MERGERS & ACQUISITIONS

ASSET RESTRUCTURING

Alieu Barry Bah
Master of Studies in Law Candidate
Wake Forest University School of Law
Winston-Salem, NC

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Abstract

Companies restructure assets as part of their financial reorganizations to generate cash flow, recalibrate strategy or business model. Also, when used as a defensive tactic, companies can restructure assets to discourage hostile takeovers, making it less attractive for a bidder. Restructuring assets can help improve management's focus on thriving lines of business, and eliminate distractions from underperforming assets. In addition, when freely executed, asset restructuring can create significant cash flow from the sale of assets, which may further reduce borrowing costs.

This research paper will explore the legal challenges of assets restructuring that companies face as they look for opportunities to optimize portfolio returns for shareholders. Furthermore, the exercise will explore the three variations of financial restructuring focused on rearranging assets, which include divestitures, spinoff, and carve-outs. Additionally, this paper will survey the drivers that shape asset restructuring, driven by market forces and the regulatory environment, with a look at recent legal cases as such; and further examine the role of third parties acquiring the assets of a seller. In most cases for the acquiring firm, shareholder approval is not required to purchase assets, but investors could be disappointed if an unprofitable asset is purchased, and vice versa if a crown jewel and profitable asset is acquired. Traditionally, the liabilities associated with the carved-out business will be separated from the parent, to follow the carved-out unit. Liability terms are
heavily negotiated in an asset sale where the acquirer is contractually responsible only for the specific liabilities it assumes.

Research has shown that corporate asset restructuring announcements are associated with a significant decline in shareholder wealth of about 2%. The uncertainty of the resulting asset restructured exerts pressure on investor confidence as to the value of the asset acquired, disposed, or repositioned. Shareholders of the acquiring firm do not want to pay more than the pre-restructured value of the asset because a seller may quantify the value of the synergy that could be realized from the asset by the acquirer. The seller on the other hand, would like to maximize gain at or beyond the market value of the asset. As part of a defensive tactic a firm may change its asset structure by buying assets that will create antitrust and other regulatory issues that a bidder did not anticipate.

**Divestiture**

In a divestiture, assets are sold to a third-party to provide liquidity for the selling company. A subsequent event such as an acquisition may follow through with the use of proceeds from the assets sold. The firm may also be forced to divest an asset such as a line of business or “crown jewel” that was once attractive to a bidder. A company may also be forced by regulators to divest an asset in order for a proposed merger to be approved, and government has prevailed in most cases where antitrust concerns have been raised. As part of settlement negotiations to remedy complaints from US antitrust agencies, the company may have to divest an asset in order to
complete a merger. In June 2012, two providers of online ratings and reviews, Bazaarvoice and PowersReviews completed a $160 million merger that was later challenged by the U.S. Department of Justice (DOJ). On January 9, 2014 after a four-week trial the District Court held in favor of the DOJ siting that the two businesses were leading competitors in their respective market service areas with over 50% combined market share. At trial, documentations suggest that the primary motive of the transaction was to eliminate competition. Awaiting the court’s ruling on remedies, the DOJ has requested the divestiture of assets to create a viable competitor. Drafting a remedy in this case would be an arduous task considering the two companies have already been integrated for almost 2 years. In another case, the Federal Trade Commission (FTC) filed an administrative complaint to block the proposed merger of Ardagh Group and St. Gobain Containers, the second and third largest manufacturers of glass containers in the U.S. The FTC alleged the proposed deal would result in the two companies controlling over 75% of the US market. Following a preliminary injunction, Ardagh argued it is willing to divest two of its own plans and two St. Gobain plans, as this would satisfy any competitive concerns. Following lengthy settlement negotiations with the FTC Ardagh offered to forego their best six of the eight plants it acquired from Anchor Glass in 2012. The FTC has articulated tentative support pending further review.

Antitrust theories and liabilities under the Clayton Act and Hart-Scott-Rodino Act (HSR) could constrain a merger and acquisition and force divestiture of corporate assets before and/or after a consummated merger. Federal antitrust agencies may
exercise their statutory powers to seek disgorgement of “ill gotten gains” from post acquisition activities. Additionally, market share concentration within an industry could also create problems under the Herfindahl-Hirschman Index (HHI) in a merger that could force a divestiture as in the case of Bazaarvoice and Ardagh Group.

**Carve-Out**

A carve-out is also a liquidity event for a parent company in which it partially divests an asset or business unit. The divested assets are placed as a subsidiary unit with the parent retaining a majority stake and offering minority equity to another company or the public. As a long run business strategy, a company may fully divest its interest in a carve-out if it is not able to find a single buyer in the beginning, or if the assets are too integrated or complicated. In the U.S. the number of carve-out M&A transactions has increased in recent years, exceeding 50% of deals in 2012. Important legal issues and considerations carve-out deals must address include the assumption or transfer of liabilities between the parent company and the carved-out business unit. Traditionally, liabilities associated with the carved-out business will be separated from the parent, to follow the carved-out unit. In negotiating asset sales transactions, the buyer can negotiate to contractually be responsible only for specific liabilities as part of an asset purchase agreement. Parties are free to negotiate liability arrangements that are most suitable to their capabilities and interests in the ownership and operation of the subsidiary. However, a buyer should conduct extensive due diligence, and beware of certain successor liabilities that may
arise even without expressly agreeing to assume such liabilities. Enumerated liabilities in negotiated deal will attempt to avoid many liability uncertainties that may arise prior to closing all after.

Liability assumptions can be leveraged as a potentially profitable arbitrage opportunity if a buyer expects liability exposure to be less than anticipated by the seller. For example, in a deal where a buyer projects spending $10 million to settle an ongoing litigation claim related to the carved-out unit while the parent believes it can negotiate a $6 million settlement, the parent may agree to retain the liability in exchange for an increase in the purchase price in excess of $6 million. These terms can further be negotiated to include indemnity clauses for any damages or losses relating to the liabilities assumed or retained by either buyer or seller.

Other liability arrangements to consider during negotiations of carved-out asset sales include balance sheet and reporting liabilities. Stand-alone financials of the carved-out business could enhance the subsidiary’s borrowing costs or access to capital, and possibly increase the number of potential buyers or sales price. Pursuant to federal regulations, a statement of financial condition of the subsidiary acquired or to be acquired must be filed for certain periods of time and meet one of three significance tests. 17 C.F.R. §§ 210.1-02, 210.3-05 (2012). Furthermore, environmental liabilities, litigation, employee benefits, products, and related contractual liabilities such as intellectual property rights should be enumerated and
precisely defined to protect the buyer and seller, mirroring both parties' intent and understanding of the identifiable and unidentifiable liabilities.

**Spinoff**

In a spinoff, a parent company separates an asset or line of business into a freestanding, independent entity with its own rights and obligations. State law and rules of the stock exchanges determine whether a company must seek shareholder approval to give effect to the spinoff. A parent does not have to register shares of the spinoff under the Securities Act of 1933 if it meets certain criteria, such as providing adequate material information about the spinoff to its shareholders and the trading markets. If required, the spinoff company must file a registration statement with the SEC's Division of Corporation Finance for further examination to ensure compliance with disclosure requirements. The SEC does not evaluate the merits of a spinoff nor determine if the securities offered are “good” investments. Even if a spinoff is structured to avoid registration under the Securities Act, it nevertheless must register the securities on Form 10 under Section 12 of the Exchange Act, and furnish shareholders with an information statement that considerably complies with Regulation 14A or 14C of the Exchange Act.

Spinoffs can take many forms, and in most cases shares of the new entity are sold or distributed to the parent's existing shareholders. There are multiple reasons why a company might separate itself from an asset through a spinoff. Unrelated businesses may be separated in order for the market to better appreciate the spinoff, or
alternatively, a company may be motivated to spin off a business unit from the desire to separate an undeforming or “poor” asset in order to further protect an un tarnished “good” business in the eyes of investors. Spinoffs also create additional shareholder value while taking advantage of tax laws. A spinoff distribution can be made tax-free to the parent company’s receiving shareholders. Requirements for a tax-free spinoff can be complex with financial reporting requirements to be satisfied. If a spinoff is not able to meet the requirements of Section 355 of the Internal Revenue Code, the company maybe liable for the full taxes due upon the divested unit. To avoid severe legal consequences the spinoff must be structured with extensive considerations given to the transaction so that it is not used as a device to distribute earnings of a company, and escaping dividend taxation rules by converting ordinary income into capital gains. Also, the transaction must meet the business test by having a substantial business purpose that must bring about material, unquantifiable cost savings, and/or other benefits such as meeting regulatory requirements, equity and debt financing, etc.

Other general considerations must address related assets and liabilities between the parent company and the spinoff. Such considerations can be difficult to trace if there are overlapping assets, operations, or services. A well-drafted roadmap to serve as guidance in conducting advanced due diligence will mitigate some of the risks and uncertainties associated with the proposed spinoff. Such considerations will also address assignment and change of control issues, solvency and fraudulent transfer,
liabilities to third parties and indemnities, intellectual property, employee benefits, and environmental liabilities.

Anti-takeover defense provisions may be incorporated as part of the profile of the spinoff business unit. Traditionally, such provisions are adopted at the beginning as the spinoff is consummated because the new board of the spinoff could always seek to reverse or eliminate them later, otherwise the decision to add antitakeover provisions when the spinoff is already public may face strong opposition from activist or institutional shareholders. Many spinoffs include antitakeover provisions in the charters to include a classified board structure, which can be an effective barrier in the event of a hostile attempt to acquire board control. Also worth noting, is that under Delaware law, if the board is not classified, shareholders can exercise the right to remove directors with or without cause.

Spinoffs involving overlapping ownership structure raise potential antitrust issues that should be given extensive consideration under Section 1 of the Sherman Act, to address coercive action with competitors, and Section 8 of the Clayton Act, which prohibits interlocking directors or officers. Under the Hart-Scott-Rodino Act (HSR) no filing is required for a spinoff provided interests in the subsidiary are distributed pro rata to the parent company’s shareholders.

In sum, the decision to spinoff an asset or business unit could trigger a myriad of complex legal and financial issues that requires extensive consideration. The degree
to which the issues and solutions arise and effectively resolved will depend in part
to the level at which the businesses are integrated before the spinoff is
consummated, and the extent of the continuing relationships between the parent
and the spinoff. Extensive considerations and planning must be coordinated and
executed to cover the broad array of general corporate separation issues that may
arise, and resolved in earnest before a spinoff is giving effect.
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