

TRACKING TRACKING STOCK

by Robert W. Wood • San Francisco

Tracking stock has generated a fair amount of tax controversy over the last few years, and a fair amount of investment interest as well. Early this year, DuPont, the chemicals conglomerate, backed away from its plans to offer investors a separate life-sciences stock to track its pharmaceuticals and agricultural businesses. In 1999 the company had announced that it was embarking on a tracking structure as a way of enabling investors to participate in its fast-growing pharmaceuticals division as well as its agrochemicals unit. Now that the life-sciences field has cooled substantially, this particular tracking stock is going out the window. See Pilling, "DuPont Reviews Tracking Stock Plan," *Financial Times*, January 31, 2000, p. 19.

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Admittedly, tracking stock has generated a great deal of interest, but recently a number of tracking issues have been scuttled. Apart from DuPont's intended foray into tracking stock, several other companies have abandoned similar strategies, including Novartis (the giant Swiss company). Novartis instead announced that it would spin off its agricultural unit. See Warren, "DuPont Cools to a 'Life-Sciences' Stock To Track Pharmaceutical, Farms Units," *Wall Street Journal*, January 31, 2000, p. B12. Another notable naysayer is Pittston Co., which abandoned the tracking stock structure of its three businesses (Brink's armored cars, a freight business, and a coal-mining unit). Smith, "Companies Favor Tracking Stocks But Investors Can Get Derailed," *U.S. News & World Report*, December 20, 1999, p. 66.

One underlying theory of tracking stocks is that the sum of the parts is greater than the whole. There have been a few cases historically where that has proven to be true. The first tracking stock was issued by General Motors in 1984, to track its then subsidiary EDS. In 1985, GM did it again with its Hughes Electronics division. Some years went by before tracking stock surfaced again, and it was not until 1998 that these issues really exploded.

By the end of 1999 there were nearly 30 tracking stocks trading, and most were new to the market in either 1998 or 1999. Though many companies may have jumped on this particular bandwagon, statistics show a rather dismal performance record for tracking stocks as a group. Apart from a few success stories (notably GM's Hughes Electronics, Sprint's PCS Wireless and Perkin-Elmer's Celera Genomics), most tracking stocks have been off, even well before the stock market took a nosedive. (For a table of tracking stock values, see Smith "Companies Favor Tracking Stocks But Investors Can Get Derailed," *U.S. News & World Report*, December 30, 1999, p. 66.)

Poor Man's Spinoff?

It is no coincidence that tracking stocks are usually justified, and marketed, as a play on a particular business or division, thought to be separate (and separable) from the more clumsy or diversified parent. But performance is another thing. Generally speaking, even when the market has been good, tracking stocks have generally traded at a 5 to 15 percent discount off of their truly separate industry peers. *Id.* Of course, the truth is that tracking stock is an accounting device, and that the separate security does not make it a stand-alone company. Compared to a spinoff, where by definition there is a separate company with different shareholders (even a pro rata spinoff will result in an eventual divergence of shareholders), the two deals are about as different as oil and water.

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Curious, though, that the existence of tracking issues may actually make a spinoff more unlikely to be approved by the IRS, at least if you subscribe to the notion that the issuance of the tracking stock in the first place truly unlocks the distinct value—the

way a spinoff can—of the ostensibly separate unit. And that brings us to tax treatment. Should tracking stock be taxed? More importantly, should the existence of previously issued tracking stock affect the likelihood of a successful spinoff?

Next month we'll review the history—and controversy—surrounding the taxation of tracking stock.