiary, Subsidiary X (the spin-off corporation).
2. In a private transaction under Section 4(2) of the Securities Act, in exchange for stock of subsidiary X, Company A may transfer to Subsidiary X the business and assets which Company A wishes to spin-off.
3. Subsidiary X will begin immediately to conduct business as a independent corporation and undertake to become a reporting company under the Exchange Act.
4. About 120 days after Subsidiary X becomes a reporting company, for good and valid business reasons, Company A can make a dividend to its common shareholders of the common stock of Subsidiary X, and thereby "spin-off" Subsidiary X to Company A's shareholders on a pro rata basis.
5. With the assistance of financial advisors and market makers, the common stock of Subsidiary X can begin to trade in the public markets.

At the conclusion of this process, Subsidiary X will be a new independent company whose stock trades in the public markets thus create liquidity for its shareholders.

The information provided herein is not intended as legal advice and should not be acted upon. If you have additional questions about this subject matter or would like to consult with an attorney, please call Jennifer J. Hagan or James Hagan at The Hagan Law Firm (650) 322-8498.

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