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# CORPORATE SPIN OFFS: FOUR ESSENTIAL COMPLIANCE STEPS



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Some publicly-traded corporations, especially large conglomerates, reach a point where the spin off of a constituent company or business unit into an independent entity is perceived as creating greater value for shareholders. The reasons for corporate spin offs vary, but they often have to do with the focus of the entity, which may, over time, become unrelated to the parent company’s core enterprises.

Liberated from the corporate parent’s control, the company’s senior executives theoretically can operate the business more entrepreneurially, cost-effectively and efficiently. At the same time, the parent organization benefits by freeing up its resources for future strategic acquisitions and investments. Both factors tend to increase shareholder returns, although studies are inconsistent on this subject.

## **REASONS BEHIND A CORPORATE SPIN OFF**

There are reasons other than those stated above for a company to pursue a corporate spin off strategy. Among them are tax considerations; a spin off is tax-free to both the parent company and its shareholders. Conversely, if the business were sold to another organization, the parent company would incur both corporate tax and state tax on the gain recognized from the sale. A spin off can shift the business strategy of a company, such as the CEO’s resolve for the organization to focus on core competencies or to help deter the possibility of a takeover.

A spin off also can relieve shareholder pressures that are absorbing too much leadership focus and resources. And it can obviate regulatory concerns—selling off certain assets prior to a planned major acquisition to reduce antitrust monopoly issues.

No matter the reason, spin offs are very complex undertakings fraught with compliance responsibilities. Parent companies must abide by tax, legal, fiduciary, labor and solvency regulations on a national, state and international basis. Below are four essential steps in handling these obligations.

## **STEP #1: IDENTIFY COMPLIANCE GAPS**

The execution of a corporate spin off is a multifaceted process, beginning with the board of director’s determinations of the reasons for the spin off and how to effectuate it, such as creating a new corporation to absorb the assets and business of the spun off company, or separating the two existing entities into independent public companies.

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This information is not intended to provide legal advice or serve as a substitute for legal research to address specific situations.

According to international law firm Debevoise & Plimpton, assessing a potential spin off of a company [requires close attention](#) to applicable laws concerning the declaration and payment of dividends, as well as solvency and capitalization requirements, contractual obligations, particularly funded debt covenants; and documenting the transaction to maximize operational efficiencies for both companies going forward.

Attention must be paid to the governance mechanisms of the new entity, as it may not be in the best interest of shareholders for the business to employ the same governance structure of the parent organization. “If the Company’s charter and by-laws are used as a starting point, any necessary revisions to those documents should be made before the spin off due to the challenges of obtaining shareholder approval to amend these documents after the subsidiary becomes a public company with an expanded shareholder base,” a [report](#) by international law firm Sullivan & Cromwell LLP states.

A compliance audit should be performed to ensure that requirements are met in every state where a surviving and non-surviving entity is registered. Companies need to make sure changes in name, addresses, and officer and director information are filed with U.S. and global jurisdictions and regulatory bodies. Non-compliance can result in serious, even criminal, penalties.

Another important step is to update registered agent appointments and service of process recipients. Failure to do so can lead to document delivery issues and potential risk of default judgments.

### **STEP #2: IDENTIFY NEW JURISDICTIONS AND BUSINESS PURPOSES**

Once a company is spun off, the parent organization may no longer operate in the same number of national and international jurisdictions as before. Similarly, the new entity may also exit certain geographic jurisdictions and engage new ones. In all cases, efforts must be waged to ensure compliance with each jurisdiction.

These efforts begin with an identification of current jurisdictions where the combined organization conducts business, and how this will change once the company is split into two organizations. To ensure compliance with the licensing requirements in each foreign jurisdiction in which

the parent company and the subsidiary currently operate, the parent organization must obtain approval from Secretary of State of each of these jurisdictions. This is accomplished by filing paperwork with each jurisdiction in which it will be doing business or those jurisdictions from which it will be exiting.



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As part of the planning to spin off a subsidiary company or business unit to shareholders, an organization must identify the business purposes guiding the decision to separate the organization from the parent company. The Secretary of State will request information on the new entity’s business objectives and whether or not the parent company’s own business objectives will change following the conclusion of the transaction.

Senior executive leaders and boards of directors should consider writing why the decision is in the best interests of shareholders, explicitly laying out what shareholders can expect to achieve from the spin off. The document should address the business plan for the new entity, including a [competitive profile](#) of the industry in which the spin off company will operate. Applicable research on market opportunities and an understanding of how the new entity will generate revenues and otherwise support itself in the future (without dependence on the parent) also should be included. For instance, will the spin off be able to operate with the current management team’s skill sets or will outside experts need to be brought in to fill talent voids? In some cases, the parent organization may need to set aside capital to financially assist the transitional needs of the new entity during its formative months of development.

### **STEP #3: EXECUTE FILINGS**

Once the board of directors approves the plan for the spin off, key legal activities follow, such as a determination of the effective dates for the spin off, a description of the corporate structure of the parent and the new entity, and the creation of financial statements and securities notifications in the event of an IPO. With regard to the latter, public companies

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must draft and file the initial disclosure documents, apply for listing on a stock exchange, implement internal controls, and manage the ensuing reporting process.

Many organizations have found great value in rehearsing the day of the spin off prior to its occurrence. Doing so may indicate problems that can be headed off before the actual date of the event, such as issues involving legal agreements, licensing, payments, stock transfer, and regulatory filings. All such tasks should be identified in a project timeline with a checklist to ensure proper management.

### **STEP #4: CLOSE OUT JURISDICTIONS WHERE REQUIRED**

Following the closure of the spin off transaction, it is prudent for the parent company to audit its survivor and non-survivor entities, and review that all required spin off notices, filings, and other documents were completed. Similar research also should be conducted to ensure that business licenses, both internationally and in each U.S. state, are updated.

### **LEARN MORE**

The inherent complexities in planning and executing a corporate spin off, in addition to complicated compliance mandates, argue for consultative assistance. CT can bring together a team of merger, acquisition and divestiture specialists and legal and regulatory experts to ensure a cohesive, compliant and cost-effective spin off process. Training tools are available to help board directors plan for the spin off, articulate the business purpose, ensure all licensing and other compliance documentation is accurate and timely, create an optimum post spin off employee compensation and benefits structure, and execute both the practice spin off and the real one.

For more information, contact your CT representative or call 844-206-9033 (toll-free U.S.).

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