

# Best Practices: How a board can enhance shareholder value creation in a spin-off

By David Rievman, Esq., Neil Stronski, Esq., Brandon Van Dyke, Esq., and Nicholas Colombo, Esq.,  
Skadden, Arps, Slate, Meagher & Flom LLP\*

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## Key points

- Strong board decision-making and engagement can be crucial to maximizing shareholder value in a spin-off.
- Due to high interest rates and the current capital markets environment, companies are increasingly considering variants on the traditional spin-off structure such as “sponsored” and “retained stake” spin-offs, which present unique costs and benefits.
- Boards should be thoughtful about pre-spin discussions with third parties regarding strategic transactions because the rules surrounding tax-free spin-offs may create limitations on future transactions.
- In determining the spun-off entity’s (spinco’s) corporate governance structure, the board should weigh a number of factors to best position the spinco for success.
- Boards will want to take an active role in certain key investor relations and communications matters regarding the spin-off.

In an article last year, we discussed the increased pressure companies face<sup>1</sup> to separate businesses that are not deemed “core,” and why tax-free spin-offs and similar transactions may be the most appealing way to achieve this.

Here we discuss the board’s role in executing a successful spin-off once a decision to pursue one has been made. While day-to-day execution of a spin-off will largely be the responsibility of management, boards have an important role to play throughout the process in order to maximize shareholder value through the transaction.

## Variants of the ‘plain vanilla’ spin-off are increasingly common, but they can complicate the process

The parent in a spin-off typically will need to right-size its capital structure by refinancing a portion of its existing debt. Often that is accomplished by the spinco issuing debt and using the proceeds to pay off a portion of parent’s debt.

However, we have observed an increased focus on equity transactions with spincos, executed before or concurrently with the spin-off, that either facilitate parent debt refinancing, provide additional capital for the spinco, or help establish a more stable trading market in spinco stock. In particular, certain companies may find these transactions more appealing in light of the continued high-interest-rate environment.

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Tax considerations play an important role here. The tax-free nature of the spin-off can generally be maintained so long as at least 80% of the shares are distributed to existing shareholders or securityholders. This means that a maximum of 20% of the spinco equity may be issued to other investors in advance of the spin-off.

Under a separate rule, the aggregate amount of spinco equity that can be issued to non-parent shareholders and securityholders as part of a plan with the spin-off cannot exceed 49.9% by vote or value.

Where the goal is to provide additional capital for the spinco or establish a more stable market in its stock, a parent board may consider a direct equity investment in the spinco by “anchor” investors through a private placement, executed concurrently with the spin-off or in an IPO ahead of the spin-off. A parent may also use the proceeds of that transaction (distributed to parent in a pre-spin dividend) to repay its existing debt.

In other cases, we have seen parent companies retain a 20% or smaller stake in the spinco following an 80% or greater spin-off, which the parent then uses to further adjust its capital structure. That can be accomplished by exchanging spinco equity for parent debt, exchanging spinco equity for parent equity or selling spinco equity for cash.

Particular transactions may pose additional tax issues which will need to be carefully assessed. In addition, boards will have to weigh potential drawbacks to these structures:

- The added time needed to negotiate a private placement with a third-party.
- The restrictions on the spinco management resulting from having a significant third-party investor.
- Potential execution risks entailed by a significant private placement or an equity-for-debt exchange (e.g., regulatory approvals).
- The potential impact of any “overhang” on the trading price for spinco stock.

### **Potential pitfall: Discussions with third parties about strategic transactions**

The decision to pursue a spin-off often comes as part of a larger review of strategic alternatives. In addition, the announcement of a spin-off may prompt unsolicited inbound proposals for transactions involving the spinco or the parent company. In addition, the parent board may expect that, as an independent entity, the spinco — or even the parent — may be better positioned to pursue certain strategic transactions.

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But companies should be cautious about any discussions or communications prior to the spin-off with third parties over strategic transactions with either the spinco or the parent because those could jeopardize the ability to consummate those transactions while maintaining the tax-free status of the spin-off.

In general, the spin-off could end up being taxable to the parent if there is an acquisition (or multiple acquisitions) of 50% or more of parent or spinco’s stock and that acquisition is deemed part of a “plan” with the spin-off.

There is a statutory presumption that an acquisition of the parent or spinco stock that occurs within two years after a spin-off is part of a “plan.” However, crucially, there is a safe harbor available if there were no “substantial negotiations” regarding the acquisition with the specific acquiring party during the preceding two-year period.

Awareness of this potential pitfall should guide any third-party discussions regarding alternative and/or post-spin transactions because they could make it impractical for tax reasons for either the parent or the spinco to enter a transaction with those parties for an extended period after the spin-off.

### **Establishing strong spinco governance and management to position the spinco for success**

The parent board will want to take an active role in establishing the corporate governance framework for the spinco, and in selecting its directors and senior management. Some boards assign these tasks to an existing committee (such as the corporate governance committee), while others establish an ad hoc committee.

In any case, the full board should ultimately approve the final approach and management choices.

#### **Spinco board framework and classified boards**

We often (but not always) observe boards replicating their existing corporate governance structure at spinco. The one exception is with respect to a classified (staggered) board for the spinco. Classified boards are far more common among newly spun-off companies than public companies generally.

Parent boards will want to evaluate the pros and cons of a classified board. A classified board with a reasonable sunset provision (e.g., board classification maintained until the first or second annual meeting following spinoff unless shareholders vote to extend it) may benefit the spinco and its shareholders, ensuring that the new board and management can execute on the strategic vision for the company during its initial stages as a public company without being unduly distracted by external pressures.

However, institutional and other shareholders may not be supportive, because classified boards may be viewed as adverse to shareholder rights. A reasonable sunset clause will be a mitigating factor.

The parent board should also decide the spinco board’s committee structure. This will in part be driven by stock exchange requirements (e.g., requirements for audit and compensation committees), but directors will want to consider whether other committees, such as an executive committee or risk committee, would be prudent.

#### **Spinco board composition**

When choosing individual spinco directors, parent boards typically pay careful attention to the professional expertise of potential directors, as well as considering “softer” skills in order to insure a collegial and productive spinco board dynamic.

To achieve a breadth of perspectives, as well as to address diversity initiatives of the parent company, institutional shareholders, proxy advisory firms and stock exchanges, the parent board should also consider gender, ethnicity and other forms of diversity.

Concerns about directors serving on too many boards (including the voting policies of shareholder advisory firms and institutional investors on “overboarding”) should also be borne in mind.

Note that, if some directors are to serve on both the parent and spinco boards, consideration will need to be given to legal limitations on overlapping/interlocking boards. U.S. antitrust laws may prohibit sharing directors if there is more than de minimis competition between the spinco and a director’s other companies, including the parent.

A substantial parent-spinco board overlap could also pose issues with respect to the tax-free treatment of the spin-off.

Lastly, the parent board will want to consider the independence and expertise requirements for directors (e.g., requisite audit committee expertise).

### **Spinco management selection**

Directors will want to take an active role in selecting the senior management of spinco. While they may be drawn from existing management, the parent in some cases engages executive search firms to locate external candidates, just as they would for selecting new members of senior management in other circumstances.

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Similarly, boards will want to work to establish compensation schemes for the spinco management and directors. These will often mirror parent's policies, but we have also seen boards make targeted adjustments to reflect the specific circumstances of a spinco.

### **Monitoring the personal dynamics that typically arise in a spin-off**

The board will exercise its authority to frame the potential spin-off at the outset when it is deciding whether to pursue that strategy. Working with advisers and management, it will determine the best portfolio re-alignment — what assets will stay in the parent and what will be assigned to the spinco — taking into account the business characteristics and macroeconomic factors.

Recently, we have also noticed boards paying particular attention to how certain mixes of businesses (on the parent or spinco side) could face greater refinancing challenges in the current high interest rate environment.

But many detailed choices about particular assets and the management structures of the post-spin parent and spinco will be made later.

And once the spin-off process is underway, management and employees can quickly fall into Team A and Team B camps, lobbying for management positions or the allocation of assets. If one of the two entities is perceived to have greater growth potential, for instance, employees may prefer to have roles there. And executives may favor assigning particular assets or personnel to the entity where they will end up.

Managing those inevitable conflicts is a vital part of the board's function during the spin-off process, and the board should make sure that, where disagreements arise, there is an escalation path that gets to a "neutral" arbiter (whether that be the board or

someone in management) who is looking at the issue from the point of view of what is best for *current* shareholders as whole.

### **Working with management on how the spinco is marketed**

While the initial decisions about the make-up of the spinco's business will be the most crucial factor in positioning the "story" of the spinco, we have seen boards take an active role in the marketing of the spinco.

### **Financial projections and exchange ratios**

Some boards devote significant attention to the spinco's financial projections, or expectations about dividend policies or leverage targets, prior to those being announced publicly.

Boards will also typically work closely with their financial advisors to determine the number of shares of the spinco that will be distributed and the resulting exchange ratio. This will have important implications for the future stock price of the spinco and, in the case of any split-off or other exchange offer, any premium will impact the potential uptake of those shares by the existing shareholder group.

### **Announcement timing**

In addition to taking an active role in the selection of the spinco directors and senior management, a board should also be actively involved in managing the announcement of those decisions. At a minimum, it should be certain that each director or member of management is willing to serve before their names are announced, and likely should finalize compensation for them before any announcement.

A variety of factors may affect when that information is released. Externally, it may be beneficial to convey progress toward execution of the spin-off, creating positive market momentum.

Internally, announcing appointments can reduce uncertainty about future positions and reporting lines, and the expected time frame for completion of the split, which can be helpful in retention efforts.

Lastly, we have also observed boards taking a keen interest in the public messaging around the anticipated timeline for completing a spin-off. There is obviously intense pressure to complete an announced spin-off as quickly as possible, and yet any number of factors may result in delays (e.g., complex IT systems that need to be separated, expanding regulatory oversight in many countries, or financing challenges).

Ultimately, boards will want to craft with management an anticipated timeline to be made public that conveys both the vigor with which they intend to pursue the transaction and a realistic estimate of the time needed for completion. If an overly ambition target date is not met, the board and management could be seen to be guilty of poor execution or insufficient planning.

### **The parent board retains its role as key decision-maker until the spin-off is complete**

Boards commonly ask when and how future directors of a spinco should be integrated into the process of executing the spin-off and setting up the spinco.

In our experience, the more common (and, indeed, better) approach is for the future spinco directors (other than those already on the parent's board) to be informed of the status of the spin-off process at appropriate intervals but not given a role in shaping or driving the process.

This means that the spin-off directors are neither formally appointed to any positions prior to the spin-off (as the spinco remains a wholly-owned subsidiary of the parent), nor consulted on an informal basis with respect to decision-making. Rather, the parent board remains the key decision-maker.

This is appropriate because the parent board is still the body legally responsible for overseeing parent and all its subsidiaries, including the spinco, until the spin-off is completed. Under Delaware law, the

board's fiduciary duties clearly remain to the existing shareholders of the parent, not the future shareholders of the spinco.

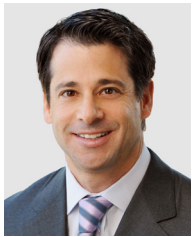
Keeping decision-making with the parent board also avoids undue delay and any unintended consequences that could arise from a spinco-centric approach to the transaction.

To facilitate the spinco board's assumption of control of the spinco when the spin-off is consummated, parents may conduct a series of informal "onboarding" sessions to educate and update the prospective directors, without involving them in substantive decision-making.

#### Notes:

<sup>1</sup> <https://bit.ly/4aChDxb>

### About the authors



(L-R) **David Rievman** is a partner in the tax group at **Skadden, Arps, Slate, Meagher & Flom LLP**. He advises U.S. and international clients on the tax aspects of complex transactions, including U.S. and cross-border mergers and acquisitions, financings, divestitures (including spin-offs), financial restructurings and recapitalizations, joint ventures, and other business transactions. Rievman can be

reached at [david.rievman@skadden.com](mailto:david.rievman@skadden.com). **Neil Stronski** is a partner in the firm's mergers and acquisitions group. He concentrates his practice on M&A, corporate governance, securities law and general corporate matters. He can be reached at [neil.stronski@skadden.com](mailto:neil.stronski@skadden.com). **Brandon Van Dyke**, also a partner in the mergers and acquisitions group, focuses his practice on M&A and corporate and securities law matters. He can be reached at [brandon.vandyke@skadden.com](mailto:brandon.vandyke@skadden.com). **Nicholas Colombo** is a counsel in the mergers and acquisitions group with a focus on M&A, private equity, corporate governance, securities and general corporate law matters. He can be reached at [nicholas.colombo@skadden.com](mailto:nicholas.colombo@skadden.com). The authors are based in the firm's New York office. This article was originally published May 16, 2024, on the firm's website. Republished with permission.

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