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Spinoffs Dominate the News

by Robert W. Wood • San Francisco

Okay, maybe this is a slight exaggeration. Maybe spinoffs don't dominate the news, but tax professionals cannot fail to notice the plethora of spinoffs that have either been

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announced or consummated recently. At the risk of filling these pages yet again with how many spinoffs are being done, let's start with a few examples lest anyone think I'm kidding.

By the Grace of...

First, W.R. Grace and Co. early on leaned toward a spinoff of its national medical division rather than a sale. Why? Tax considerations, what else. The sale of this unit would generate, by some estimates, a capital gains tax to W.R. Grace between $850 million and $1 billion. A spinoff to shareholders? Tax-free. See "Grace is Leaning Toward Spinoff of Dialysis Unit," *Wall Street Journal*, June 5, 1995, p. A5. W.R. Grace would have to distribute at least 80% of the stock of that national medical division to its shareholders. The shareholders would receive shares of what would be a new publicly traded company. W.R. Grace could remain a shareholder, of course, but would obviously have relinquished control by virtue of the 80% plus distribution. Of course, a ruling from the IRS would be far easier to achieve if W.R. Grace would distribute all of the stock, not retaining any interest in the newly spunoff company.

Indeed, after some discussion, the Grace directors voted recently to the spinoff plan. See "W.R. Grace Directors Agree to Spinoff of National Medical to Grace Holders," *Wall Street Journal*, June 15, 1995, p. A4. The spinoff is expected to occur in the fourth quarter. The announcement came as a formal rejection of two other bids that had been made for National Medical, the country's largest kidney-dialysis provider.

The speculation about Grace was rampant, with many articles noting not only the likelihood of the spin, but also the rather demonstrable tax advantages. See "Grace Board is Expected to Back Spinoff of National Medical Unit Over Two Bids," *Wall Street Journal*, June 14, 1995, p. A5. The W.R. Grace transaction is perhaps one of the best in recent memory to illustrate the manner in which a spinoff can not only achieve tax advantages, but also be used in defense of miscellaneous buyout and/or merger proposals.

In the case of W.R. Grace, Dr. Constantine Hampers had made a buyout bid for Grace's National Medical Unit, which the spinoff obviously contradicts. Likewise, the spin announcement contradicts a recent merger proposal by three leveraged buy-out groups. They had intended to merge National Medical with another dialysis entity, Vivra, Inc., plus put in new cash. That plan may not be entirely killed, since it is conceivable that National Medical and Vivra could merge after the spin.

In any case, apart from the obvious tax implications—which the W.R. Grace situation frustrates rather neatly—the takeover reaction and strategic planning potential for a spinoff is well underscored. The valuation question will obviously be debated by investment bankers and brokers. To use the reverse of the traditional "2+2=5" synergy, the question is whether dividing Grace into two pieces would make Grace's stock (now trading between $60 and $65 a share) worth more like $70 or $80 on a combined basis. Time will tell, of course. (To go back to my trite "2+2=5" formula, have you *ever* heard someone say "2+2=3"?)

Sears Spins Allstate

In a transaction that has been kicking around for several years, Sears Roebuck & Co. announced that its Board had given final approval to the spinoff of its 80.3% stake in Allstate Corp. See "Sears Directors Give Approval to Spinoff of Stake in Allstate," *Wall Street Journal*, June 21, 1995, p. A14. The announcement in late June called for the tax-free stock dividend to go out to holders as of June 30, which should already have happened by the time *M&A Tax Report* readers receive this issue.

Sears may be one of the major users of the spinoff device, having spun off a number of businesses over the past few years. Recall that back in 1992, Sears geared up for an initial public offering of 20% of its Dean Witter, Discover & Co. and Allstate units. As readers will remember, Sears later spun off its remaining holdings in Dean Witter. (See Wood, "Sears' Spinoff: In the Land of the Giants," Vol. 1, No. 4 *M&A Tax Rep't* (Nov. 1992), p. 1.)

Travelers Group Spins Health Insurance

In another shedding of skins, Travelers Group has announced that it will spinoff a small health

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insurance unit worth about $250 million to its shareholders. See "Travelers Group Says It Plans to Spin Off Health Insurance Unit," *Wall Street Journal*, June 13, 1995, p. A11. The spin plan calls for Travelers to distribute out the stock, but also to bring in an outside investor group that could ultimately end up owning just under 50% of the insurance unit. The insurance unit is called Transport Holdings. Common shareholders of the Travelers are expected to receive a total of 1.6 million shares in Transport Holdings, being one share of Transport Holdings stock for every 200 Travelers shares they own. The Transport Holdings stock is expected to be listed on the NASDAQ stock market.

ITT, Too

In yet another June statement, ITT was discussing a split of its businesses into its three major product and services areas. The three broad areas involved insurance, manufacturing and hotels and gambling. See "ITT's Board Meets to Discuss Splitting Company into 3 Parts," *Wall Street Journal*, June 13, 1995, p. B2.

The plan was expected to be approved at the Board meeting on June 12, 1995, following ITT's more than year long study of splitting the company into various chunks. Analysts have been rubbing their hands over the likely valuation of the business split into its three constituent parts (remember, 100÷3 and then added together might well equal 150!)

True to form, the split was announced thereafter, with the cute and James Bond-ish name announced of "Operation Hat Trick." See "ITT to Split Into 3 Companies; Araskog to Head Hotel/Casino Business," *Wall Street Journal*, June 14, 1995, p. A3. So-called Operation Hat Trick will produce three companies, designated as ITT Industries, Inc. (ITT's automotive parts, defense and electronics, and fluid technologies businesses); ITT Hartford (insurance businesses now operated by ITSS); and what is meant to be the "new and improved" ITT Corp., made up of Caesar's World, ITT's 50% interest in Madison Square Garden, and of course the ITT Sheraton and Ciga Hotels.

True to form, notwithstanding a nice jump in ITT's stock price on the announcement to approximately $115 a share, analysts are predicting that the ITT business post-"Hat Trick" could be worth as much as $140 a share.

What about getting the ruling from the IRS? Obviously, this is an enormous transaction. According to public reports, as one would expect, management claims the ruling will surely be issued. Current ITT Chairman Rand V. Araskog reports he is "99.9% confident" that the IRS will rule favorably. See "ITT to Split Into 3 Companies; Araskog to Head Hotel/Casino Business," *Wall Street Journal*, June 14, 1995, page A3, at p. A5.

Sprint May Shed Cellular Line

One day after the formal ITT announcement, Sprint Corp. is said to be pursuing a possible spinoff valued at several billion dollars of its cellular businesses. See "Sprint May Sell or Spin Off Burgeoning Cellular Line," *Wall Street Journal*, June 15, 1995, p. A3. Not surprisingly, Sprint's CFO, Arthur Krause, has suggested that a spinoff might be much more attractive than a sale because of the hefty capital gains tax that would be levied on a sale of the cellular line. Id. Of course, a formal announcement of a spinoff is far from certain, notwithstanding the fact that the spinoff would be considerably less expensive than a sale.

Eli Lilly, Too

Finally, Eli Lilly & Co. has announced that Guidant Corp. (which makes medical devices) filed a registration statement with the SEC describing the plans for the splitoff of the remaining equity interest in Guidant held by Lilly. See "Eli Lilly Says Guidant Filed SEC Statement on Plans for Split-Off," *Wall Street Journal*, June 7, 1995, p. C11. In January of 1994, Eli Lilly announced that it would separate the medical device businesses it ran from what it viewed as its core business, pharmaceuticals. Guidant Corp. was formed in June of 1994 as a result. Thus, the current announcement represents the final leg of the split.

The Lilly/Guidant transaction, of course, was a splitoff rather than a spinoff. (For discussion of spinoffs vs. splitoffs, see Wood and Willens, "To Spin or Split: It's All In the Name?" *M&A Tax Rep't*, Vol. 3, No. 6 (January 1995), p. 6.) A splitoff may be seen as having advantages over a

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traditional spin, not the least of which is minimizing (via the retirement of parent stock) the dilution in earnings associated with a spinoff. The parent would record a gain (or a loss) calculated by reference to the difference between the book value of the subsidiary and the fair market value of the parent stock that is retired. Perhaps of greatest importance, a splitoff would allow a parent in effect to retire stock with pre-tax as opposed to after-tax dollars. This can be significantly less painful than if the parent sells stock in a subsidiary for cash and pays tax on the gain, then using the after-tax proceeds of this stock sale to fund a stock buyback.

More and More...

We at the *M&A Tax Report* might get accused of having a favored topic in spinoffs. But it's hard not to notice them. A recent article in the *Wall Street Journal* listed not only many of the recent spins, but included a rather impressive chart showing the growth in spinoffs. See "Spinoffs Flourish, Fueled by Tax Status, Investor Pressure and Stock Performance," *Wall Street Journal*, June 15, 1995, p. C1. According to the *Journal*, between 1993 and 1995 the market value of new companies spun off from parents jumped from around $15 billion to close to $30 billion. This growth is nothing short of phenomenal. Of course, the 1995 figures are projected, not based on closed transactions, and explicitly take into account the anticipated ITT Corp., W.R. Grace, and Allstate transactions, as well as some others. The *Journal* cites J.P. Morgan & Co. for its source.

Likewise, the *Journal* article includes a list of the largest global spinoffs, with ITT and Allstate topping the list. By comparison, the W.R. Grace & Co. transaction (at $3.5 billion) rates a paltry tenth. In its review of the spinoff hit parade, the *Journal* also labels its tables "Breaking Up Is Easy To Do." I wish I'd thought of that. ■