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Spin-off: How to find hidden treasures in the desert of market crisis

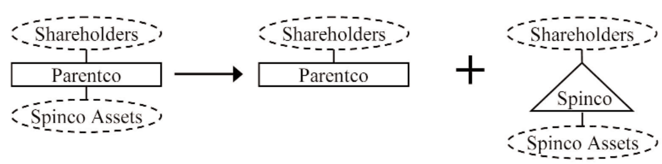
by Philip Webb

In recent years, relatively few Russian companies have taken advantage of the corporate restructuring process known as a "spin-off" (a distribution of certain assets into a separate, independently operating company), which can unlock the potential of a non-core business unit and increase the value of the corporate group as a whole. However, a number of successful examples of spin-offs on the Russian market demonstrate how this form of restructuring can be an attractive alternative to conducting an IPO or strategic sale to divest a non-core business.

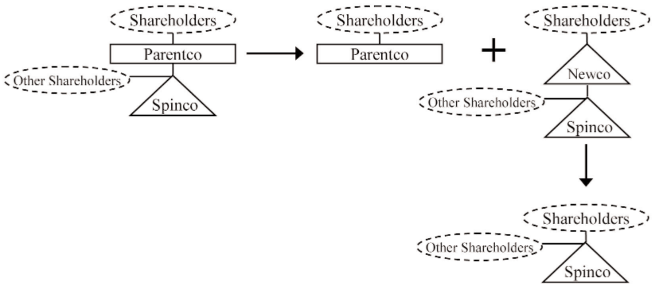
A spin-off is most often conducted in circumstances where a company is engaged in a number of businesses, one of which is considered non-core in relation to the company's primary business areas, and also where that business may attract a different investor base. Although spin-offs are relatively common in the EU and the U.S., this type of corporate restructuring is still a novelty for most major Russian companies. Among the Russian companies who have taken advantage of the spin-off process so far, two notable examples are Norilsk Nickel's spin-off of Polyus Gold and the spin-off of a number of different companies (generating and transmission) in the course of the RAO UES restructuring. If current volatility in the capital markets persists, shareholders of Russian companies may make more active use of the spin-off procedure to move non-core businesses into separate companies. The spin-off expands shareholders' options so they can make independent investment decisions with respect to unrelated developments in different business areas and at the separate companies themselves, while each of them can pursue its own development strategy unhindered by the other.

Spin-off process unraveled

In essence, the process of a spin-off involves the distribution of shares of a spun-off entity ("**Spinco**") for no consideration to existing shareholders of the parent company ("**Parentco**"). In the base case for a spin-off under Russian law, Spinco will be a newly created company to which Parentco transfers part of its assets/liabilities in the course of the spin-off:



This type of spin-off is usually applicable only if Parentco holds 100% of the assets being spun-off (as in Norilsk Nickel's spin-off of Polyus Gold). If that is not the case, the spin-off would result in a multi-tiered ownership structure that could be difficult to manage, reducing Spinco's value. To deal with this problem, in 2006 a new form of spin-off was introduced to Russian legislation (Art. 19.1 of JSC Law): the "spin-off with simultaneous merger". In this process, Parentco's shares in an existing subsidiary (Spinco) are contributed to another, newly-created subsidiary ("**Newco**"), which simultaneously merges with and into Spinco, as a result of which Parentco's shareholders receive shares directly in Spinco.



RAO UES was one of the first to use this spin-off/merger process in its spin-off of OGK-5 and TGK-5. This form was also later used in the spin-off of most of its remaining subsidiaries and business units in the final restructuring of RAO UES.

Reasons for conducting a spin-off

There are a number of reasons for conducting a spin-off, but primary among them is that a spin-off permits Parentco to divest a business unit and transfer it to Parentco's shareholders without any adverse tax implications. Parentco's shareholders will still be subject to profit tax (or personal income tax) from the sale of shares in Spinco or Parentco – if they decide to sell those shares. However, following the spin-off each shareholder can make an independent decision as to whether and when to dispose of such interests, which can be a great advantage.

For example, Parentco's shareholders may be unwilling (or unable) to sell their shares in Parentco but want to divest their underlying interest in Spinco, or vice versa. By conducting a spin-off, Parentco effectively expands the realm of options available to its shareholders with respect to their investment.

A spin-off can also add value to both of the companies involved. Where Parentco has, in addition to its primary activities, a non-core business, management may consider its options for divesting that non-core business: distribution of shares as a dividend, IPO, strategic sale and spin-off. The distribution of shares as a dividend generally creates unfavorable legal and tax implications, so as a practical matter usually only the latter three options are considered.

In contrast to an IPO, a spin-off involves the distribution of Spinco shares only to Parentco's shareholders; and, in contrast to both an IPO and a strategic sale, the spin-off does not result in any new capital for Parentco. Nevertheless, even without raising capital, a spin-off can still be value-enhancing for Parentco and/or Spinco. By ridding itself of the non-core business, Parentco will likely be better placed to concentrate on its primary business, with related improvements in efficiency. At the same time, Spinco can attract capital and develop within its particular business environment, without regard to unrelated economic conditions that affect Parentco's activities. Other reasons for conducting a spin-off include:

- separating businesses with different risk profiles;
- serving as an element of a wider group restructuring and a tax-effective mechanism to transfer property/securities;
- creating synergies and enhancing value through subsequent strategic combinations; and
- facilitating the reorganization of debt structures, including de-leveraging of Parentco if debt exists at the Spinco level (however, Russian law requires that the spun-off liabilities be supported by comparable assets).

U.S. and EU legal considerations

If among Parentco's shareholders or depositary receipt holders there are U.S. persons (as defined in U.S. securities law), management will need to consider the requirements of U.S. securities law. Even though U.S. securities law affords spin-offs an exemption from registration with the U.S. Securities and Exchange Commission ("**SEC**"), a similar reorganization conducted under Russian law may not meet the requirements of U.S. law.

From a U.S. securities law perspective, a spin-off is viewed as an offer of securities (i.e., Spinco shares) that must be registered with the SEC unless a specific exemption from registration is available. Spin-offs generally are exempt from registration if the transaction meets several criteria, including:

- a "valid business purpose" for the spin-off;
- no consideration paid by shareholders for the spun-off shares;

- the spun-off shares are distributed to shareholders on a pro-rata basis; and
- "adequate information" about the spin-off is provided to shareholders.

If the spin-off of a Russian company does not meet any of the applicable criteria, then the transaction may need to be structured in such a way as to meet other requirements for exemption from registration, such as:

- private placements that are exempt from registration; or
- offerings to "Qualified Institutional Buyers".

Under EU law (if Parentco has European shareholders or depositary receipt holders), a distribution of securities, such as Spinco shares, would ordinarily require publication of a prospectus. The exemption most likely to apply in a spin-off relates to shares that are offered free of charge to existing shareholders. Additional exemptions may be available if the shares are offered only to "Qualified Investors" or the securities are offered to a limited number of persons (less than a hundred, excluding Qualified Investors) in each country of the European Economic Area.

Disclosure of information about the spin-off

To satisfy the requirement of providing "adequate information" or to conform with international practice, Parentco may produce a detailed Information Statement for its shareholders, which would contain:

- information about the transaction, including the reasons for spin-off;
- risk factors related to Spinco's business;
- information about Spinco, including:
  - a description of its business and management,
  - historical financial information, and
  - pro forma financials giving effect to separation from Parentco;
- information about major shareholders; and
- on-going litigation.

Corporate approvals

If there is a downside to conducting a spin-off, it is the time required. Although a spin-off generally requires fewer financial expenditures than an IPO or strategic sale, it may take considerably longer to obtain the necessary corporate and regulatory approvals.

To begin the process, Parentco's Board of Directors must meet to convene an extraordinary general shareholders meeting and to approve draft documents and other aspects of the spin-off to be put to the shareholders for approval. In addition, although not specifically required by Russian law, the Board of Directors may approve the form of the Information Statement.

Parentco's shareholders must adopt, by a ¾ vote of the shares represented at the general meeting, a number of important decisions with respect to the spin-off, including:

- spin-off procedure;
- the number of Spinco shares to be issued for each Parentco share;
- the form of separation balance sheet; and
- the election of Spinco's management bodies and approval of their founding documents.

Shareholder and creditor rights

Shareholders who either vote against or do not vote on the spin-off may require that Parentco redeems their shares. The redemption price is determined by the Board of Directors, based on the market price as determined by an independent appraiser. However, Russian law limits the amount that Parentco may spend in such redemption to 10% of Parentco's net assets, calculated as of the date of the extraordinary general shareholders meeting. If the shareholders tender more shares than can be redeemed, the tendered shares will be redeemed on a pro rata basis.

In addition, Parentco must notify its creditors about the spin-off by publication in the journal "Vestnik gosudarstvennoi registratsii". If the rights of a Parentco creditor arose before the first publication of the notice of reorganization, then that creditor may demand early performance of the relevant obligations and, if early performance is not possible, termination of those obligations and compensation of related damages.

In the case of "spin-off with simultaneous merger", this process is two-fold:

- approval of spin-off matters by shareholders of Parentco; and
- approval of merger matters by shareholders of Spinco (recall that, in this two-stage process, Newco will merge into Spinco immediately upon being spun-off from Parentco).

Subsequent international IPO or foreign listing

Once all the necessary procedures of the spin-off are completed, Spinco will operate independently and be able to pursue its own business strategy, including conducting a Russian or international IPO. However, often times Spinco will have received sufficient cash for its operations along with the other assets transferred by Parentco in the spin-off. In such cases, or where market conditions for an IPO are not favorable, Spinco could decide to proceed with a foreign listing without an offering, which would improve the liquidity of Spinco shares.

Philip Webb is a NY lawyer, senior associate in the Moscow office of the law firm Debevoise & Plimpton LLP. Mr. Webb has advised Russian companies in a number of M&A and securities matters, including the spin-off of Polyus Gold from Norilsk Nickel and the spin-off of generating and other energy companies in the course of RAO UES's restructuring.

Spin-off Process: Indicative Timetable*

- X – meeting of Parentco's Board of Directors calling an extraordinary general shareholders meeting (GSM) to approve the spin-off, approving substantially final form of Information Statement and other draft documents to be provided to the shareholders.
- X + 71 – approval of the spin-off at the extraordinary GSM.
- X + 85, X + 101 – publication of the notice of reorganization in the journal "Vestnik gosudarstvennoi registratsii".
- + 116 – end of redemption election period for shareholders who vote against or do not vote on the spin-off.
- X + 131 – deadline for creditors to exercise their right to demand early performance of the relevant obligations and, if early performance is not possible, termination of those obligations and compensation of related damages.
- X + 146 – completion of redemptions of Parentco shares surrendered by shareholders who vote against or do not vote on the spin-off.
- X + 155 – state registration of Spinco.
- X + 200 – state registration of Spinco shares.
- X + 215 – listing of Spinco shares on RTS and/or MICEX (if applicable).
- X + 240 – FSFM approval for the circulation of Spinco shares abroad (applicable only if the spin-off envisages distribution of depositary receipts, representing rights to Spinco shares, to Parentco's depositary receipt holders).
- X + 245 – Depositary receipt program established; Spinco depositary receipts distributed to Parentco's depositary receipt holders.
- All days are minimum calendar days required, estimated based on applicable notice periods and other legislative requirements.

Comparison of Spin-Off of a Subsidiary, its IPO and Strategic Sale as a Means of Increasing Shareholder Value

	Spin-Off	Subsidiary IPO	Strategic Sale
Structure	Parent separates from Subsidiary	Parent retains stake in Subsidiary, offers shares/DRs in Subsidiary	Parent sells all or portion of Subsidiary
Consideration to Parent's Shareholders	Shares/DRs in Spinco	None directly, but possible enhanced valuation of Subsidiary and, as a result, an increase in Parentco's value	None directly, but possible enhanced valuation of Subsidiary and, as a result, an increase in Parentco's value
Capital Raised	None	New capital raised for Subsidiary	Proceeds raised by Parent
Corporate Approval Requirements at Parentco Level	75% shareholder approval	No shareholder approval likely required	No shareholder approval likely required, unless "major transaction"
Timing	8-12 months	3-4 months	Flexible: 2-3 months
Disclosure	Information Statement with 3 years financials, subject to availability	Prospectus, with 3 years financials	Flexible: no specific requirements