

WEBINAR

# *Unlocking Value Through Life Sciences Spin-offs and Carve-outs*

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WEBINAR  
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# *Agenda*

- Overview
- Key Corporate Separation, Structuring, Documentation and Governance Considerations
- Tax Considerations
- IP and Licensing Considerations
- Capital Markets and Securities Law Matters
- Conclusion and Q&A

# *Overview*



## *Why Consider Spin-Off or Other Carveout Transaction?*

- Unlock value of unrecognized or undervalued assets
- Enhance business focus
- Create “pure play” identity
- Rationalize capital structure and potentially improve access to capital
- Increase effectiveness of equity-based compensation
- Make better use of equity as acquisition currency
- Response to shareholder activism



# *Spin-Off and Other Carveout Transaction Structures*

- Spin-Off
- IPO Followed by Spin
- Partial Spin
- Sponsored Spin
- Spin Combined with M&A Transaction
- Split-Off
- Carveout Sale
- SPAC Business Combination



# *Announced and Completed Healthcare and Life Sciences Spin-Offs*

## Announced Transactions:

- Becton-Dickson – Spin of diabetes care unit
- GlaxoSmithKline – Partial spin of consumer health unit
- Colfax – Spin of specialty medtech unit
- Tenet – Spin of Conifer healthcare services unit
- Zimmer Biomet – Spin of spine and dental businesses
- Bluebird Bio – Spin of oncology unit
- Bausch Health – Spin of Bausch & Lomb eye care business
- Sanofi – IPO/spin of EUROAPI unit



# *Announced and Completed Healthcare and Life Sciences Spin-Offs*

## Completed Transactions:

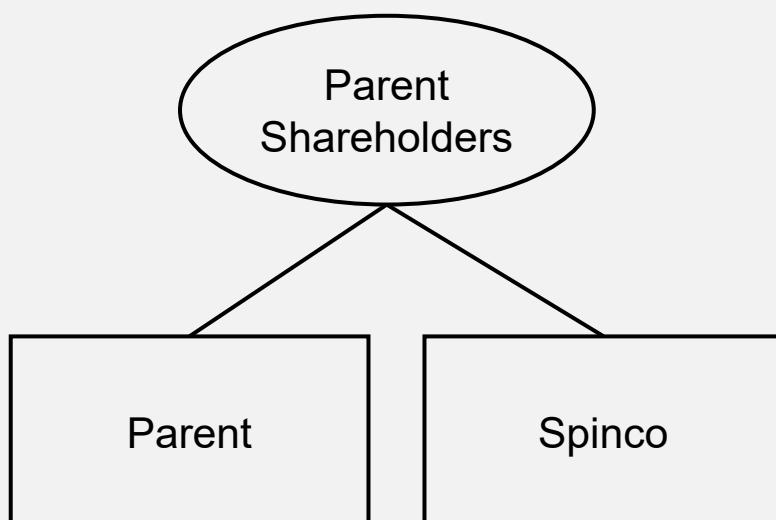
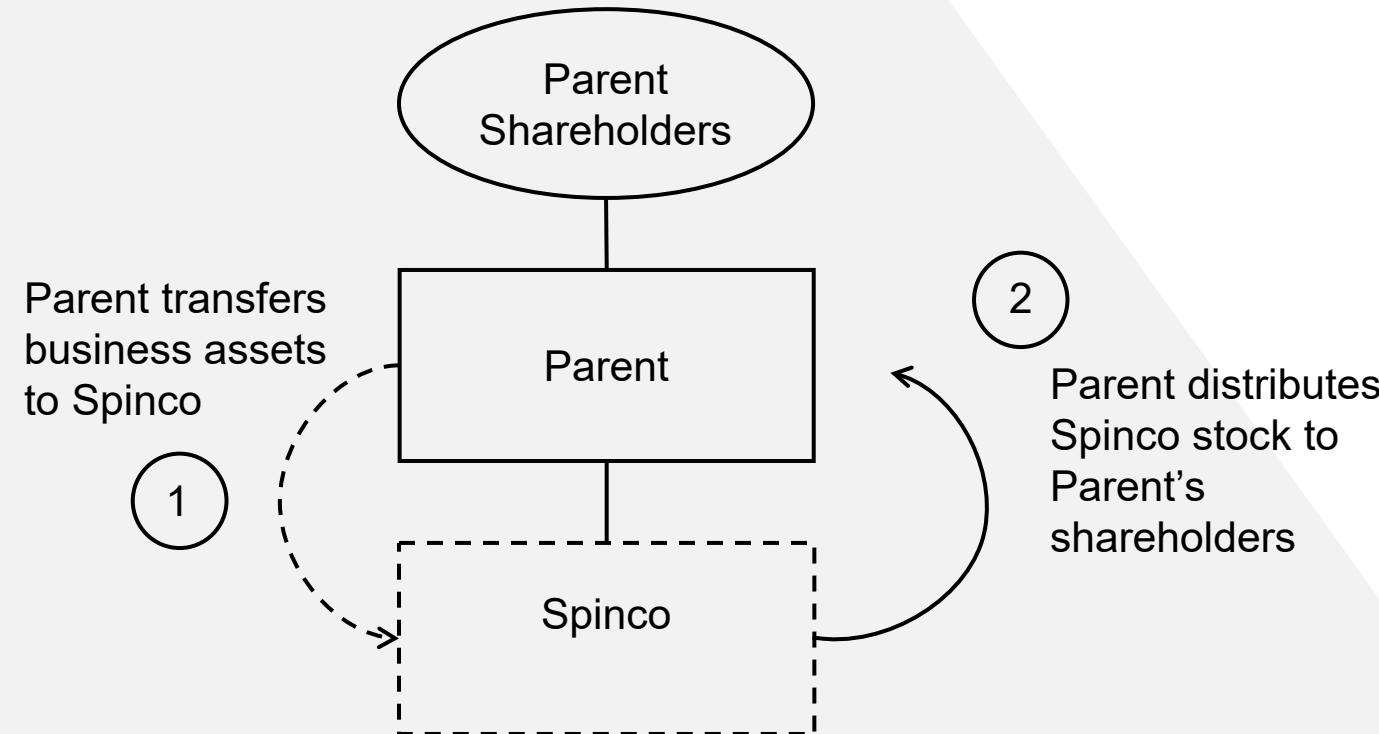
- Merck – Spin of Organon (women's health)
- Pfizer – Spin-merge of Upjohn business with Mylan to create Viatris
- PDL Biopharma – Spin off of LENSAR device company
- Novartis – Spin of Alcon eye care business
- Ironwood Pharmaceuticals – Spin of Cycleron Therapeutics
- Henry Schein – Spin-merge of animal health business with Vets First to create Covetrus
- Eli Lilly – IPO carve-out of Elanco animal health business
- Johnson & Johnson – Spin of Idorsia R&D unit from acquisition of Actelion
- Biogen – Spin of Bioverativ hemophilia business
- Varian Medical Systems – Spin of Varex imaging
- Emergent Biosolutions – spin of Apteva Therapeutics
- Community Health Systems – spin of Quorum Health
- Ventas – Spin of Care Capital Properties
- Baxter – Spin of Baxalta
- Integra Life Sciences – spin of SeaSpine
- Biotime – spin of OncoCyte



# *Key Corporate Separation, Structuring, Documentation and Governance Considerations*



## *Example of Basic Structure of Spin-off*



- Step 1 is the transfer of the assets of the business to be spun-off to Spinco in exchange for Spinco stock and Spinco's assumption of liabilities.
- Step 2 is the distribution of Spinco stock to Parent's shareholders
- After the spin-off, each of Parent and Spinco will be separate, independent companies and the shares of stock in each company will be separately tradeable



## *Key Separation Considerations*

Significant advance planning is required:

- Defining the “Business”
- Identifying assets and liabilities to be separated
- Allocation of employees
- Identifying and addressing shared assets and contracts
- Consents, waivers, notices, replacement of credit support



# *Key Separation Consideration: Key Documents*

## Separation and Distribution Agreement

- Allocates assets/liabilities
  - Asset sale style provisions (e.g., assumed/excluded assets/liabilities; “exclusively related to” vs. “primarily related to” vs. specific schedules)
- Consistency with new SpinCo financial statements
- Contingent Liabilities
- Distribution mechanics
- Cross indemnification

## Transition Services Agreement

- Identify necessary shared services, pricing, and period of service
- Arm’s length terms

## Tax Matters Agreement

Other agreements regarding specific matters, e.g., litigation, employee benefits, intellectual property



## *Governance Considerations*

### Parent Board Duties in evaluating a spin:

- Duty of Care: To act on an informed, deliberative basis with same level of care and diligence as a reasonable person would in similar circumstances based on all information reasonably available
  - Board must be informed and active – can rely on experts including bankers, valuation firms and counsel, but can also rely on own industry and market knowledge and knowledge of the Company
- Duty of Loyalty: To act (including deciding not to act) on a disinterested and independent basis, in good faith, with an honest belief that the action is in the best interest of the company and its stockholders
  - Board must consider any actual or potential conflicts
- Directors of parent do not owe fiduciary duties to SpinCo, or the prospective shareholders of SpinCo (even post-announcement)



## *Governance Considerations (cont'd)*

### Business Judgment Rule:

- If Parent Board satisfies its duties of care and loyalty (including good faith) regarding a decision to spin off a business or subsidiary, then courts will review that decision under the deferential business judgment rule, which presumes that the Board acted on an informed basis and in the good faith belief that the action was taken with the best interests of the company and its shareholders
  - In satisfying this duty, the Board is entitled to rely on advice from management, financial advisors, legal advisors and other experts

However, if shareholders can overcome this presumption, including by showing that the directors did not act on an informed basis or in good faith, or that a conflict exists, then heightened judicial scrutiny may apply

- Typical director conflicts could include personal benefits from consulting or business contracts from spin transaction or, in some cases, overlapping directorships



## *Governance Considerations (cont'd)*

Importance of record of thorough and well-informed decision making process, reflecting careful deliberation

- Reliance on appropriate outside advisors and management
- Courts continue to emphasize importance of minutes and other contemporaneous written records of board's consideration (including board decks), which will be given significant weight in litigation challenging board actions



## *Governance Considerations (cont'd)*

### Dividends:

- Under Delaware law, a corporation may only pay dividends out of its “surplus” or net profits for current or prior year (and only if it would not render the corporation insolvent)
- Directors may be held personally liable if directors are determined to have acted negligently regarding approval of unlawful dividend
- Some states (including Delaware) provide for a safe harbor for directors who rely on reports of employees, committees of the board or experts as to the availability of surplus or other funds



## *Governance Considerations (cont'd)*

### Solvency

- Risk of potential subsequent attack based on solvency, fraudulent transfer (actual or constructive), and/or other similar claims
- Transfer of assets and liabilities typically not for “reasonably equivalent value,” thus the focus on solvency
- Solvency opinions from valuation firms
- Both companies should be financially viable, and able to bridge to independence
- Risks posed by contingent liabilities

# *Tax Considerations*



## *Tax-free Spin-offs: General requirements*

To qualify as a tax-free spin-off under Section 355 of the Code, the spin-off must meet a number of requirements, including (but not limited to) the following:

- **Control:** Parent must own 80% or more of Spinco and generally must distribute its entire interest in Spinco
- **ATB Requirement:** after the spin-off, each of Parent and Spinco must actively conduct a business, which has been conducted for 5 years prior to the spin-off
- **Business Purpose:** the spin-off must be undertaken for one or more substantial corporate business purposes
- **Device:** the spin-off cannot be used principally as a “device” to distribute earnings and profits of Parent
- **Section 355(e):** the spin-off cannot be part of a plan in which one or more persons acquire 50% or more of Parent or Spinco
- **Separation:** the spin-off must affect a genuine separation of the businesses



# *Tax-free Spin-offs: IRS Rulings and Tax Opinions*

- A “failed” tax-free spin-off generally would result in substantial tax to Parent and its shareholders
- An IRS ruling and/or tax opinion from Parent’s advisors is generally obtained to assure that the complex tax rules for tax-free spin-offs are satisfied
- IRS generally will not rule on the following, which must be addressed by a tax opinion:
  - Business Purpose
  - Device
  - Section 355(e)
- It takes approx. 6 months to obtain an IRS ruling after the request is submitted



## *ATB Requirement*

- Each of Parent and Spinco must be engaged in an active trade or business (“ATB”) immediately after the spin-off
- To obtain IRS ruling, the fmv of the ATB assets must be 5% or more of the total fmv of the gross assets of Parent or Spinco, as applicable
- Each ATB must have been actively conducted for the last 5 years by Parent or its subsidiaries
  - Historically, the IRS generally required the collection of income in each of the last 5 years to satisfy the ATB requirement.
  - In 2018, the IRS announced that it is considering guidance to address whether a business can qualify as an ATB if entrepreneurial activities take place with the purpose of earning income in the future, but no income has yet been collected.
  - In 2020, the IRS released a PLR in which the absence of income collection did not prevent Spinco’s business from qualifying as an ATB where the facts indicated that such business had the ability to generate income for the 5-year period prior to the spin.



## *ATB Requirement*

IRS has indicated that it is considering whether the following factors could substitute for the collection of income requirement:

- Regular, continuing research and related activities by a significant number of full-time management and operational employees;
- Regular, continuing expenses for research and related activities;
- Significant progress toward developing an income-producing product;
- Holding out that the business is available to enter into an income-producing arrangement;
- An actual offer or expression of interest made or received by the business to enter into an income-producing arrangement; and/or
- Similarly situated business have entered into income-producing arrangements with research that has progressed to a similar level as the taxpayer's research.



## *Business Purpose*

Distribution must have a substantial corporate business purpose

- Cannot be shareholder purpose

Possible corporate business purposes:

- Increase value of stock of Parent and/or Spinco to use equity, in more efficient manner, for (i) equity compensation, (ii) future acquisitions, or (iii) to raise money in the public markets
- To resolve management, systemic or other problems, such as competition for capital, that arise from operation of the business divisions in one group
- To facilitate an acquisition (but need to be cognizant of Section 355(e) limitations)

Business purpose will need to be documented in detail

- depending on the business purpose, third-party documentation, such as a letter from bankers, may be recommended



## *Device*

Distribution may not be used principally as a device to distribute earnings and profits of Parent

- Distribution generally may not be used to facilitate sale of stock in Parent and retention of shares in Spinco, or vice versa, by shareholders

To obtain IRS ruling, Parent will need to make certain representations regarding the gross investment assets of Parent and Spinco, such as:

- The fmv of the gross investment assets of each of Parent and Spinco are less than 2/3 of the fmv of its total gross assets

or

- The fmv of the gross assets of the ATB of each of Parent and Spinco will be 10% or more of the fmv of its total gross investment assets.



# *IP and Licensing Considerations*



## *Nature of Intellectual Property to be Allocated*

- Platform IP used for product generation and/or fundamental for business to operate
- Product-specific IP
- Tool IP
- IP category (patent, know-how, software/other copyrightable material, trademark)
- How will IP be transferred (assignment vs. license)?
- Will IP rights be divided by field?
- Need for licenses back?
- Licenses to subsequent inventions/improvements?
- Is IP to be transferred or shared governed by upstream license agreements?



## *Business Considerations*

### Role of IP in businesses

- Need for freedom to operate
- Need to protect exclusivity of products
  - Need for IP enforcement rights
- R&D/product innovator businesses vs. commercialization businesses
- Need for sublicensing rights
  - Right to monetize IP through sublicensing or sublicense rights limited to products generated by business?
- Need for right to further assign IP or IP licenses



## *Business Considerations*

- Can IP management and enforcement rights be allocated in a manner that is consistent with business objectives?
- Potential competition with parent company
  - Solvable with field-limited license structure?
  - Exclusive know-how licenses can function as long-term non-compete covenants
- Potential need for ongoing IP-based services (e.g., R&D or manufacturing)
- Limited license term?
  - Are businesses likely to remain reliant on transferred IP over long-term?
- Intercompany license economics?



# *Capital Markets and Securities Law Matters*



## *Capital Markets and Securities Law Matters*

Spin-offs must be registered with the SEC, an extensive process that takes 6-12 months on average

- Preparation of audited Spinco carve-out financial statements, pro formas and registration statement
- Choice of stock exchange
- Spinco governance
- Public company readiness
- Spinco financing structure



## *SEC Registration on Form 10 or Form S-1*

Choice of form depends on transaction structure

- Form 10 permitted for pro rata distributions of Spinco stock for no consideration (Exchange Act registration)
- If IPO will precede spin, Parent stockholders make an investment decision or distribution is not pro rata, Form S-1 is required (Securities Act registration)

Contents of both forms are essentially identical

- Same financial statements required
- Same business and management disclosures, management's discussion and analysis ("MD&A") and risk factors required
  - "Emerging growth company" status is primary driver of level of disclosures
- Agreements between Parent and Spinco will be filed as exhibits



## *SEC Registration on Form 10 or Form S-1*

SEC review process is essentially identical

- Able to file confidentially – 30 days to initial SEC comments
- No filing fee for Form 10

### **Liability**

- Strict liability for Spinco, officers and directors for Form S-1 transactions (subject only to a due diligence defense for directors and officers)
- More limited Spinco “10b-5” liability (with additional defenses) for Form 10 spins

More communications restrictions with Form S-1 transactions



## *Choice of Stock Exchange*

Companies consider a number of factors when deciding whether to list Spinco stock on Nasdaq or the NYSE

- Quantitative listing standards vary between the exchanges and among different listing segments of each exchange
- Nasdaq historically was more common choice for IPOs and for life sciences companies; larger cap companies may be more inclined to the NYSE
- Governance requirements are similar, but not identical; phase-in periods can differ
- Most common to list Spinco on same exchange as Parent but exchanges are very competitive for new listings
- If Spinco is listed on a different exchange than Parent, careful coordination of when-issued and ex-div trading is required



## *Spinco Governance*

Stock exchange listing requirements drive certain decisions, particularly board composition

- Independent directors and board committees
- “Controlled company” exceptions likely available where IPO precedes spin-off
- Overlapping director considerations
- Related party transaction approval and disclosure

Takeover defense considerations

- More defenses for Spinco (classified board, supermajority protections, limits on stockholder action, etc.) may be appropriate
- Must weigh against investor reaction



## *Public Company Readiness*

Spinco must be a fully functioning, stand-alone public company

- Disclosure controls and procedures
- Internal control over financial reporting
- Employee benefits and executive compensation matters
- Investor relations
- Regulation FD and corporate communications policy
- Board committee charters and corporate governance guidelines
- Insider trading policy/ Section 16 reporting
- D&O insurance



## *Spinco Financing*

Spinco's capital structure must be designed and implemented ahead of the separation

- Spinco must be solvent at the time of the spin-off and have the resources to pursue its business agenda
  - Working capital facility
- Parent debt commonly reallocated through a variety of structures, which are heavily tax-driven
  - Public or private offering of Spinco bonds, with proceeds dividdended to Parent to repay Parent debt
  - Exchange offer of new Spinco bonds for existing Parent bonds

# *Conclusion and Q&A*



# Questions

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