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Insulation by Separation: When Dual-Class Stock Met Corporate Spin-Offs

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INSULATION BY SEPARATION: WHEN DUAL-CLASS STOCK MET CORPORATE SPIN-OFFS

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The recent rise of shareholder engagement has revamped companies' corporate governance structures so as to empower shareholder rights and to constrain managerial opportunism. Notwithstanding the general trend, this Article uncovers corporate spin-off transactions—which divide a single company into two or more companies—as a unique mechanism that insulates the management from shareholder intervention. In a spin-off, the company's managers can fundamentally change the governance arrangements of the new spun-off company without being subject to monitoring mechanisms, such as shareholder approval or market check. Those changes often empower managers over shareholders. Furthermore, most spin-off transactions enjoy tax benefits. The potential agency problems associated with the managers' unilateral governance changes can be further compounded when the managers adopt multiple classes of common stock with unequal voting rights ("dual-class stock") in the new spun-off company without shareholder approval.

This is the first Article to systematically examine the problem from both corporate and tax law perspectives and to offer possible solutions. The Article argues that when the managers' unilateral governance changes are substantial, certain adjustments to corporate and tax laws may be necessary to curb managerial opportunism. For instance, under corporate law, when spin-off transactions accompany a charter amendment, shareholder approval, either at the state law level or company charter level, can be mandated. In addition, tax law can revisit the "continuity of interest" requirement to evaluate whether material changes in shareholder voting rights can disqualify certain spin-offs from tax-free treatment. The Article will also present new insights into the long-standing debate on dual-class stock by showing how the perceived risk of dual-class stock can be magnified when combined with spin-off transactions.

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INTRODUCTION

Suppose A, B, C, and D share one pepperoni pizza. Each paid exactly one quarter of the pizza price and all equally like pepperoni. Suppose A was in charge of dividing the pizza evenly. Initially the pizza was cut in four slices, but A thought each pizza slice was too big to hold and cut each slice further in half without asking the others. Now the pizza is cut in eight identically-sized slices. The pepperoni toppings were relatively evenly-distributed when the pizza was sliced in four, but not anymore when sliced in eight because some of the toppings were bunched. A chose two pizza slices with the most pepperoni toppings, and B, C, and D got two slices each with visibly less pepperoni toppings than A's slices. Given the situation, B, C, and D all claim that A's decision to cut the pizza into eight slices resulted in unequal distribution of the pizza. Specifically, they argue that A should have asked for B, C, and D's agreement before the division. Alternatively, they say that A should pay more for the pizza because A got more pepperoni toppings. Should dividing the pizza into the *same number* of equally-sized slices but with *different toppings* be treated as an equal distribution of the pizza? Or, should A pay more because of getting more toppings? Would it be different if A got approval from the others to divide in that way?

This division of pepperoni pizza provides a hypothetical, somewhat sophomoric, but perhaps serves as a useful lens to understand the current real-world issue associated with corporate spin-offs. This Article criticizes that neither corporate law nor tax law properly addresses the new phenomenon of "proportional in number of stock (i.e., same number of equal-sized pizza slices) but differential in benefit attached to the stock (i.e., different amount of toppings on each pizza slice)" problem arising from corporate spin-offs. Both laws have rarely considered the differences in rights attached to stock as long as the distributed number of stock is "pro-rata" to stock ownership. The Article argues that the rights attached to stock should be taken into account in evaluating spin-offs in order to prevent opportunistic management insulation from shareholder intervention.

A corporate spin-off divides a company into more than two independent public companies.[1] As a result, it creates a new spun-off public company ("SpinCo") by distributing the new company's stock to the parent company

[1] *See, e.g.*, WACHTELL, LIPTON, ROSEN & KATZ, SPIN-OFF GUIDE 1 (2018) [hereinafter WACHTELL SPIN-OFF GUIDE], http://www.wlrk.com/files/2018/SpinOffGuide.pdf. For a detailed timeline for a spin-off transaction, *see* Paul Hammes et al., *Tax-Free Spin-off Roadmap*, https://www.ey.com/Publication/vwLUAssets/EY-tax-free-spin-off-roadmap/$FILE/EY-tax-free-spin-off-roadmap.pdf.

("ParentCo")'s existing shareholders in the form of dividends proportionally to their stock ownership. A spin-off offers unfettered discretion for managers. On the one hand, unlike an Initial Public Offering ("IPO"), i.e., the very first sale of a new company's stock to the public, a new SpinCo does not need to worry about the market reaction to the SpinCo's various features including governance arrangements. This is because the SpinCo stock is internally distributed to the existing ParentCo's shareholders.[2] On the other hand, a spin-off has been consistently treated as a way to distribute dividends to ParentCo's shareholders, which is within managers' discretion under current corporate law. Thus, ParentCo's managers can decide whether, when, and how to make dividends through the form of a spin-off without shareholder approval.[3] An important assumption for such lack of shareholder approval in a spin-off is that there are no fundamental changes to shareholder rights before and after the spin-off. Furthermore, the same assumption of mere change in forms of ownership also functions as a basis for tax-free benefit for spin-offs. The recent practice, however, shows that the consequences of spin-off may be far more transformative than a simple dividend distribution.[4]

For illustration, when managers of ConocoPhillips (ParentCo) separated its refining business into a stand-alone public company called Phillips 66 (SpinCo) through a spin-off transaction in 2012, they also had full discretion

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[2] *See infra* Part I.B.1. For instance, while each shareholder can trade the SpinCo stock individually on the market later on, the individual shareholder rather than the SpinCo will bear the costs of potentially entrenching governance arrangements. In that sense, managers who initially design the SpinCo's governance arrangements have little incentive to optimize them.

[3] *See infra* Part I.B.2. While corporate law defers spin-off decisions to directors, the Securities Exchange Commission ("SEC") substantially oversees spin-offs through Form 10 registration statement filings pursuant to Section 12(b) or (g) of the Securities Exchange Act of 1934. Since spin-offs involve the issuance of new stock, SpinCo must file Form 10, a registration form for spin-offs, with the SEC. *See* 17 CFR 240.12b or 240.12g. The typical SEC review process begins with SpinCo's submission of its initial Form 10 filing with the SEC. The SEC generally provides comments within 30 days of an initial Form 10 filing. The Form 10 will not be declared effective by the SEC until SpinCo has responded to all comments and the responses have been cleared by the SEC. *See* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 41. The SEC's oversight, however, does not effectively extend to corporate governance issues. While Form 10 filings submitted to the SEC contain SpinCo's charters as exhibits, the SEC also—even more than typical court—tends to defer the optimal corporate governance arrangements to managers of each company.

[4] *See, e.g.,* Robert Daines & Michael Klausner, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs*, Working Paper (2004), at 3 [hereinafter *Agents Protecting Agents*] ("Comparing spinoffs to their parent firms, we find that spinoffs tend to have more takeover protection than their parents and that entrenchment of spinoff management is costly to parent shareholders."); WACHTELL SPIN-OFF GUIDE *supra* note 1, at 22. ("In many spin-offs and IPOs, the spin-off company has more antitakeover provisions in its charter and bylaws than the parent.").

to adopt an initial corporate charter for Phillips 66. The SpinCo's charter was modeled after ParentCo's charter provisions almost verbatim. On top of those identical provisions, the managers added a charter provision allowing a staggered board of directors in the new SpinCo.[5] The adoption of the staggered board—a powerful defensive device for management—went in the opposite direction of the recent mainstream trend of eliminating staggered boards in other public companies.[6] More notably, the adoption of the staggered board provision for the SpinCo was subject to neither shareholder approval nor market-pricing checks.[7] Also, the spin-off transaction was able to avoid paying taxes on the built-in gain in Phillips 66, which would have been imposed if ConocoPhillips simply sold its refining business instead of spinning it off.[8] As such, the spin-off transaction provided an extraordinarily counterintuitive opportunity for Phillips 66, which became a new stand-alone public company, to adopt the effective anti-takeover provision without shareholder approval or market checks. This opportunity also allowed Phillips66 to enjoy juicy tax-free benefits. As shown in the Phillips 66 example, empirical data has suggested that managers tend to stretch their discretion in spin-offs even to set governance arrangements in a way to empower themselves over shareholders and to make them less accountable to shareholders.[9]

Does this phenomenon conform to the assumption that there are no fundamental changes before and after the spin-off? If ParentCo's managers add a new provision affecting the allocation of power between shareholders

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[5] *See* AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF PHILLIPS 66, Fifth A. (May 2, 2012); AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF CONOCOPHILLIPS, Fifth A. (Jul. 28, 2008).

[6] *See, e.g.*, Erik Krusch, *Corporate Governance: Staggered U.S. Boards Are Endangered Species*, REUTERS (Mar. 23, 2011), http://blogs.reuters.com/financial-regulatory-forum/2011/03/23/corporate-governance-staggered-u-s-boards-are-endangered-species/ ("The overwhelming trend in corporate governance is towards the declassification of boards and this year is no exception, with several shareholder proposals calling for declassification making their way onto 2011 proxies.").

[7] *See infra* Part I.B.1.

[8] *See* Anna Driver, *Conoco Board Approves Spin-off of Refining Unit*, REUTERS (Apr. 4, 2012), https://www.reuters.com/article/us-conocophillips/conoco-board-approves-spin-off-of-refining-unit-idUSBRE83318820120404.

[9] Adopting anti-takeover provisions in SpinCo's corporate charter, such as a staggered board, is a good example of the governance rearrangements. A recent empirical study on corporate opportunity waivers shows that managers tend to opt out of the fiduciary duty of loyalty when they have an option to waive the duty. The corporate opportunity waivers are common in SpinCo particularly when multiple ParentCo managers also sit on SpinCo. *See, e.g.*, Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 COLUM. L. REV. 1075–1152 (2017).

and managers into a SpinCo's charter, the change is not likely a mere distribution anymore. The assumption for special treatment for spin-offs is under attack. Going back to the pizza analogy, it might be the distribution of the same number of equal-sized pizza slices (i.e., proportional number of stock) to stakeholders, but managers who decide to separate the pizza (i.e., ParentCo managers) unevenly allocate pepperoni toppings (e.g., differential voting rights) and take the most lucrative pieces. Such governance changes through corporate charters are considered fundamental changes to the companies, and shareholder approval is necessary in all cases—except in spin-offs.

The current procedural privilege for spin-offs, which enables managers' unilateral governance changes, raises concerns about potential managerial entrenchment. It seems that the lack of a monitoring mechanism for governance changes over spin-offs would facilitate the managers' opportunistic governance changes and thus increases agency costs out of entrenchment. Even when managers implement anti-takeover provisions in a SpinCo to advance shareholder value, this legitimate incentive does not necessarily justify the elimination of a checking mechanism due to the rigidity of corporate charters. State corporate laws require mutual consent between managers and shareholders to amend corporate charters, so that neither shareholders nor managers can change corporate charters unilaterally.[10] Thus, once ParentCo managers implement an anti-takeover provision in a SpinCo's charter, shareholders cannot take it off without managers' consent. Because the efficiency of anti-takeover provisions is volatile as the company's other features evolve (e.g., ownership structure, company age, or company size), an efficient anti-takeover provision at the time of the adoption would not be necessarily efficient ten years after the adoption. Because most anti-takeover provisions inherently have a self-serving element to managers by securing their tenure on the board, the adoption of an "efficient-for-now" anti-takeover provision is always vulnerable to managerial entrenchment.[11]

The agency problems inherent in the managers' unilateral governance changes described above can significantly be compounded when ParentCo's managers adopt a dual-class stock structure in SpinCo's charter without shareholder approval. Dual-class stock, which involves two or more classes of common stock with unequal voting rights, has been on rise. By adopting a dual-class stock structure, one class of shareholders receives a higher voting right per share than the others.[12] Often times, trading high-vote stock on the

[10] *See, e.g.*, DEL. CODE. ANN. TIT. 8, § 242(b)(1) (2014).
[11] *See infra* Part II.A.1.
[12] For instance, the voting rights ratio between Facebook's Class A and Class B

market is even prohibited by corporate charters. Thus, dual-class stock is one of the most effective tactics for a small number of insiders to retain corporate control without corresponding equity interests.[13] As shareholder voting remains the primary tool for incorporating shareholders' voice into corporate decisions, any deviation from the one-share-one-vote standard (e.g., by adopting dual-class stock structure) is required to be explicitly set forth in the company's charter.[14] Nevertheless, as this Article reveals, a spin-off offers leeway for managers to switch to the dual-class structure post-IPO stage. The adoption of dual-class stock through spin-off not only bypasses the shareholder approval requirement for a charter amendment under corporate law, but it also overrides the rules of the major stock exchanges that prohibit a post-IPO switch from a one-share-one-vote principle to dual-class stock except through Initial Public Offerings (IPOs).[15]

As such, ParentCo managers' unilateral governance changes through a SpinCo charter are likely to make fundamental changes to a company before and after the spin-off. These changes should not be eligible for special treatment (i.e., no shareholder approval) under corporate law.

The deviation from the assumption of no fundamental changes before and after the spin-off also has significant implications for tax law treatment of spin-offs. The reason that tax law offers a tax-free benefit to certain spin-offs is that if a corporate reorganization through spin-offs is a mere change in form and yet more efficient for the business, tax law will facilitate such transactions by deferring tax liability that should have been imposed on the separating transaction.[16] The tax benefit is so attractive that the popularity of

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stockholders is 1:10. Mark Zuckerberg and a small group of insiders of insiders hold Class B high vote stock. *See* AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF FACEBOOK, INC., Article IV.3.2. (Jun. 20, 2016).

[13] Facebook's Class B stockholders including Mark Zuckerberg own approximately 18% of the company's share, but control nearly 70% of the voting power. *See* Bob Pisani, *Shareholders Won't Force Zuckerberg's Hand in Facebook Management*, CNBC (Mar. 21, 2018), https://www.cnbc.com/2018/03/20/shareholders-wont-force-zuckerbergs-hand-in-facebook-management.html.

[14] *See, e.g.,* DEL. CODE. ANN. TIT. 8, § 212(a) ("Unless otherwise provided in the certificate of incorporation…each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder."); Model Bus. Corp. Act Ann. §7.21(a) ("[U]nless the articles of incorporation provide otherwise, each outstanding share, regardless of class or series, is entitled to one vote on each matter voted on at a shareholders' meeting.").

[15] NYSE Listed Company Manual Section 313.00 (1992); NASDAQ Stock Market Rule 5640. Public companies cannot amend their charters to adopt dual-class stock even when their shareholders approve it without giving up their inclusion on major stock exchanges.

[16] Legislative history and Treasury Regulations explain that the purpose of the tax-free treatment of reorganization transactions is to make exceptions from the general rule for certain "readjustments of corporate structures . . . as are required by business exigencies" and "which effect only a readjustment of the shareholder's continuing interest in property

corporate spin-offs largely derives directly from the tax-free benefit status of the spin-off. While tax-free benefits are not the only or primary reason for corporate spin-offs, spin-offs are often conditioned on their tax-free status.[17] In that sense, the dynamic of corporate spin-offs cannot be accurately understood without considering the element of taxation. However, if the governance changes during spin-offs are considered to be fundamental changes of the company, it is hard to justify tax-free benefits for those spin-offs. Nonetheless, current tax law fails to scrutinize the problem, which this Article aims to address.

This Article does not claim that managers' discretion regarding a corporate spin-off in general should be constrained. Rather, it highlights the potential risks of unconstrained managerial discretion over governance arrangements during spin-offs, which deviates from the initial intent of both corporate and tax legislation on the issue. Also, given the increasing popularity of both corporate spin-offs and dual-class stock issuances in recent years,[18] the adoption of dual-class stock in corporate spin-offs seems likely to expand. As the first academic paper that provides a cooperative analysis of both corporate law and tax law issues in spin-offs, this Article not only reveals a new practice largely ignored by previous literature, but also contributes to multiple strands of academic literature.

First, it adds another important, but underdiscussed, specific situation that expands the managers' tendency to exercise their discretion to advance their own benefits over shareholders' to the situations brought out by the prior literature.[19] Second, because the Article examines spin-offs together with dual-class stock, it connects with the current, sometimes heated debate on whether dual-class stock is conducive to shareholder value.[20] Amid the raging debate over dual-class stock, however, both supporters and opponents

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under modified corporate forms." For acquisitive reorganizations, such as mergers and acquisitions, *see* Treas. Reg. § 1.368-1(b); for divisive reorganization, such as spin-off, *see* STAFF OF J. COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 337 (1987) and Treas. Reg. § 1.355-2(b)(1).

[17] *See infra* Part I.C.1.

[18] *See, e.g.*, WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 1 ("The volume of spin-offs in 2017 increased slightly from 2016 to approximately $132 billion."); Andrea Tan & Benjamin Robertson, *Dual-Class Shares Are Coming Under Fire-Again*, BLOOMBERG NEWS (Sep. 27, 2017), https://www.bloomberg.com/news/articles/2017-09-27/can-democracy-stage-a-comeback-at-stock-exchanges ("One percent of U.S. IPOs had weighted voting rights in 2005, according to Sutter Securities Inc. in San Francisco; a decade later 15 percent did, with technology companies making up more than half the total.").

[19] *See* Rauterberg & Talley, *supra* note 9 (discussing managers tendency in the context of waiving fiduciary duty of loyalty); Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549–1595 (2010) (critizing managerial opportunism in a bunded shareholder approval of a merger itself and a new corporate charter.).

[20] *See infra* Part II.B.

pay little attention to the situation where managers can unilaterally adopt dual-class stock or change existing voting rights for each class, specifically through corporate spin-offs.

Third, this Article updates the tax law literature on the "continuity of interest" requirement in spin-offs that has not been reviewed since the early 2000s. The continuity of interest doctrine requires that shareholders of ParentCo continue their proprietary interest in SpinCo more than at a certain level. Along with other requirements for tax-free spinoffs, this requirement is supposed to guarantee that the spin-off is a mere change in corporate forms. However, the continuity of interest requirement fails to review whether spin-offs with significant governance changes could still be viewed as mere changes in form and thus deserving of tax-free benefits. This Article offers critiques on current rules from a policy and legal perspective. Furthermore, this Article advances the debate on the efficacy and merit of current tax law influencing corporate governance and agency costs.

Finally, this Article argues that the current legal regime regarding spin-offs fails to address potential agency problems, specifically when a SpinCo adopts dual-class stock and proposes possible incentives or deterrents in important policy implications both to corporate and tax law. Specifically, it proposes that corporate law should consider a shareholder approval requirement for spin-offs that are sizable, or that substantially amend a SpinCo charter. At the same time, tax law needs to revisit the continuity of interest requirement to evaluate to what extent a spin-off involving governance changes can be treated as a tax-free (or tax-deferred) transaction.

This Article proceeds as follows. Part I overviews the legal rules on spin-offs in both corporate and tax law. It explains how spin-offs may be executed without shareholder approval and how spin-offs enjoy tax-free benefits. Part II shows that adopting dual-class stock via spin-off may exacerbate agency problems incurred by unilateral governance changes before and after the spin-off. It also explains why this phenomenon raises normative and doctrinal concerns about the associated tax-free benefits. In addition to theoretical analysis, it presents real-world examples demonstrating both corporate and tax problems. Part III urges lawmakers and/or companies to require shareholder approval as an enhanced shareholder monitoring mechanism for managers' unilateral governance changes through spin-offs and to reconsider the continuity of interest requirement in the Pilot Program on spin-offs offered by the Internal Revenue Service ("IRS"). Part IV concludes.

I. CORPORATE SPIN-OFFS AS TAX-FREE BUSINESS DECISION

In this Part, we explain how corporate spin-offs differ from other types of corporate separations and to what extent managers have discretion in shaping corporate governance arrangement for spun-off companies. We also show how spin-offs utilize tax-free benefits. Depending on the technique of corporate separation, legal constraints on managerial discretion vary significantly.

A. Legal Boundaries of Spin-offs

A corporate spin-off, where a single public company is divided into more than two stand-alone companies, is often regarded as the mirror image of a corporate merger. In contrast to the vigorous discussion on M&A issues, the volume of academic literature on corporate separations has been relatively thin. Prior studies on corporate separations were mainly conducted by financial economists focusing on the economic impacts of corporate break-ups.[21] Legal aspects of corporate separations have rarely been explored by academics, despite the increase in volume of corporate separations in practice.[22] The scope of the term "spin-off" varies among academics, and it is crucial to define the scope of corporate spin-offs as distinct from other types of corporate separations.

1. Definition of Spin-offs

Unfortunately, the term corporate "spin-off" has been used inconsistently. In its broadest meaning, the term encompasses many different types of corporate separations.[23] But more often a "spin-off" indicates only a specific type of corporate separation in a much narrower way. In this Article, a spin-off refers to a transaction that distributes the entire stock of a spun-off company to shareholders of a parent company as dividends on a pro rata basis such that the shareholders of a parent company hold stock of both the parent and the spun-off companies (i.e., a typical 100% spin-off). This 100% spin-off has become a typical form of corporate separation and the most widely used definition of corporate spin-offs. Corporate spin-offs are generally subject to business judgment rule protection and also eligible for tax-free

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[21] *See, e.g.*, Debra J. Aron, *Using the Capital Market as a Monitor: Corporate Spinoffs in an Agency Framework*, 22 RAND J. OF ECON. 505 (1991); Mehrotra L. Daley & R. Sivakumar, *Corporate Focus and Value Creation Evidence from Spinoffs*, 45(2) J. OF FIN. ECON. 257 (1997); Thomas J. Chemmanur et al., *Antitakeover Provisions in Corporate Spin-offs*, 34 J. OF BANK. FIN. 813 (2010).

[22] *See* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 1 ("The volume of spin-offs in 2017 increased slightly from 2016 to approximately $132 billion.").

[23] For instance, in prior literature, the term "spin-off" referred either to an equity carve-out which involves a public offering of SpinCo or to comprehensive corporate separations. *See* Daines & Klausner, *Agents Protecting Agents*, *supra* note 4 (discussing equity carve-out only.).

benefits.[24] Before discussing the unique features of such transactions, it is worth discussing several common spin-off variants; an appreciation of the differences between these related transactions is critical.

Since the purpose of this Article is to examine a unique and largely overlooked legal issue in corporate spin-offs, rather than to portray the complete landscape of corporate separations, this Article exclusively focuses on corporate spin-offs. Nevertheless, it is crucial to understand how corporate spin-offs differ from other types of corporate separations. After all, when these corporate spin-offs combine with public offerings or mergers as discussed below, the combination cures the lack of monitoring mechanism problem to some extent.

The first type combines corporate spin-offs with a public sale: the "equity carve-out." Because this transaction involves offering new securities to the public rather than a distribution to ParentCo's existing body of shareholders, the separation is subject to the market checks applicable to Initial Public Offerings ("IPO"). In order to maximize the market price of the stock at its IPO, managers have incentive to minimize managerial opportunism in all aspects of the company. By contrast, a typical spin-off is not subject to this price mechanism. In addition to the market checks, corporate separation with public offerings can also be subject to shareholder approval. State corporate laws generally give managers as agents of a corporation power to sell corporate assests without shareholder approval. When a corporation sells "all or subtantially all" of its assets, the sale requires approval of a majority of the outstanding stock of the corporation entitled to vote.[25] Another type of corporate separation is a separation combined with a concurrent merger: the "spin-merger." Typically in this case, after a spin-off, either SpinCo or ParentCo merges with a third party.[26] When a parent company merges with a third party, the parent company's shareholder approval is required to effectuate the merger. By contrast, when a spun-off company merges with a third party right after a spin-off, managers of a parent company can bypass getting the Spinco's shareholders' approval by getting shareholder approval before the spin-off. Spin-mergers are eligible for tax-free benefits under certain conditions.

These two types of corporate separations must be conceptually distinguished from a typical spin-off, and they do not share the agency

[24] For detailed tax-free benefits for spin-offs, *see infra* Part I.C.

[25] For instance, DEL. CODE. ANN. TIT. 8, § 122 (4) states, "Every corporation… shall have power… to sell… all or any of its property and assets . . .", but the power is limited by the shareholder approval requirement for "all or substantially all" assets at DGCL Section 271(a).

[26] Even among spin-mergers, when a SpinCo merger with a buyer before a ParentCo distributes stock, a spin-merger can bypass shareholder voting on the merger. *See* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 10.

problems that arise in typical spin-offs. After all, equity carve-outs are subject to market checks, and spin-mergers are subject to shareholder approval. Each of these corporate separations are accountable to at least one monitoring mechanism, and managers' discretion regarding the separation is thus limited to that extent. By contrast, managers can exercise greater discretion when they pursue a typical spin-off.

2. Purpose of Spin-offs

Corporations are not static; they dynamically transform over time. Multiple firms sometimes combine themselves into one, and at other times a single firm breaks up into pieces. Both corporate mergers (or "acquisitive reorganization" in tax terminology) and corporate separations[27] (or "divisive reorganization") demand sophisticated legal work throughout the process. While corporate mergers have been viewed as the pinnacle of sophisticated transactional techniques, corporate separations have received surprisingly little attention from legal academia. In general, a corporate separation is a complex deal, and it can be extremely difficult to identify the real motive driving the deal or to evaluate the impact of the deal.

In most cases, however, a corporate separation is principally driven by a valid business purpose. In dividing one business into two or more entities, management pursues operational objectives (e.g., to enhance business focus), financial objectives (e.g., to use more appropriate capital structure), or both.[28] In addition to the principal business reasons, tax treatment is known to be one of the most crucial factors to consider. Most spin-offs have been using a format of distribution of SpinCo's stock to shareholders of the parent company, and whether the stock distribution qualifies for tax-free dividends often serves as a prerequisite for completing spin-offs.[29] Compared with tax consideration, the corporate governance implications of spin-offs have received little emphasis until the recent uptick in shareholder activism. As a rare opportunity to reform a company's corporate governance arrangements in a direction management prefers, law firms have started advising companies to include management-empowering provisions in a governing document of SpinCo.[30]

[27] We use the term "corporate separation" in its broadest meaning that embraces all kinds of divisive reorganizations including spin-offs, equity-carve outs, and split-ups.

[28] *Id.* at 3.

[29] For instance, in 2015, Yahoo called off a plan to spin-off its stake in Alibaba after the IRS refused to grant a tax-free blessing. *See* Yahoo Inc., Current Report (Form 8-K) (Dec. 9, 2015), https://www.sec.gov/Archives/edgar/data/1011006/000119312515398244/d93711dex991.htm; *see* text accompanying *infra* notes 46–56.

[30] For a detailed discussion, *see infra* Part I.B.2.

All things considered, management's ultimate goal in pursuing a spin-off, at least nominally, is always to increase shareholder value. It is, however, extremely difficult both to prove or rebut what really motivates such a move. Rather than there existing one predominant shareholder-friendly reason, it is more likely that multiple reasons are inseparably intertwined. Thus, this paper does not argue that certain spin-offs are *solely* driven by managers' self-interests in corporate governance changes. Rather, it claims that the current legal regime does not properly address the potential risk due to managers' unfettered discretion in spin-offs used to significantly influence shareholder rights. Even in cases where a change in corporate governance remains a mere consequence of a spin-off, the protections afforded to managerial decisions by courts warrant concern, because it is extremely difficult for shareholders to reverse the change.

B. Governance Changes Without Monitoring Mechanisms

Practitioners advising corporate managers tend to recommend adoption of anti-takeover provisions, such as a classified board, in a SpinCo's corporate charter.[31] Because a SpinCo is relatively small in size and vulnerable to hostile takeovers, it needs anti-takeover provisions to protect itself from takeover attempts.[32] The most unique trait of spin-offs is that the transaction is subject to neither express shareholder approval nor market check in adopting those anti-takeover provisions. In contrast, mergers and acquisitions require an express shareholder approval, either in terms of voting or through tender. Several mechanisms—primarily market pressures and shareholder approval—are, in principle, supposed to rein in management's discretion by preventing transactions that are inefficient, wasteful, or whose benefits inure primarily to management's interests rather than those of the shareholders. Also, in the case of an initial public offering or secondary offering, there exists a market pricing mechanism that determines the amount of proceeds the issuing corporation will receive. This can provide a meaningful market check against inefficient transactions. As discussed below, these mechanisms, while imperfect, have important consequences in many transactions; critically, however, they are absent or weak in the spin-off context.

1. No Market Pricing Mechanism

Traditional theory on the effect of anti-takeover provisions has argued that a company which goes on the market for the first time (i.e., IPO) is under

[31] WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 22-25.
[32] *Id.*

pressure to minimize the number of anti-takeover provisions in its charter.[33] The theory assumes that anti-takeover provisions lower a firm's stock price on the market because investors will be wary of the managers' decreased accountability by insulating incumbent directors from potential challenges. Thus, companies that do go on to have an IPO have incentive to minimize the number of anti-takeover provisions to attract more investors. Subsequent empirical studies, however, have shown the puzzling phenomenon that many companies include anti-takeover provisions in their IPO charters anyway.[34] On the question of whether anti-takeover provisions in IPO charters were intended to benefit shareholders or managers, studies found mixed results.[35]

As such, while the imperfect IPO pricing has its own limits in monitoring opportunistic adoption of anti-takeover provisions, at least investors in IPO firms are aware of the existence of anti-takeover charter provisions of the company. They may choose to purchase the stock despite these provisions because of the other overriding benefits. Also, the investors had an alternative option to purchase other stock. By contrast, a typical corporate spin-off does not have a public sale element and is not subject to any market pricing mechanism at all.

More importantly, as the first public sale of stocks of a company, the IPO means that a company that raises capital through the issuance of stock and its management has a strong incentive to raise more money which will be a part of the company's assets. By contrast, a corporate spin-off does not involve raising capital from new investors. Rather, it only divides a stock into more pieces for existing shareholders.[36]Accordingly management has little or no

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[33] *See* Frank Easterbrook & Daniel Fischel, THE ECONOMIC STRUCTURE OF CORPORATE LAW 204-205 (1991).

[34] *See, e.g.*, Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?, Antitakeover Protection in IPO Firms*, 17 J. L. ECON. & ORG. 83-120 ; Laura Casares Field & Jonathan M Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857–1889, 185 (2002). *See also* Michael Brennan & Julian Franks, *Underpricing, Ownership and Control in Initial Public Offerings of Equity Securities in the U.K.*, 45 J. FIN. ECON. 391-414 (1997) (claiming that managers opportunistically include anti-takeover provisions in the IPO charters to secure their private benefits of control after the company goes public).

[35] Some studies found that the use of anti-takeover provisions has no impact on the subsequent likelihood of acquisition or takeover premium, which are powerful ways to increase shareholder value. Rather, the findings show that those provisions that protect managers were adopted mainly to preserve their private benefit of control, which suggests agency problems in firms at the IPO stages. *See* Field & Karpoff, *supra* note 34, at 1884; Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713 (2003). By contrast, Daines & Klausner found that anti-takeover provision is used to protect management when takeovers are most likely, but did not find evidence that supports management's desire to protect high private benefits. *See* Daines & Klausner, *Do IPO Charters Maximize Firm Value?*, *supra* note 34.

[36] In other words, while an IPO decides how big the company's size will be, a spin-off

incentive to attract investors by providing the optimal terms and governance structures, which makes spun-off companies more vulnerable to potential managerial entrenchment.[37]

2. No Ex-Ante Shareholder Approval Requirement

A spin-off has long been treated as a way of distributing a company's assets to its shareholders.[38] Just as with other dividends, the managers' decision to declare a spin-off is protected as a business decision that does not require shareholder approval.[39] Most state corporate laws as well as the Model Business Corporation Act provide that directors have full discretion to declare dividends without shareholder approval.[40] Only managers decide whether, when, and how to pay dividends to shareholders and the shareholders do not have a right to demand dividends. But whether this managerial discretion extends to their freedom to decide all other details associated with SpinCo, particularly SpinCo's corporate governance arrangements in its corporate charters, without shareholder approval remains unsettled. If this were the case, it would be a huge exception to most state corporate laws' mandatory provisions requiring shareholder approval for charter amendments.[41]

Furthermore, given that both spin-offs and mergers are the same forms of corporate reorganizations going in opposite directions, the waiver of shareholder approval for spin-offs is more peculiar because mergers require

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divides in smaller pieces without changing the sizes of the company.

[37] One might argue that because a spun-off company is a stand-alone public company and its shareholders' subsequent sales of its stock can function as a monitoring mechanism. However, profit from the subsequent sales is irrelevant to the company's assets and is not necessarily function as a monitoring mechanism for management.

[38] Distribution of SpinCo' stock to ParentCo shareholders is neither cash dividend nor stock dividend and a company's charter provision on stock dividend does not apply. *See* In re IAC/InterActive Corp. 948 A. 2d 471, 511 (Del. Ch. 2008).

[39] For instance, Delaware General Corporation Act does not have a separate statutory provision regarding spin-offs, let alone shareholder approval requirement. *See* John Savva & Davis Wang, *Spin-Offs: Frequently Asked Questions*, DEAL LAWYERS (March-April 2016), https://www.sullcrom.com/files/upload/krautheimer-savva-wang-deal-lawyers-spinoffs-frequently-asked-questions-march-april-2016.pdf ("Under Delaware law, the generally accepted view is that a spin-off is not a "sale, lease or exchange" of property or assets of the parent that may implicate the requirement to obtain shareholder approval.").

[40] *See, e.g.*, DEL. CODE. ANN. TIT. 8, § 141, 170; MODEL BUS. CORP. ACT ANN. § 12.01(4) (explicitly providing that no shareholder approval is required "to distributes assets pro rata to the holders of one or more classes or series of a corporation's shares." However, managers' discretion in declaring dividends is subject to any restrictions in each company's corporate charters. *See* MODEL BUS. CORP. ACT ANN. § 12.01.

[41] *See, e.g.*, DEL. CODE. ANN. TIT. 8, § 242.

shareholder approval.[42]

C. Spin-off and Tax-Free Benefits

As we discussed in II.B above, a spin-off allows managers unparalleled discretion and immunity under corporate law. In this Part, we now turn to tax law to introduce the tax benefits that make a spin-off an even more attractive choice to management.

1. Taxable Sale v. Tax-Free Spin-off

If the rationale for a spin-off is that it is advantageous to separate the spun-off entity from the parent, a simpler way to achieve this result is for ParentCo to sell the spin-off's assets or stocks. Given that selling is simple, why would management opt to pursue a spin-off strategy instead? The reason lies in the tax consequences of the transaction. Assuming that the stock or assets that would be separated from ParentCo appreciated in value while ParentCo held them, such a sale would realize the built-in gain on such stock or assets and thus ParentCo and its shareholders would be liable to pay taxes on such gain.[43] On the other hand, the distribution of the spun-off entity's stock to the parent's shareholders as a spin-off division can be completed tax-free for both ParentCo and its shareholders,[44] as long as the transaction satisfies the requirements set out in the Internal Revenue Code (the "Code"), which are explained in Subpart C.2. To be precise, the tax which would have been imposed on the spin-off transaction becomes deferred until a subsequent taxable event occurs—so the current spin-off is not subject to tax.[45]

In our pizza example, if A, B, C, and D order a pepperoni pizza and A transfers his share – i.e., a quarter of pizza – to a third party, E, such transfer is a sale of pizza and treated as a taxable event. On the other hand, if A, B, C,

[42] Commentators have criticized that shareholder voting requirement in mergers is not sufficient to prevent agency problem in governance changes during mergers due to "bundling" issue. That is, when shareholders vote on a merger agreement, adoption of anti-takeover provisions in a new company remains just a tiny part of the merger agreement. Even when shareholders do not want an anti-takeover charter provision, it is usually not a viable option for shareholders to reject a merger agreement solely for that reason. *See* Bebchuk and Kamar, *Bundling and Entrenchment*, *supra* note 19. This agency problem only worsens when there is no shareholder approval requirement—as in governance changes during spin-offs.

[43] *See* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 4.

[44] *Id.* at 5.

[45] Candace A. Ridgway, *Corporate Separations*, 776-4TH TAX MGMT. BNA U.S. INCOME PORTF. (2017) [hereinafter BNA, *Corporate Separations*]. Alongside the sizable tax benefits weighing in favor of a spin-off, a sale may also require due diligence, negotiation, execution, higher risk, and regulatory approvals. A spin-off, however, is generally accomplished on an "as is," "where is" basis. *Id.*

and D cut the whole pizza into four slices and have one slice each, or eight slices and have two slices each, that situation is analogous to a spin-off. The Code treats such slicing and distributing as tax-free. In other words, the Code allows tax-free benefits for certain spin-off transactions only if such spin-off is a mere change in corporate form – from a whole pizza into slices among stakeholders. It could vary how many pieces would the pizza be sliced into and how many slices would be allocated to A, B, C, and D. The Code's requirements for tax-free spin-offs, therefore, are to guarantee that the slices are allocated proportionately among existing stakeholders.

The tax-free status of the spin-off becomes crucial in many transactions aiming at separating corporate stock of assets. A notable example is Yahoo's recent spin-off saga. Yahoo! Inc. first planned a tax-free spin-off of its stake in Alibaba Group Holding Ltd., a major Chinese e-commerce group.[46] The Alibaba stock price had increased substantially since Yahoo! acquired Alibaba, such that Yahoo shareholders would have had to pay about $10 billion in capital gains taxes should it have disposed of its shares outright. However, if the proposed deal had qualified for a tax-free spin-off, Yahoo! shareholders would have saved that substantial tax liability.[47] The plan was criticized, however, as undeserving of the tax-free benefit. This was because Yahoo! planned not only to spin off its 284 million shares in Alibaba, worth $32 billion,[48] by putting them into a newly registered company called Aabaco, but also planned to contribute its minor operating business to Aabaco so as to plausibly meet the requirements of a tax-free transaction.[49] The IRS declined to issue a private letter ruling on the proposed transaction, which suggested that the agency did not want to bless the deal by issuing a ruling.[50] Yahoo!'s tax adviser, Skadden Arps, issued a legal opinion reaffirming that the deal would be tax-free to the company and its shareholders.[51] However,

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[46] Brian Womack, *Yahoo to Spin Off Alibaba Stake Tax-Free as Public Company*, BLOOMBERG NEWS (Jan. 27, 2015), https://www.bloomberg.com/news/articles/2015-01-27/yahoo-unveils-tax-free-spinoff-of-its-holding-in-alibaba.

[47] Victor Fleischer, *Yahoo's Spinoff Plan Could Be Risky Business*, N.Y. TIMES (Dec. 4, 2015), https://www.nytimes.com/2015/12/05/business/dealbook/yahoos-spinoff-plan-could-be-risky-business.html.

[48] *Id*. Other sources estimated the value of Alibaba shares at $40 billion or $23 billion. *See* Womack, *supra* note 46; Hannah Kuchler et al., *Tax Rebuff Clouds Yahoo Spin-off Plan*, FIN. TIMES (Sep. 8, 2015), https://www.ft.com/content/907b671a-566c-11e5-a28b-50226830d644, respectively.

[49] The requirement at issue was a valid (non-tax) business purpose. Victor Fleischer, *Yahoo's Tax-Free Spinoff Plan Parallels a Historic Case*, N.Y. TIMES (May 27, 2015), https://www.nytimes.com/2015/05/28/business/dealbook/yahoos-tax-free-spinoff-plan-parallels-a-historic-case.html.

[50] Fleischer, *supra* note 47.

[51] *Id*.

in response, the IRS issued Notice 2015-59, an administrative pronouncement expressing its concern about what it saw as possibly aggressive deals.[52]

Although the language was general, everyone understood the IRS guidance was addressed to Yahoo!.[53] Amid pressure from investors urging the board to abandon the spin-off of the Alibaba stock, the company dropped its former plan and instead introduced a new plan to spin off the company's core business (i.e., web and advertising business), leaving the Alibaba stock and other assets as is in Yahoo!.[54] However, the revised plan also had tax risks because the IRS would have likely evaluated the "reverse spin-off" in the same way it viewed the "forward spin-off" and denied it tax-free status.[55] And the result was as expected. Observing that the IRS had strengthened its position to curb aggressive tax-free spin-offs (as discussed with more details in Part III.C.), the company finally dropped the spin-off plans after concluding that both the forward and reverse spin-offs had the same tax risks. In the end, Yahoo decided to sell the core business to Verizon Communications, Inc, which, of course, is a taxable transaction.[56]

2. Requirements for Tax-Free Benefits

Tax law offers tax-free treatment when it comes to corporate reorganization, because it is inefficient to impose taxes on a transaction which is a mere change in existing corporate form or a shuffle of corporate assets. As shown in the pizza example, it holds true in corporate separation, such as spin-offs. The Code distinguishes mere changes in corporate structure via spin-off (distributing pizza slices) from cashing out a business sector (selling

[52] I.R.S. Notice 2015-59, 2015-40 I.R.B. 459.

[53] Fleischer, *supra* note 47.

[54] Laura Davison, *Yahoo Reconsiders Spinoff Plans as IRS Forms New Policies*, DAILY TAX REP. (BNA) (Dec. 4, 2015); Brian Womack, *Yahoo Scraps Alibaba Spinoff Amid Investor Pressure*, MIAMI HERALD (Dec. 9, 2015), http://www.miamiherald.com/news/nation-world/national/article48785550.html. Such "reverse spin-off" might have produced a modest amount of tax, but $10 billions of Yahoo's potential tax liability on built-in gains on the Alibaba stock would not be taxed currently and could further be deferred indefinitely. Fleischer, *supra* note 47.

[55] Laura Davison, *Yahoo's Reverse Spinoff Also Has Tax Risks; Will It Happen?*, DAILY TAX REP. (BNA) (Dec. 11, 2015), https://www.bna.com/yahoos-reverse-spinoff-n57982065029/; Laura Davison, *Yahoo Expects Reverse Spinoff Will Be Taxable*, DAILY TAX REP. (BNA) (Feb. 2, 2016), https://www.bna.com/yahoo-expects-reverse-n57982066892/.

[56] Davison, *supra* note 54; Womack, *supra* note 54. Even after the core asset sale, Yahoo still has to go through reorganization of its holdings in Yahoo Japan and Alibaba. Laura Davison, *Yahoo Still Has to Deal With Alibaba Assets After Core Sale*, DAILY TAX REP. (BNA) (Jul. 27, 2016).

a slice), and treats the former as a non-taxable event for ParentCo and its shareholders and the latter as a taxable transaction. This Subpart briefly examines the relevant statutory requirements in Section 355 of the Code and the judicially created requirements.[57]

a. Statutory Requirements

There are four basic statutory requirements a spin-off must meet to qualify as a tax-free division under Section 355: 1) control, 2) distribution, 3) active trade or business, and 4) device limitation.[58]

First, the parent may distribute only the stock of SpinCo that it "controls" immediately before the distribution by owning at least 80% of the stock by vote and number.[59] Second, the parent generally must "distribute all" of the stock of SpinCo that it controls.[60] Third, each of the surviving corporations (i.e., both ParentCo and SpinCo) should be engaged in the conduct of an active trade or business immediately after the division that was actively conducted for the five-year period prior to the spin-off.[61] The purpose of this rule is to ensure the corporation is engaging in an active business rather than "merely hold[ing] a package of investment assets" in an attempt to "bail out corporate profits."[62] Finally, a spin-off must not be used principally as a "device" for the distribution of the earnings and profits of either ParentCo or SpinCo.[63] This limitation is also to prevent a spin-off from being part of a

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[57] WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 45; BNA, *Corporate Separations*, *supra* note 45, at I.D.2.

[58] *Id.* at I.D.2.

[59] I.R.C. §§ 355(a)(1)(A), (D), 368(c); *see* BNA, *Corporate Separations*, *supra* note 45, at III.A, and II.B.1.

[60] However, if ParentCo does not distribute all of the stock in SpinCo, it must be able to explain to the IRS that its primary purpose for retaining the stock was not tax avoidance. I.R.C. § 355(a)(1)(D)(ii); BNA, *Corporate Separations*, *supra* note 45, at III.C.

[61] I.R.C. § 355(a)(1)(C), (b); MARTIN J. MCMAHON, JR. ET AL., FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 1130 (5th ed. 2014).

[62] BNA, *Corporate Separations*, *supra* note 45, at VI.B. The regulations further explain that an "active business" generally means the corporation itself performs the substantial management and operational activities through its own employees. Treas. Reg. § 1.355-3(b)(2)(iii).

[63] *See* I.R.C. § 355(a)(1)(B). Determining what constitutes such a device is not clear, and the definition depends on all the facts and circumstances. The regulations list factors that indicate that a transaction is a "device" as well as factors that indicate a transaction is not a "device." The factors that indicate a transaction is a device include: 1) pro rata distribution; 2) subsequent sale or exchange of stock; and 3) the nature and use of assets. By contrast, the factors that indicate a transaction is not a "device" include: 1) corporate business purpose; 2) distributing corporation is publicly traded and widely held; and 3) distribution to domestic shareholders. Treas. Reg. § 1.355-2(d)(2), (3); BNA, *Corporate Separations*, *supra* note 45, at V.A.

plan to bail out earnings and profits by selling stock or liquidating one of the corporations.[64]

b. Judicial Requirements

In addition to the statutory requirements, three judicially-developed requirements have emerged: 1) business purpose, 2) continuity of business enterprise, and 3) continuity of (proprietary) interest.[65] They are subsequently included in the Treasury Regulations.[66]

First, a spin-off must be carried out in whole, or substantial part, for one or more "business purposes," and not solely for tax-avoidance reasons[67] Examples of valid business purposes for a spin-off are pursuing fit and focus, cost savings, employee compensation, resolving shareholder conflicts, better capital raising condition, and so on.[68]

Second, both the parent and the spun-off entity are required to "continue one of their businesses," or to use a significant portion of their historic business assets in a business post spin-off.[69]

Last but not least is the "continuity of proprietary (shareholder) interest" requirement. One or more shareholders of ParentCo are required to own an amount of stock establishing continuity of interest in each of the corporate forms in which the enterprise is conducting business following the spin-off.[70] The regulations do not specify a minimum required continuity. However, the examples in the regulations indicate that 20% continuity is too little and 50% continuity is adequate.[71]

Those judicial requirements generally serve "substance over form" purposes to prevent a corporation from cashing out an active business through

[64] *See* MCMAHON, *supra* note 61, at 1149.

[65] BNA, *Corporate Separations*, *supra* note 45, at II.

[66] Treas. Reg. § 1.355-2(b), -1(b), -2(c), respectively.

[67] Treas. Reg. § 1.355-2(b)(1); BNA, *Corporate Separations*, *supra* note 45, at VIII. "Business purpose" is defined as a real and substantial non-tax purpose germane to the business of the parent, the spin-off, or an affiliated group. Treas. Reg. § 1.355-2(b)(2). There is a relationship between the business purpose requirement and the device limitation such that a strong business purpose for the spin-off may outweigh evidence that would otherwise indicate the spin-off was used as a device. BNA, *Corporate Separations*, *supra* note 45, at VIII.A.

[68] *Id.* at VIII.C.1.–5; *see also* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 3.

[69] Treas. Reg. § 1.355-1(b). The continuity of business requirement has traditionally been understood as the same requirement for other reorganizations. *See* Treas. Reg. § 1.368-1(d)(1); BNA, *Corporate Separations*, *supra* note 45, at VII.B..

[70] Treas. Reg. § 1.355-2(c)(1). It is included in the regulation to emphasize that the continuity of interest is an independent test that must be met under Section 355.

[71] *See* Treas. Reg. § 1.355-2(c)(2) Ex. 1–4; BNA, *Corporate Separations*, *supra* note 45, at VII.A.1.

a spin-off transaction that has the same economic consequences as just selling a business which would have been a taxable sale transaction.[72] To merit the tax-free benefit, the substance of the transaction must consist of the mere rearrangement of corporate assets in one or more continuing corporate enterprises owned by the original owners.

However, what if the rights and role of the original owners, or those of the parent's shareholders, have changed significantly post spin-off? Figuratively speaking, what if the pepperoni topping is allocated in a significantly disproportionate fashion while slicing? The question might be raised in the context of the continuity of interest requirement. The existing rules only concern whether original shareholders receive an instrument labeled "equity" and whether these original shareholders receive more than the minimum percentage – i.e., about 50% – set out in the regulations.[73] The rules do not consider the qualitative difference in stock due to governance changes in the enterprises, such as voting rights changes occurred during the spin-off.

In our pizza example, pizza slice is considered as equity and pepperoni topping is considered as shareholder rights attached to the equity, such as voting right. Current law only makes sure that the slices are the same size and allocated fairly to the existing stakeholders—that is, original shareholders should receive at least 50% of the slices to meet the continuity of interest requirement. Current law, however, does not concern whether the pepperoni topping is continued in original shareholders at a substantially similar level after slice distribution. As long as original stakeholders receive the substantially proportional number of the same-sized slices, it does not consider the disproportionate distribution of topping among stakeholders who receive the slices. However, is the pizza slice distribution that is proportional in slice quantity but disproportional in topping quality a mere change in form? Analogously, is a spin-off that distributes stock that is qualitatively different from ParentCo stock due to the governance disparity to original shareholders a mere change in form? Does such spin-off qualify tax-free benefit? The answer under current law is positive. The authors, however, argue that the rule should be revisited to reconsider the current treatment. This problem will be revisited in Parts II.A.2 and II.C.2. after exploring the governance disparity relating to spin-offs below.

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[72] *Id.* at II.E.1. The judicial requirements overlap considerably with the device limitation, which patrols against prearranged post-distribution sales as part of its anti-bailout mission." STEPHEN SCHWARZ ET AL., FUNDAMENTALS OF BUSINESS ENTERPRISES TAXATION 921 (6th ed. 2017).

[73] *Id.*; Joshua D. Blank, *Confronting Continuity: A Tradition of Fiction in Corporate Reorganizations*, 2006 COLUM. BUS. L. REV. 1, 2 (2006).

D. Spin-offs as Joint Products of Corporate and Tax Laws

This Part examined how corporate spin-offs are entitled to special treatment under both corporate law (i.e., no checking mechanisms) and tax law (i.e., tax-free benefits). Spin-offs generally are initiated by strong business goals, but the completion of spin-offs is often conditioned on obtaining tax-free treatment of those spin-offs. As such, corporate law and tax law considerations function as key elements among others for spin-off transactions. In that light, neither corporate law nor tax law alone would be sufficient to fully address problems arising from spin-offs and the first cooperative analysis of corporate and tax law in this Article would provide a holistic view to the problems we identify in the next chapter.

II. MANAGEMENT INSULATION BY CORPORATE SEPARATION

As we have discussed in the previous Part, a corporate spin-off provides a unique opportunity for managers to transform corporate governance structures without shareholder approval or market checks. The fact that ParentCo's managers have full discretion in setting SpinCo's governance arrangement in its corporate charter brings us to the question of whether, and if so to what extent, managers actually exercise the discretion. Having a right is one thing, but exercising the right is another. When managers have discretion free from shareholder approval, how do they use the discretion?

In practice, managers tend to proactively utilize the opportunity to adopt governance choices that may limit shareholder power. Adoption of anti-takeover charter provisions in SpinCo has been the most common form of governance changes. Recently, along with the new phenomenon of dual-class stock structure, the frequency of dual-class stock structure in SpinCo also has increased. The potential risk of the unilateral reallocation of power is significantly intensified when a spin-off is combined with a dual-class stock structure in the sense that any change in voting rights is often times irreversible, and thus perpetuates the unilateral allocation of control. In this Part, we uncover how the combination of dual-class stock and spin-offs raises not only a perceived risk but a real one by discussing a real-world example.

A. Spin-offs and Managers' Unilateral Governance Changes

As we discussed above, most state corporate laws treat a spin-off as a dividend to shareholders, which is within managers' discretion.[74] Thus, the

[74] *See, e.g.,* DEL. CODE. ANN. TIT. 8, § 170. ("Courts have consistently refused to second-guess management's decision on dividends holding that those decisions should be deferred to business judgment protection. *See, e.g.,* Kamin v. Am. Express Co., 3e83 N.Y.S.

rationale for granting unfettered discretion to managers in making spin-offs stems from the managerial discretion for dividends, which emphasizes operational efficiency. Corporate law has consistently viewed managers' decision on dividends as a business decision on the basis that dividends do not change shareholder rights fundamentally.[75]

In the recent practice of spin-offs, however, managers have been using their discretionary power not only for a dividend decision but also to change governance structure. For instance, during a spin-off, the managers of a ParentCo can adopt provisions in a SpinCo's corporate charter that shareholders would likely reject if it were up for ParentCo shareholders' vote because those governance changes tend to give more power or protection to management.[76]

1. Corporate Law Considerations of Unilateral Governance Changes

In 2012, ConocoPhillips spun off from its downstream businesses under a new independent company named Phillips 66. At that time, the spun-off company was worth about $34.5 billion, consisting of roughly 28%, in terms of the market capitalization, of the parent company.[77] As one of the largest public companies itself, Phillips 66 was not necessarily vulnerable to a hostile takeover attempt, but its corporate charter implemented a staggered board provision on top of other provisions modeled after the parent company's charter provisions.[78]

The adoption of a staggered board, however, went in the opposite

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2d 807, 812 (Sup. Ct. 1976).

[75] Lucian Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 847 (2005) ("Corporate law does not view decisions about distributions, however economically important, as involving the kind of fundamental change that calls for shareholder veto power. Rather, such decisions are viewed as part of the ordinary conduct of business delegated to the sole prerogative of management.").

[76] Empirical data shows the frequent use of antitakeover provisions in spun-off companies. *See supra* note 4. This practice remains consistent with guidance provided in client letters generated by law firms. *See, e.g.*, Francis J. Aquila, *Key Issues When Considering a Spin-off* (Jun. 2015), https://www.sullcrom.com/files/upload/June15_InTheBoardroom.pdf ("Putting takeover defenses (such as establishing a classified board…) in the subsidiary's charter or by-laws puts the subsidiary's board in a better negotiating position against a potential acquirer, allowing directors to protect the interests of the shareholders by fending off unfair or undesirable bids.").

[77] Christopher Helman, *As ConocoPhillips Spins Off Refining Assets, Think Twice Before Buying the New Phillips 66*, FORBES (Apr. 30, 2012), https://www.forbes.com/sites/christopherhelman/2012/04/30/as-conocophillips-spins-off-refining-assets-should-you-own-the-new-phillips-66/.

[78] AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF PHILLIPS 66, Article Fifth.

direction of the recent movement of eliminating such structure from corporate charters on shareholders' request. A staggered board has long been regarded as one of the most effective anti-takeover provisions that insulates management from shareholder intervention.[79] Similar to U.S. senators' staggered elections, when a company staggers its board, only one third of directors are elected each year and the directors cannot be removed without cause.[80] This tactic can delay a hostile insurgent's attempt to replace the directors up to three years at its maximum.[81] The management of ConocoPhillips did not even need to persuade shareholders to adopt this controversial staggered board structure because it emerged through the spin-off process without shareholder approval.

As such, the current practice of managers' unilateral governance changes in the course of spin-offs is inconsistent with corporate law's implicit assumption for spin-offs: no fundamental changes to the company before and after the spin-off. Adopting an anti-takeover charter provision is a common way for ParentCo's managers to change governance arrangements. If ParenCo's managers add a new provision affecting the allocation of power between shareholders and managers into a SpinCo's charter, the change is not a mere distribution anymore. Accordingly, the assumption for a spin-off that there are no fundamental changes before and after the spin-off is broken when the spin-off introduces governance change.

Empirical data supports the prevalence of anti-takeover provisions in SpinCo.[82] On why SpinCo tends to have more anti-takeover provisions than ParentCo, two competing hypotheses have existed.[83] First, the "entrenchment hypothesis" argues that ParentCo's managers adopt antitakeover provisions in SpinCo when those provisions would extract more of their private benefit out of the entrenchment.[84] Alternatively, the "efficiency hypothesis" claims

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[79] For the discussion of antitakeover effect of staggered board structure, *see, e.g.,* Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002). Recent study finds that a staggered board's effect on firm value vary depending on each company's unique characteristics. Yakov Amihud, Markus Schmid, and Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PA. L. REV. 1475 (2018) ("The effect of a staggered board is idiosyncratic; for some firms it increases value, while for other firms it is value-destroying.").

[80] For a default structure of staggered boards, *see, e.g.,* DEL. CODE. ANN. TIT. 8, § 141(b).

[81] If a company's charter or bylaws gives shareholders the right to call a "special meeting" or to act by "written consent" between annual meetings, hostile insurgent can replace the entire members on the staggered board in less than three years.

[82] *See* Daines & Klausner, *Agents Protecting Agents*, *supra* note 4, at 22-23.

[83] For the detailed development and empirical tests of the two hypotheses, *see* Daines & Klausner, *Agents Protecting Agents*, *supra* note 4, at 13-15.

[84] Daines & Klaunser's empirical finding supports the "Entrenchment Hypothesis." ("[T]hese results are consistent with the proposition that the takeover defenses are adopted out of entrenching, rather than share value-maximization, motivations.") Daines & Klaunser,

that ParentCo's managers adopt new antitakeover protections in SpinCo to enhance shareholder value. For instance, when SpinCo is much smaller than the previously combined company and thus more vulnerable to hostile takeover attempts, antitakeover provisions may protect from those attempts or at least increase SpinCo's bargaining power for the better price.[85]

The purpose of this Article is not to claim that an additional anti-takeover provision in SpinCo itself is necessarily entrenching or efficient. This is because both the incentives of managers and the effects of an anti-takeover provision may vary depending on each company's unique situation. Instead, this Article focuses on the *procedural loophole* where governance changes are made during spin-offs. The current regime grants managers unfettered freedom for governance changes in the course of spin-offs, and managers have been actively exercising discretion in choosing more anti-takeover provisions.

The concern about managers' unilateral governance changes in spin-offs is still valid but with different weights under entrenchment and efficiency hypotheses on the prevalence of on why SpinCo has more antitakeover provisions than its ParentCo. First, if ParentCo's managers adopt antitakeover provisions in furtherance of their entrenchment (as under the "entrenchment hypothesis"), it is palpable that the lack of a monitoring mechanism for governance changes over spin-offs would facilitate the managers' opportunistic governance changes and thus increases agency costs out of the entrenchment. For instance, entrenching managers would have ample incentives to take advantage of this procedural loophole to adopt a charter provision that protects them from shareholder intervention even further.

Second, even when managers implement anti-takeover provisions in SpinCo to advance shareholder value (as argued in the "efficiency hypothesis"), this legitimate incentive does not necessarily justify the elimination of a checking mechanism for introducing the anti-takeover provisions in SpinCo charter. This is largely because of the rigidity of corporate charters. State corporate laws require mutual consent between managers and shareholders to amend corporate charters and neither shareholders nor managers cannot change corporate charters unilaterally.[86] Thus, once ParentCo managers implement an anti-takeover provision in SpinCo's charter, shareholders cannot take it off without managers' consent.

Agents Protecting Agents, *supra* note 4, at 21.

[85] *See* WACHTELL SPIN-OFF GUIDE, *supra* note 1, at 22-23. This rationale, however, is not compelling for the recent trend of spin-offs dividing a ParentCo into two companies of comparable sizes as occurred with Motorola, Hewlett Packard, Tyco, and DowDuPont. *See id.*

[86] *See, e.g.*, DEL. CODE. ANN. TIT. 8, § 242(b)(1) (2014).

Because the efficiency of anti-takeover provisions is volatile as the company's other features evolve (e.g., ownership structure, company age, or company size), an efficient anti-takeover provision at the time of the adoption is not necessarily efficient ten years after the adoption. Also, because all anti-takeover provisions inherently have a self-serving element to managers by securing their tenure on the board, the adoption of an "efficient-for-now" anti-takeover provision is always vulnerable to managerial entrenchment. Thus, a shareholder approval requirement may still function as a useful checking process even for adoption of efficient charter provisions to maximize shareholder value.

Furthermore, in other contexts of corporate law including mergers, shareholder approval is necessary for managers to change corporate charter provisions regardless the efficiency of the provision at the time of the adoption. When it comes to fundamental changes such as governance changes through corporate charters, shareholders are given a chance to voice themselves on the issue. In that sense, the current procedural loophole in spin-offs, which enables managers' unilateral changes, make the use of efficient anti-takeover provision less desirable because it inadvertently intensifies the risk of managerial entrenchment.

2. Tax Considerations of Unilateral Governance Changes

Setting aside the corporate law consequences, let us consider the tax consequences from a policy perspective. Allowing tax-free benefits to spin-offs encompassing significant governance changes is not a good tax policy. It is inefficient and unfair for the following reasons.

First, current tax law treatment of spin-offs is inefficient because it may encourage certain spin-off transactions that are not mere changes in form. The rationale for the tax-free benefits for reorganization transactions is to support such reorganization that would transform the business structure into more efficient one. As long as such a transformation is a mere change in form that is economically equivalent before and after the fact, it is worth facilitating it by deferring tax liability on the built-in gain in the business. Thus, it is critical that the reorganization represents merely a change in form and does not entail any change in substance.

However, contemporary spin-offs are not simply used to reorganize corporate structures. There are many examples showing that a spin-off is a convenient way not only to slice off a profitable sector from ParentCo but also to create the corporate structure of SpinCo completely different from ParentCo without shareholders' consent. And the resulting new corporate governance structure benefits managers, not shareholders.

Tax law, then, should not encourage such analogous spin-offs at least.

Nonetheless, current tax law ignores the potential risk of governance change in spin-offs and offers tax benefits as long as the transaction technically satisfies the outdated requirements that only consider the quantity of the continued equity. This encourages such deviant spin-offs that would not be executed had it incurred a risk of triggering tax liability on the built-in gains. Such behavioral distortion has nothing to do with correcting market failure on corporate reorganizations. Rather, it promotes the market manipulation on corporate reorganizations by managers by lifting a regulatory hurdle, called tax.

Second, current tax law treatment of spin-offs is unfair because it treats two different types of spin-offs the same and allow tax free benefits to both. Without the special tax provisions for reorganizations, the reorganization transaction should be considered as a taxable event. However, tax law specially offers tax-free benefits to certain type of reorganizations that are mere changes in form. Thus, given the rationale of tax-free benefits for reorganization, tax treatment should be different between the reorganization transactions that are mere changes in form and that of reorganization transactions that are changes in substance. Tax free benefits should only be allowed to the former and not to the latter.

Nonetheless, current law does not distinguish the two and rather treats them the same. It ignores the potential risk of governance changes in spin-offs and offers tax benefits to those spin-offs that might be changes in substance. It is the violation of horizontal equity that demands the equal treatment for taxpayers in equal situations and the different treatment for taxpayers in different situations.

Another criterion to consider in tax policy analysis is administrability. Current law might be simpler than the proposed approach that distinguishes spin-offs that are mere changes in form from those that are not.[87] A long and detailed statute may result in compliance complexity, but if it gives a very specific solution to a problem, that feature can reduce rule complexity and can make things simpler overall. It also may contribute to more efficient and equitable result.

B. Spin-offs and Dual-Class Stock

The agency problems arising out of the managers' unilateral governance

[87] The third prong for tax policy analysis is complexity. David Bradford categorizes complexity into three different categories – i) compliance complexity (the cost taxpayers has to pay to comply the rule), ii) rule complexity (the difficulty to understand what the law is), and iii) transactional complexity (complexity that arises from taxpayers organizing their affairs to minimize taxes). DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 266-67 (1986).

changes described above can significantly be compounded when ParentCo's managers adopt a dual-class stock structure in SpinCo without shareholder approval. Dual-class stock structure, which allocates varying voting rights (e.g., high-vote and low-vote) to different classes of common stockholders, is an extremely effective form of governance choice that separates ownership from control. Academic literature evaluating spin-offs and dual-class stock respectively have developed, and no prior studies have analyzed an interaction between spin-offs and dual-class stock. The scarcity of studies may be largely because both have not been prevalent until recent years.[88] Given that both spin-offs and dual-class stock have been surging recently, however, it is crucial to understand how the interaction between spin-offs and dual-class stock can affect the corporate governance landscape.

1. Dual-Class Stock as a Separator of Ownership and Control among Shareholders

Among various charter and bylaw provisions that may affect shareholder rights, a dual-class stock structure is one of the most effective mechanisms for keeping control within a small number of insiders. Dual-class stock enables high-vote stockholders to dominate all shareholder voting agendas, from annual director elections to M&A approvals. Typically, dual-class stock limits the transfer of high-vote stock by means of neutralizing higher voting rights when the stock is transferred to non-initial holders. In that way, the high-vote stock can remain only in hands of the initial holders.

Dual-class capital structures are sometimes used not because of concerns about short-term market pressure and takeover threats but to achieve tax or other transaction planning objectives. For example, when a parent company decides to spin off a subsidiary, it often also decides to raise capital before the spin-off by causing the subsidiary to engage in an IPO. If the parent company maintains at least 80% of the voting power in the subsidiary following the IPO, the subsequent spin-off receives tax-free treatment. Raising large amounts of capital, however, may require the parent company to sell more than 20% of the subsidiary's common stock. The dual-class structure offers a solution. The parent company can create a dual-class structure in the subsidiary, then sell low-vote stock to the public in the IPO, and retain the high-vote stock. This practice allows the parent company to sell as much stock as necessary to raise capital while still maintaining 80% of the voting power in the subsidiary to realize tax benefits. In the Zoetis IPO in January 2018, Pfizer used the dual-class structure to raise $2.2 billion in

[88] Dains & Klusner, *Agents Protecting Agents*, *supra* note 4, at 12 ("Dual-class stock is more entrenching but not common.").

the IPO while maintaining 98% of the voting power in Zoetis and preserving the flexibility to conduct a tax-free spin-off at a later stage.[89]

Dual-class stock structure has become one of the most heavily debated issues in corporate governance, and the debate is still far from over.[90] While dual-class stock itself has been subject to regulation on and off for several decades,[91] the recent debate over its desirability was sparked when Google (now Alphabet) adopted unequal voting rights at its IPO in 2004.[92] The debate was inflamed when Snap, Inc.'s founders offered only non-voting stock to the public in its IPO in 2017.[93] The dual-class stock has been commonly used for founders, as holders of higher votes per share, to retain control over the company without corresponding economic risk.[94]

Proponents of dual-class stock offer arguments rooted in the traditional corporate law approach to governance that values each company's flexibility to choose the rules that best suits its needs, including dual-class stock structure.[95] For certain companies—young tech firms, for instance—

[89] Stephen I. Glover & Aarthy S. Thamodaran, *Debating Pros and Cons of Dual-class Capital Structures*, 27 Insights Volume (Mar. 2013) http://www.gibsondunn.com/publications/Documents/GloverThamodaran-DualClassCapitalStructures.pdf.

[90] For a comprehensive review of the debate, *see generally* Dorothy Lund, *Nonvoting Shares and Efficient Corporate Governance*, STAN. L. R.(forthcoming) (2019).

[91] Dual-class stock dates back to 1920s. *See* Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 693–97 (1985); Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 982 (1989); Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 VA. L. REV. 585, 596 (2017).

[92] The ratio of voting rights per share for each class of Google common stock is Class A (1): Class B (10): Class C (0).

[93] Steven Davidoff Solomon, *Snap's Plan Is Most Unfriendly to Outsiders*, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/business/dealbook/snap-ipo-plan-evan-spiegel.html.

[94] *See* Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L. J. 560, 563 (2016).

[95] *See* David J. Berger, *Dual-Class Stock and Private Ordering: A System That Works*, HARVARD LAW SCH. FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (May 24, 2007), https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/#more-90363 ("[W]e believe that the present system of private ordering with respect to dual-class stock will—*and should*—continue. Private ordering allows boards, investors, and other corporate stakeholders to determine the most appropriate capital structure for a particular company, given its specific needs."); *The Promise of Market Reform: Reigniting America's Economic Engine*, NASDAQ (2017), https://business.nasdaq.com/media/Nasdaq_Blueprint_to_Revitalize_Capital_Markets_April_2018_tcm5044-43175.pdf ("Each publicly-traded company should have flexibility to determine a class structure that is most appropriate and beneficial for them, so long as this structure is transparent and disclosed up-front so that investors have complete visibility into

founders benefit from the insulation that dual-class stock provides from short-term market pressure because it enables the founders to pursue their long-term vision, which may increase shareholder value in the long run.[96] Opponents of dual-class stock, on the other hand, raise concerns about how the structure could exacerbate agency costs based on the traditional perspective regarding the private benefit of control.[97] They argue that, since controllers' economic benefit may be less aligned with stock value, they would find it more beneficial to extract private benefit using their control rather than to improve firm value. Early empirical studies suggested that companies with dual-class stock are more likely to reduce shareholder value.[98] As a more practical solution, some opponents propose limiting the duration of the voting power differential under a dual-class system.[99] They argue that sunset provisions, which fix a dual-class stock's expiration date, should be included to balance costs and benefits of dual-class stock because potential benefits of dual-class stock decrease as time passes and thus are likely to be outweighed by potential costs.[100]

Both proponents and opponents of the debate, however, pay little attention to the further possibility that managers can unilaterally rearrange

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the company.").

[96] *See generally* Albert H. Choi, *Concentrated Ownership and Long-Term Shareholder Value*, 8 HARV. BUS. LAW REV. 53 (2018); Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right to Use Dual-class Share Structures in IPOs*, 63 VILL. L. REV. (2018) ("Once we start thinking in terms of minimizing total control costs, it becomes easier to accept that allowing for the private benefits of control associated with dual-class share structures may actually be a contributing factor to the long-term value of the firm.").

[97] On July 21, 2016, thirteen high profile executives and investment managers declared that a "[d]ual class voting is not a best practice." COMMONSENSE PRINCIPLES OF CORPORATE GOVERNANCE 5 (2016).

[98] *See* Bebchuk & Kastiel, *supra* note 91, at 603 ("Paul Gompers … studying U.S. dual-class companies over 1995-2002, found evidence that these companies exhibited increased agency costs and reduced value."); Paul A. Gompers et al., *Extreme Governance: An Analysis of Dual-Class Firms in the United States*, 23 REV. FIN. STUD. 1051, 1051-54 (2010); Ronald W. Masulis et al., *Agency Problems at Dual-Class Companies*, 64 J. FIN. 1697, 1722 (2009) ("Our evidence is consistent with the hypothesis that insiders holding more voting rights relative to cash flow rights extract more private benefits at the expense of outside shareholders."); Blair Nicholas & Brandon Marsh, Bernstein Litowitz Berger & Grossmann LLP, *Dual-Class: The Consequences of Depriving Institutional Investors of Corporate Voting Rights*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE AND F. REG. (May 17, 2007), https://corpgov.law.harvard.edu/2017/05/24/dual-class-stock-and-private-ordering-a-system-that-works/#more-90363 ("[s]uch structures reduce oversight by, and accountability to, the actual majority owners of the company. They hamper the ability of boards of directors to execute their fiduciary duties to shareholders. And they can incentivize managers to act in their own interests, instead of acting in the interest of the company's owners.").

[99] *See generally* Bebchuk & Kastiel, *supra* note 91.

[100] *Id.*

the initial allocation of voting rights through spin-offs. The costs from this possibility should be considered in evaluating the advantages and disadvantages of dual-class stock. This Article contributes to the current debate on the desirability of dual-class stock by providing a necessary but little-known perspective to evaluate dual-class stock.

2. Spin-off as a Waiver to Current Restrictions on Dual-Class Stock

Due to dual-class stock structure's power to perpetuate the disparity of ownership and control, adoption of dual-class stock without shareholder approval significantly intensifies potential agency costs discussed in the earlier section of this paper.[101] Adoption of dual-class stock also circumvents major stock exchange rules prohibiting a midstream conversion from single-class to dual-class stock structure. Since the current major stock exchange rules prohibit dual-class recapitalization (i.e., switching to dual-class stock midstream), listed companies can adopt dual-class stock only when they issue their stock to the public for the first time via initial public offering ("IPO").[102] During the IPO process, the perception of the value of the dual-class stock will be reflected in the price of the securities issued. Once the company has gone public, market participants will be able to make their own decision about whether they find the dual-class stock acceptable. In spin-offs, by contrast, shareholders have no opportunity to veto managers' adoption of dual-class stock to a spin-off company even when it may significantly dilute their voting rights.

C. Aggravating Effects of Spin-off and Dual-Class Stock

So far, we have analyzed how the new practice of dual-class stock structure in a spun-off company may increase agency costs at a theoretical level. This Subpart presents a real-world example that demonstrates how shareholder voting rights can be distorted by dual-class stock adopted in a SpinCo. While anti-takeover provisions in a SpinCo charter are much more troubling when managers add a new provision that does not exist in a ParentCo charter without shareholder approval, the existence of dual-class stock structure in SpinCo itself has a power to significantly change the allocation of power within the company, notwithstanding the extremity of the case where managers newly adopt dual-class stock structure in SpinCo without shareholder consent.[103]

[101] *See supra* Part II.A.

[102] *See* NYSE Listed Company Manual Section 313.00 (1992); NASDAQ Stock Market Rule 5640.

[103] On the context of anti-takeover provisions, Daines & Klausner call this type of

1. Corporate Law: Reallocation of Voting Rights

In 2017, NACCO Industries ("ParentCo") spun off its home appliances and commercial restaurant equipment business under the name of Hamilton Beach Brand Holding Company (HBB, "SpinCo"). In the process of separation, the SpinCo took a significant majority of the ParentCo's revenue. ParentCo's CEO resigned his role as CEO of ParentCo and became the executive chairman of SpinCo.[104] This was another case where the SpinCo took the lion's share.

The SpinCo's charter was largely modeled after the ParentCo's charter, including a dual-class stock structure. Because the ParentCo already was structured as dual-class stock, some may argue that the SpinCo's dual-class stock was not a surprise to the ParentCo shareholders, and thus the risk of voting right distortion before and after the spin-off was low. The NACCO/HBB spin-off, however, presents a vivid example showing how the existence of dual-class stock in the SpinCo itself can facilitate manager-driven governance changes while retaining the voting rights gap between high-votes and low-votes stockholders—all without shareholder approval.

a. Allocation of Voting Rights in ParentCo Before the Spin-off

NACCO Industries, the ParentCo, has had a dual-class structure since its incorporation in 1987. The arrangement gives one vote per share for Class A Common stockholders and ten votes per share for Class B Common stockholders.[105] As of 2017, NACCO's dual-class stock structure enabled the high-vote Class B stockholders to exercise 75% of voting rights despite their ownership of only 23% of the company stock. By contrast, while the low-vote Class A stockholders hold 77% of economic interests, their collective voting rights were only 23%, which was far below the 50% threshold. Table 2 below shows this disparity between stock ownership and voting rights prior to the spin-off using simplified numbers/ratio of actual ones. The disparity

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charter amendment as a "back door charter amendment." *See* Daines & Klausner, *Agents Protecting Agents*, *supra* note 4, at 22. (claiming that ParentCo managers inclusion of anti-takeover provision in their SpinCo charter when the ParentCo's own charters do not have those anti-takeover provisions would in effect, amend the SpinCo charter without shareholder consent and finding that "such back-door amendments commonly occur.").

[104] Hamilton Beach Brand Holding Company, Registration Statement (Form S-1) at 4 (Aug. 21, 2017). *See also* George Joshman, *Everything But the Kitchen Sink-NACCO to Spin Off Hamilton Beach Kitchen Appliance Division*, Stock Spinoffs (Aug. 23, 2017) https://www.stockspinoffs.com/2017/08/23/everything-kitchen-sink-nacco-spin-off-hamilton-beach-kitchen-appliance-division/.

[105] RESTATED CERTIFICATE OF INCORPORATION OF NACCO INDUSTRIES, INC., Article Fourth. 3 (a) (Mar. 31, 1993).

between ownership and voting rights may not be bad per se, but it makes the company more susceptible to the agency problem with the high-vote holders, mostly corporate insiders including founding family members.[106]

Table 2. Pre-Spin-off: NACCO Stock Ownership and Voting Rights[107]

	Number of Stock in NACCO	% of Equity Ownership in NACCO	Number of Votes in NACCO	% of Voting Right in NACCO
NACCO Class A (1 vote/share)	250	**77%**	250 (250x1)	**25%**
NACCO Class B (10 votes/share)	75	**23%**	750 (75x10)	**75%**
Total	325	100%	1,000	100%

Moreover, the ParentCo had a charter provision on the equal distribution requirement in dividends preventing the reallocation of voting rights that may arise from stock dividends.[108] The ParentCo's charter provision on dividends stipulates that its low-vote Class A and high-vote Class B common stock have equal rights to stock dividends as long as each class receives the same class of stock as a dividend when it comes to the distribution of the company's stock.[109] When the company distributes cash, stock, or property of the

[106] *See supra* Part I.B.1.

[107] The numbers in the Tables 2-4 are simplified forms of the actual numbers/ratio disclosed in the SEC filings. *See* NACCO Industries, Proxy Material for the 2017 shareholder meeting. ("Stockholders of record at the close of business on March 20, 2017 will be entitled to notice of, and to vote at, the Annual Meeting. On that date, we had 5,260,048 outstanding shares of Class A Common Stock, par value $1.00 per share ("Class A Common"), entitled to vote at the Annual Meeting and 1,570,815 outstanding shares of Class B Common Stock, par value $1.00 per share ("Class B Common"), entitled to vote at the Annual Meeting.").

[108] RESTATED CERTIFICATE OF INCORPORATION OF NACCO INDUSTRIES, INC., Article Fourth. 6. (Mar. 31, 1993).

[109] *Id.* The full text of the charter provision is as follows:

> [E]ach share of Class A Common Stock and Class B Common Stock shall be equal in respect of rights to dividends and other distributions in cash, stock or property of the Corporation, provided that in the case of dividends or other distributions payable in stock of the Corporation, including distributions pursuant to stock split-ups or divisions of stock of the Corporation, which occur after the date shares of Class B Common Stock are first issued by the Corporation, only shares of Class A Common Stock shall be distributed with respect to Class A Common Stock and only shares of Class B Common Stock shall be distributed with respect to Class B Common Stock.

company, the company has to make an equal distribution to both Class A and Class B common stock in proportion to the amount of stock owned. If the company declares a dividend for only one class of stock or makes different types or amounts of dividends, it would violate the charter provision.[110] The only exception applies when the company distributes *the company's own stock*. In other words, the charter requires that Class A and Class B stockholders should receive the *identical class* of stock as dividends respectively: Class A stockholders receive Class A stock only, and Class B stockholders receive Class B stock only as dividends.

However, the charter provision has been silent on the distribution of its subsidiary's stock, which is a common mechanism of a spin-off. In spin-offs, what ParentCo distributes is not the company's own stock but its subsidiary company (i.e., SpinCo)'s stock, which is a part of ParentCo's assets.[111] Due to this silence, when ParentCo spin-offs a subsidiary, its Class A and Class B stock classes are both entitled to receive the equal distribution of subsidiary stock. Specifically in the NACCO/HBB spin-off, the ParentCo's low-vote Class A stockholders and high-vote Class B stockholders have equal rights to the distribution of the SpinCo's stock and thus the ParentCo was required to distribute one share of the SpinCo Class A common stock and one share of SpinCo Class B common stock to each stock of the ParentCo as dividends in proportion to the total number of ParentCo stock they own.[112]

Due to this equal distribution provision, NACCO's subsequent spin-offs would incrementally dilute the high-vote Class B stockholders' voting rights. The corporate insiders who were managers and held most of the high-vote Class B stock in NACCO were in need of preventing a further dilution of voting rights during spin-offs. Instead of going through a charter amendment process that requires shareholder approval, the managers of NACCO took advantage of occasion of the spin-off to amend the charter provision without shareholder consent.[113]

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[110] Alternatively, other companies may provide an option for shareholders to receive dividends either in cash or in stock. But this option has not been prevalent because it rejects tax-free benefit for the distribution under the tax code. *See* I.R.C. § 305(b)(1).

[111] The court distinguishes a distribution of a company's own stock and a distribution of a subsidiary's stock. *See, e.g.*, In re IAC/InterActive Corp (Del. Ch. 2008).

[112] *See* Hamilton Beach Brand Holding Company, Registration Statement (Form S-1) at 37. (Aug. 21, 2017).

[113] In a company with a dual-class structure, managers tend to be under the influence of high-vote class stockholders such as founders of the company. Thus, while technically ParentCo's managers are the ones who set SpinCo's governance arrangement, the direction of change aligns with the interest of high-vote class stockholders in most cases.

b. Nominal Change in Voting Rights Allocation After Spin-off

What managers claimed, however, in the new SpinCo's registration statement does not seem to benefit ParentCo's high-vote stockholders and managers. On the contrary, managers claimed that the equal distribution requirement in ParentCo charter would reverse the proportional interest that ParentCo's shareholders will have in SpinCo, and thus ParentCo's high-vote stockholders will hold minority voting powers in SpinCo, while ParentCo's low-vote stockholders will hold majority voting powers in SpinCo.

Table 3 below, using simplified numbers/ratio of the actual ones/ratio of the actual ones, explains the argument by the managers. ParentCo's low-vote Class A stockholders previously had 250 shares in ParentCo, representing 25% voting rights in ParentCo as shown in Table 2 above. Due to the equal stock distribution requirement for spin-offs, ParentCo Class A stockholders receive 250 Class A shares and 250 Class B shares in SpinCo. Because SpinCo also has a dual-class stock structure, SpinCo's low-vote Class A stock gets one vote per share, and SpinCo's high-vote Class B stock gets ten votes per share. Consequently, ParentCo's low-vote Class A stockholders' total voting rights in SpinCo would be 2750 (=250x1+250x10), representing 77% of the votes in SpinCo. In the same way, ParentCo's high-vote Class B stockholders' voting rights in SpinCo is 825 (=75x1+72x10), representing 23% of the votes in SpinCo.

In sum, the low-vote Class A stockholders in ParentCo, representing only 25% voting rights in ParentCo, will control 77% of the votes in SpinCo (=2750/(2750+825)), whereas high-vote Class B stockholders in ParentCo, representing 75% voting rights in ParentCo, will control only 23% of voting right in SpinCo.

TABLE 3. POST-SPIN-OFF: CHANGES BASED ON MANAGERS' CALCULATION[114]

	Number of NACCO Stock	% of NACCO Stock	Number of Post-Spin-off HBB Stock	Number of Post-Spin-off HBB Votes	% of Post-Spin-off HBB Votes
NACCO Class A (1 vote/share)	250	77%	500 (250A+250**B**)	2750 (250x1+250x10)	77%
NACCO Class B (10 votes/share)	75	23%	150 (75A+75B)	825 (75x1+75x10)	23%
Total	325	100%	650	3575	100%

[114] *Id.*

c. High-to-Low Conversion and Actual Changes in Voting Right Allocation

At first glance, as ParentCo managers argued, this reversal of the voting rights between low-vote and high-vote class shareholders seems to be desirable. This is because it looks like the insiders holding high-vote stock in ParentCo now yield their majority voting power to low-vote stockholders, and thus the disparity between ownership and voting control is attenuated.[115] However, the reversal of the voting power is not as apparent as it looks. This is because of the SpinCo's post-spin-off conversion provision in the charter. While the post-spin-off allocation of voting rights in SpinCo shown in Table 3 above is not factually inaccurate, the allocation is temporary and misleading because of a charter provision on high-to-low conversion for transfer.

Both the ParentCo's and SpinCo's high-vote Class B common stock are not listed on stock exchanges. Only their low-vote Class A common stock are publicly tradable on the New York Stock Exchange.[116] For those who want to trade their high-vote Class B stock, only two options are available. First, they can transfer their high-vote stock only to or among the "Permitted Transferees," who are closely related to the high-vote Class B stockholders as defined in the charter.[117] The violation of this restriction of transfer would automatically convert the high-vote Class B stock into low-vote Class A stock.[118] Second, they can convert their high-vote Class B stock into the low-vote Class A stock on a share-for-share basis. They can then transfer low-vote Class A stock on the stock exchange.[119] In either case, the high-vote Class B stock converts into the low-vote Class A stock on transfer, either voluntarily or involuntarily, if the fellow high-vote Class B stockholders do not agree to that transfer. The result is that the transferor's voting rights in SpinCo will be reduced from ten votes to one vote per share.

Who, then, holds the high-vote Class B stock in SpinCo? Due to the equal distribution requirement in ParentCo's charter, not only high-vote Class B stockholders in ParentCo but also low-vote Class A stockholders in ParentCo

[115] *Id.* at 4. ("By virtue of the spin off, there will be a greater concentration of voting power in Hamilton Beach Holding among the holders of NACCO Class A Common than such holders have in NACCO and a corresponding reduction in the concentration of voting power in Hamilton Beach Holding among the holders of NACCO Class B Common.").

[116] *Id.* at 4. ("Like the NACCO [the ParentCo] Class B Common, our [the SpinCo's] Class B Common will not be listed on the NYSE or any other stock exchange, and we do not expect any trading market for our Class B Common to exist.").

[117] Hamilton Beach, Corporate Charter Article 4. Section 3. 4. (a) (i).

[118] *Id.*

[119] Hamilton Beach, Registration Statement, at 4. ("If you want to sell the equity interest represented by your shares of our Class B Common, you may convert those shares into an equal number of shares of our Class A Common at any time, without cost, and then sell your shares of our Class A Common.").

received high-vote Class B stock in SpinCo.[120] Most of ParentCo's low-vote Class A stockholders, however, tend to be more interested in the investment from trading rather than the control of the company. They must inevitably convert their high-vote Class B stock in SpinCo into low-vote Class A stock in SpinCo for transferability, despite the reduction in voting rights. By comparison, the insiders who initially were holding ParentCo's high-vote Class B stock and were not as interested in trading as outside investors have an incentive to retain SpinCo's high-vote Class B stock.

If we reflect this conversion issue and assume that most of the high-vote Class B stock in SpinCo is owned by insiders (i.e., initial holders of ParentCo's high-vote Class B stock), the allocation of voting rights between Class A and Class B stockholders in SpinCo would be significantly different from what the managers described in SpinCo's registration statement. The ParentCo's high-vote Class B stockholders, who used to have 75% voting rights in ParentCo in Table 2, still retain up to 62% voting rights in SpinCo, which is more than majority.

TABLE 4. POST SPIN-OFF & CONVERSION: ACTUAL REALLOCATION OF VOTING RIGHTS

	Number of NACCO Stock	% of NACCO Stock	Number of Post-Spin-off HBB Stock	Number of Post-Spin-off HBB Votes	% of Post-Spin-off HBB Votes
NACCO Class A (1 vote/share)	250	77%	500 (250A+250**A**)	500 (250x1+250x1)	38%
NACCO Class B (10 votes/share)	75	23%	150 (75A+75B)	825 (75x1+75x10)	62%
Total	325	100%	650	1,325	100%

In other words, assuming that *all* high-vote Class B stock of SpinCo held by non-insiders converted to the low-vote Class A stock of SpinCo for the transferability, the ParentCo's high-vote Class B stockholders may enjoy possibly up to 62% voting rights in SpinCo as shown in Table 4, with only 23% of equity interests in the company. In contrast, ParentCo's low-vote Class A stockholders, who used to have 25% voting rights in ParentCo, retain 38% voting rights in SpinCo, which would be still minority in terms of voting power.[121]

[120] *See supra* Part II.C.1.a.

[121] This issue was addressed as one of the risk factors in the New SpinCo's registration statement. Hamilton Beach, Registration Statement, at 18. ("After the spin-off, holders of our [the SpinCo's] Class A Common and holders of our [the SpinCo's] Class B Common

Some might question why this situation poses a problem, given that ParentCo's high-vote Class B stockholders' voting rights decreased from 75% (in Table 2) to 62% (in Table 4) before and after the spin-off transaction. Others might argue that given that ParentCo already had a dual-class stock structure before the spin-off, the disparity between economic interests and voting rights in SpinCo is similar to what ParentCo shareholders contracted into.

However, the real issue here involves vote dilution. Specifically, the concern is that the voting power that ParenCo's low-vote Class A stockholders have in SpinCo will not be 77% (as alleged by the managers), but will instead be closer to 38%, due to the stock conversion provision. On the flip side, ParentCo's high-vote Class B stockholders will maintain the majority of voting control in SpinCo close to 62% with much less equity interests of 23%. This actual change is possible because both ParentCo and SpinCo had a dual-class stock structure along with the conversion provision. In that sense, even though a dual-class stock structure was not a new implementation to the SpinCo, its existence itself substantially increased potential agency costs.

Nevertheless, the degree of voting control in SpinCo by the insiders of ParentCo is not certain because it relies on the conversion rate of high-to-low vote stock. If significant numbers of high-vote stock in SpinCo held by the outside investors are dormant, it is still possible that the insiders' voting rights do not sufficiently increase to become the majority in voting as quickly as the insider wants.

d. SpinCo's Governance Transformation through Spin-off

As we discussed earlier in Part I.B.2., the current law grants ParentCo's managers ample discretion in setting corporate governance arrangements of SpinCo's charters without shareholder approval. On top of the voting rights reallocation discussed above in NACCO/HBB spin-off, ParentCo managers proactively exercised this discretion and unilaterally made additional changes to SpinCo's charter provision. The SpinCo's charter was largely modeled after ParentCo's charter, but it implemented new anti-takeover provisions that ParentCo does not have (e.g., supermajority voting requirement,[122] a

generally will vote together on most matters submitted to a vote of our stockholders. Consequently, as holders of our Class B Common convert their shares of our Class B Common into shares of our Class A Common, the relative voting power of the remaining holders of our Class B Common will increase.").

[122] RESTATED CERTIFICATION OF INCORPORATION OF HAMILTON BEACH BRAND HOLDING COMPANY, Article V Section 3 & Section 4, Article VI, and Article VII.

limit on shareholder actions in written consent,[123] limit on shareholders' right to call a special meeting,[124] limit on shareholders' right to amend bylaws[125]).

In particular, SpinCo made changes to ParentCo's provision on dividend by adding one new paragraph at the end of the exact same wording to ParentCo's provision.[126] The newly added part in SpinCo charter specifically states that spin-offs would be another exception to the equal distribution requirement in dividends:

> provided, further, that in the case of any other distribution of *stock of any subsidiary* of the Corporation that occurs after the date of the Spin-Off, shares of Class A common stock of such subsidiary may be distributed with respect to Class A Common Stock and shares of Class B common stock of such subsidiary may be distributed with respect to Class B Common Stock. (emphasis added).[127]

Consequently, unlike ParentCo's charter provision requiring an equal stock distribution to both high-vote and low-vote stockholders, the new SpinCo charter provision mandates that in the future low-vote Class A stock shall be distributed only to the Class A stockholders and high-vote Class B Stock shall be distributed only to the Class B stockholders. This same-kind

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[123] *Id*. Article VII (a).

[124] *Id*. Article VII (b).

[125] *Id*. Article VIII ("Article I, Sections 1, 3 and 8, Article II, Sections 1, 2, 3 and 4 and Article VII of the Bylaws may not be amended or repealed by the stockholders, and no provision inconsistent therewith may be adopted by the stockholders, without the affirmative vote of the holders of at least 80% of the voting power of the outstanding Voting Stock, voting together as a single class.").

[126] RESTATED CERTIFICATE OF INCORPORATION OF NACCO INDUSTRIES, INC., Article Fourth. 6. (Mar. 31, 1993).

[127] RESTATED CERTIFICATION OF INCORPORATION OF HAMILTON BEACH BRAND HOLDING COMPANY, Article IV. Section 3. 6. The full text of the provision is as follows:

> [E]ach share of Class A Common Stock and Class B Common Stock shall be equal in respect of rights to dividends and other distributions in cash, stock or property of the Corporation, provided that in the case of dividends or other distributions payable in *stock* of the Corporation, including distributions pursuant to stock split-ups or divisions of stock of the Corporation which occur after the date of the Spin-Off, only shares of Class A Common Stock shall be distributed with respect to Class A Common Stock and only shares of Class B Common Stock shall be distributed with respect to Class B Common Stock, and provided, further, that in the case of any other distribution of stock of any subsidiary of the Corporation that occurs after the date of the Spin-Off, shares of Class A common stock of such subsidiary may be distributed with respect to Class A Common Stock and shares of Class B common stock of such subsidiary may be distributed with respect to Class B Common Stock.

stock distribution requirement applies to a distribution of any subsidiary company's stock after the spin-off. This charter provision explicitly and perpetually stopped the dilution of voting rights of the high-vote Class B stockholders.

More importantly, due to this new provision on unequal distribution, the current allocation of voting rights between Class A and Class B stockholders is not final. Since the new SpinCo's charter provision allows the board to make a heterogeneous stock distribution for different classes of stockholders in spin-off, it is possible that the high-vote Class B stockholders in SpinCo will get even greater voting rights in the future through subsequent spin-offs. In this way, the adoption of dual-class stock structure in SpinCo can enhance the insiders' voting rights without any monitoring mechanism and magnifies the disparity between equity interests and voting rights.

As such, the managers of ParentCo unilaterally changed governance arrangements of SpinCo by implementing charter provisions that shareholders would have likely resisted if it were up for ParentCo's shareholder vote for the amendment. Under the new governance arrangements, the rights and power of ParentCo stockholders seem to have fundamentally changed.

2. Tax law: Analysis on the "Continuity of Interest" Requirement

a. Interrupted Continuity

Let us develop the discussion further by combining corporate issues arising from dual-class stock with tax law. The spin-off of HBB by NACCO was carefully designed to qualify as tax-free under Section 355 of the Code,[128] which is supported by the legal opinion of NACCO's legal counsel, McDermott, Will & Emery.[129] As demonstrated in Subpart B, dual-class structures exacerbate agency problems by creating discrepancies in shareholders' voting rights before and after the spin-off.[130] If such discrepancies occur during an acquisitive reorganization, such as mergers and acquisitions, shareholders can voice their opinions through the shareholder approval process.[131] However, there is no mechanism for shareholders to

[128] Hamilton Beach Brand Holding Company, Registration Statement, *supra* note 104, at 6.

[129] *Id.*, at Exhibit 8.1.

[130] *See supra* Subpart B.

[131] *See* H. Kirt Switzer & Gary B. Wilcox, *Corporate Acquisitions – (A), (B), and (C) Reorganizations*, 771-4th TAX MGMT. BNA US INCOME PORTF., I.D.6. (2017) (discussing shareholder approval in acquisitive reorganizations); CLAIRE HILL ET AL., MERGERS AND ACQUISITIONS: LAW, THEORY, AND PRACTICE 35–38 (2016) (discussing the shareholder approval process in mergers and acquisitions).

monitor the governance disparity when it comes to a spin-off.[132]

The rationale of the tax-free benefits for both an acquisitive reorganization, such as mergers and acquisitions, and divisive reorganization, such as spin-offs, is that those reorganizations are mere changes in corporate form.[133] From a tax perspective, then, the question becomes whether those corporate reorganizations with significant governance changes could still be viewed as mere changes in form and thus deserving of tax-free benefits. This question boils down to the continuity of interest requirement by which the shareholders of the acquired corporation in a merger or acquisition or the parent company in a spin-off must maintain some equity portion in the continuing enterprise to gain tax-free status.[134] This Article claims that corporate governance changes (more specifically, voting right changes) via spin-off potentially interrupt the continuity of equity interest and thus may render the transaction a taxable event.

As explained in II.C, the continuity of interest doctrine at issue requires the historic shareholders of ParentCo to continue to control all the resulting corporations.[135] This is a common requirement applicable to all tax-free reorganizations, including mergers and acquisitions and spin-offs.[136] As to the quantitative standard to determine continuity of interest, several examples in the regulations indicate that a 50% equity interest should be sufficient in the case of acquisitive reorganizations, and the regulations for other types of reorganizations, including spin-offs, also refer to that standard.[137]

The continuity of interest requirement has been criticized, however, as an insufficient criterion for a tax-free benefit.[138] Part II.A. provides a broad, policy-level criticism, arguing that allowing tax-free benefits to spin-offs

[132] *See supra* Part I.B.2.

[133] SCHWARZ ET AL., *supra* note 72, at 803.

[134] *See* Treas. Reg. § 1.355-2(c)(1); MCMAHON, *supra* note 61, at 1173.

[135] *See* I.R.C. § 368(a)(1)(D); Gregory N. Kidder (Steptoe & Johnson LLP), *Basics of Tax-Free Spin-Offs Under Section 355*, 5 J. INT'L TAX'N 50, 55 (Nov. 2011) ("Where the spin-off involves a divisive "D" reorganization, there is an additional requirement that either [the parent company] or its shareholders control the spun off corporation immediately after the transaction.").

[136] Treas. Reg. §§1.368-1(b), 1.355-2(c).

[137] Treas. Reg. § 1.355-2(c)(1); Treas. Reg. § 1.368-(e)(2)(v) Ex. 1; Rev Proc. 77-37, 1977-2 C.B. 568 (discussing the 50% benchmark for satisfying the continuity of interest requirement); Rev. Proc. 86-42, 1986-2 C.B. 722; STEPHEN SCHWARZ & DANIEL LATHROPE, FUNDAMENTALS OF CORPORATE TAXATION 403–04, 491–93 (9th ed. 2016) (discussing continuity of interest requirement in the context of acquisitive reorganizations and spin-offs).

[138] For a recent reform proposal that seeks to provide for an objective continuity of interest testing period and for efforts to narrow the scope of Section 355 so that it cannot be used to effectuate a tax-free sale of a subsidiary to a new economic group in avoidance of Congress desire to repeal the *General Utilities* doctrine, *see* Bret Wells, *Reform of Section 355*, 65 AM. U. L. REV. 447 (2018).

encompassing significant governance changes is not a good tax policy. This Subpart further elaborates on the criticism based on the doctrinal analysis of the current rule applicable to the NACCO-HBB spinoff case.

Commentators criticize that the continuity of interest requirement in general does not do enough to distinguish a corporate reorganization that deserves tax-deferred treatment from a regular sale that should be taxed currently in the context of mergers and acquisitions.[139] Furthermore, when it comes to spin-offs, current law fails to ask deeper questions about the basic premise of the doctrine: whether a spin-off (or corporate reorganization more broadly) represents pure paper transactions for shareholders and mere changes in corporate form.[140] There is no clear rule that requires the resulting corporations to preserve "the corporate identity" of historic ParentCo following a spin-off "in a real and meaningful way."[141] It merely requires historic ParentCo shareholders to receive more than about 50% of SpinCo's instrument labeled "equity."[142] Almost any type of stock will serve as a valid distribution.[143] SpinCo may distribute non-voting preferred stock to historic shareholders of ParentCo, who previously owned voting stock. In this case, the distribution will be treated as a sufficient equity interest in SpinCo when it comes to testing continuity of interest.[144] Thus, any qualitative changes in the stock, such as the voting powers of historic shareholders or the corporate governance disparity between ParentCo and SpinCo, are not considered.[145] Current law is simply content with the technical continuity of interest as long as historic shareholders receive more than about 50% of equity interest in SpinCo.[146]

But what if historic shareholders experienced a qualitative difference in equity before and after the spin-off? Are those continued interests really continuous? Is not the continuity interrupted if the intrinsic value of the equity interest has been altered significantly (with the exception of continuing a certain percentage ratio in both old and new corporations)?

Tax law has not addressed this issue and does not consider any qualitative difference in stock, such as in shareholders' rights and in corporate governance structure, emerging through spin-off transactions.[147] To address

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[139] Blank, *supra* note 73, at 2.

[140] *Id.* at 24 ("Effectively, the doctrine judges whether a thing has been changed by looking to its owners rather than to the thing itself.").

[141] *See id.* at 28.

[142] *See id.* at 41–42 and text accompanying *supra* note 73.

[143] *See* Blank, *supra* note 73, at 42.

[144] *Id.*

[145] *See id.*

[146] *See* Treas. Reg. § 1.355-2(c)(1); MCMAHON, *supra* note 61, at 1173.

[147] Blank, *supra* note 73, at 26 (quoting *Monty Python: And Now for Something*

this oversight, this Article argues that the continuity would be interrupted not only when historic shareholders fail to continue a certain percentage of ownership in SpinCo, but also when the intrinsic value of the equity interest, such as voting rights, has been substantially changed during reorganization.

As the continuity of interest requirement is common throughout all types of corporate reorganizations, a similar observation by a tax scholar is found in the context of acquisitive reorganizations, such as mergers and acquisitions.[148] Joshua Blank offers two scenarios where the continuity is disrupted and thus "shareholders" are required to recognize gains in the acquisitive reorganizations.[149] The first scenario is when voting shareholders receive non-voting stock.[150] Voting rights may carry a premium, because they represent the power to participate in the election of directors who make fundamental decisions affecting the strategic direction of the company.[151] The second scenario is the disproportionate reduction in percentage interest measured by either vote or value.[152] Inferring from other tax code sections on disproportionate reduction in interest, such disproportionate equity reduction is deemed to be engaged in a sale rather than a corporate reorganization.[153] Blank concludes that considering the change in the shareholders' relative position as a shareholder following a merger or spin-off, neither scenario should qualify for the tax-free benefit.[154]

This Article observes that such problems may be more serious with regard to spin-offs. This is because there exists no systematic shareholder monitoring process throughout the transaction, whereas shareholder approval is mandatory in acquisitive reorganizations. Blank's critique is analogous to this Article's inquiry into spin-offs inasmuch as both acquisitive and divisive reorganizations share the continuity of interest doctrine.[155] Hence, Blank's two scenarios to analyze the continuity of interest requirement are useful tools for analyzing the requirement in the context of spin-offs.

Based on this finding, let us now return to the NACCO-HBB spin-off case, where the historic shareholders' role and rights within the enterprises have changed significantly following a spin-off.[156] The NACCO-HBB dual

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Completely Different (1971) [VHS] Directed by I. MacNaughton. London: Columbia Pictures Co.).

[148] *See* Blank, *supra* note 73.

[149] *Id.* at 8.

[150] *Id.* at 43.

[151] *See* Bebchuk & Kastiel, *supra* note 91, at 594.

[152] Blank, *supra* note 73, at 8 (E.W. Scripps and Belo were spun off with dual-class stock in 2007).

[153] *Id.* at 62.

[154] *Id.* at 60.

[155] *Id.* at 14.

[156] *Id.* at 26.

stock example comes under both scenarios—distributing non-voting stock to historic voting shareholders and the disproportionate reduction in interest.[157] In other words, shareholders' new stock in SpinCo is something completely different from that in ParentCo. Such a change may make the HBB spin-off something more than a mere change in form, leading to the conclusion that HBB shareholders should not qualify for the tax-free benefit.[158]

We note that the above argument is contentious because its conclusion inevitably urges a fundamental overhaul of the continuity of interest rule. Indeed, the continuity of interest doctrine has failed to serve as an adequate means to distinguish between certain reorganizations that ought to receive tax-free benefits and other ordinary sales.[159] One of the reasons that the continuity of interest has failed to serve its purpose might be its unjustifiable obsession with the quantitative analysis of the continued equity. This approach disproves the effectiveness of the continuity of interest requirement, considering the fact that there has not been any meaningful report of any transactions that have failed to satisfy such requirement.[160]

In sum, roughly 50% of historic shareholders' equity interest in the aggregate thus far satisfies the continuity of interest requirement, regardless of whether the fundamental rights of shareholders continue before and after the spin-off.[161] However, this traditional approach cannot solve more recent problems regarding spin-offs—i.e., significant change in the quality of historic shareholders' voting power via dual-class stock.[162] Thus, even if historic shareholders continue to hold a continuity of propriety interest, this Article argues that the continuity of propriety interest requirement might not be satisfied if their rights with regard to the stock have changed significantly.

b. Dual-class Stock and Post-Distribution Continuity

In Subpart 2.a., we examined the continuity of interest doctrine by taking a snapshot as of the closing date of the spin-off transaction. Now, let us examine whether such continuity remains during a certain period after the

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[157] *Id.* at 60–61.

[158] Ajay K. Mehrotra, *Mergers, Taxes, and Historical Materialism*, 83 IND. L. J. 881, 896 (2008).

[159] *Id*.; Blank, *supra* note 73, at 44–45.

[160] *Id.* at 44.

[161] Katherine Schipper & Abbie Smith, *Effects of Recontracting on Shareholder* Wealth, 12 JOURNAL OF FINANCIAL ECONOMICS 437, 439 (1983).

[162] *See supra* Part II.C.1. *See also* Wei Du, Essay on Anti-takeover Provisions and Corporate Spin-offs 3901 (May 2016) (unpublished Ph.D. Dissertation, Louisiana State University), http://digitalcommons.lsu.edu/gradschool_dissertations (discussing the change in corporate governance via spin-off more generally).

spin-off.[163]

Current law and regulations require historic ParentCo shareholders to retain a continued equity interest in the ongoing enterprises not only before the distribution but also afterwards.[164] This requirement remains the same as the pre-1998 regulations that required post-acquisition continuity for acquisitive reorganizations.[165] In 1998, the post-acquisition continuity requirement was abandoned, allowing Target shareholders to sell freely the acquired stock to third parties without violating the continuity of interest requirement. At the time there was discussion of whether the change should be extended to divisive reorganizations such as spin-offs.[166] Since then, however, neither the Treasury nor the IRS has announced a revised position on the continuity of interest requirement in the corporate divisive context.[167] Current law thus still requires both pre-distribution and post-distribution continuity of interest.[168]

Specifically, Treasury Regulation § 1.355-2(c) dealing with continuity of interest primarily discusses pre-distribution sales, whereas Treasury Regulation § 1.355-2(d) dealing with the device limitation that prohibits shareholders from cashing out primarily discusses post-distribution sale.[169] The device regulation is considered "a particularly strong form of continuity of interest requirement with respect to post-distribution sale."[170] Furthermore, the continuity of interest requirement in Treasury Regulation § 1.355-2(c) broadly includes post-distribution sales in the issue of continuity of interest. It does not explicitly limit the issues to pre-distribution sales.[171] Furthermore, Section 355(e) of the Code, which requires that spin-offs not be followed by any pre-arranged change-in-control (50% or more) of either ParentCo or SpinCo within a period beginning two years before the distribution and ending two years after the distribution, appears to reinforce the post-distribution continuity of interest requirement.[172]

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[163] I.R.C. § 355(e); Blank, *supra* note 73, at 37; David F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Divisions*, 18 VA. TAX REV. 473, 480–486 (1999).

[164] *Id.* at 486.

[165] SCHWARZ & LATHROPE, *supra* note 137, at 492 n.118.

[166] *Id*., at 492 n.118; Shores, *supra* note 163, at 475 (arguing that the revised regulations for acquisitive reorganizations should apply to divisive reorganizations as well).

[167] Treas. Reg. §§ 1.355-2(c),2(d).

[168] *Id.*

[169] Shores, *supra* note 163, at 497–498.

[170] *Id.* at 481.

[171] *Id.*

[172] I.R.C.§ 355(e), often called the "Morris Trust" rules, was enacted in 1997, followed several spin-merger deals where ParentCo extracted substantial cash proceeds by putting leverage on SpinCo. Congress thought that a spin-merger with a 50% change in ownership

Nonetheless, the interrupted continuity problem becomes more puzzling when we expand our analysis from a static snapshot of the continuity to a certain timeframe after the spin-off. Indeed, as explained above, the divisive reorganization rules have a more vigorous continuity of interest requirement than the acquisitive reorganization rules. However, the continuity of interest requirement for spin-offs attempted to eliminate the ownership change from historic shareholders to a third party, such as a spin-off followed by a merger with a third party, rather than addressing the ownership change within historic shareholders after spin-off.[173] However, as in the NACCO-HBB case where conversion from Class B to Class A is anticipated, we are now faced with the latter form of ownership change that should also be considered in the context of post-distribution continuity of interest.

Due to the lack of rules regarding this newly emerged form of post-distribution ownership change, NACCO-HBB insiders argued that their spin-off would not be taxed. They made this argument because it is not certain whether any increase in voting power in HBB by NACCO Class B shareholders by conversion is considered an "acquisition" after the spin-off that renders the transaction taxable.[174] It is true that the regulations have not anticipated this new form of post-distribution ownership change not caused by a merger or acquisition with a third party, as in the NACCO-HBB case. However, it also seems questionable whether the law only intends to prohibit a shareholder sale to third parties and not those cases where the ownership change among existing shareholders enables insiders who were previously

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or greater (measured by vote or value) looked more like a sale than a restructuring, and it thus concluded that it should not qualify for tax-free treatment if, as part of the plan of distribution, one or more persons acquires at least a 50% interest of either ParentCo stock or SpinCo stock. If that acquisition occurs within a period beginning two years before the distribution and ending two years after the distribution, it is presumed to be a part of the plan of distribution, i.e., spin-off. This essentially requires a 2-year pre-distribution and a 2-year post-distribution holding requirement for both ParentCo and SpinCo, which in effect reinforces the post-distribution continuity of interest requirement. Shores, *supra* note 163, at 536–37. Today, there are a great number of regulations that try to define what is and what isn't a prearranged transaction.

[173] Michael L. Schler, *Simplifying and Rationalizing the Spinoff Rules*, 56 S.M.U. L. REV. 239, 272 (2003); George K. Yin, *Taxing Corporate Divisions*, 56 S.M.U. L. REV. 289, 296 (2003).

[174] NACCO, Form S-1, at 7. The parties further argue that even if so, it does not cause 50% or more changes triggering a taxable transaction under Section 355(e). However, a 50% or more requirement has been criticized severely because any post-distribution merger would easily avoid the requirement by making the smaller of the two merging corporations the surviving entity. Shores, *supra* note 163, at 537. If the parties arrange for the survival of the smaller of the two merging corporations, the shareholder of the smaller (or transferee) corporation would hold less than 50% of its stock following the merger and would be treated as having acquired less than 50% of the larger (or transferor) corporation's stock.

unable to amend the charter to now turn the group into a supermajority that can amend the charter. This is exactly what we examined as the qualitative difference in equity before and after the spin-off in Subpart 2.a. This scenario violates the continuity of interest requirement and thus is not a mere reorganization that is entitled to tax-free treatment.[175]

Notably, a recent IRS Revenue Procedure and private letter ruling seem to approve a spin-off transaction harnessing dual-class stock structure.[176] The ruling provides tax-free benefits to a transaction where the public ParentCo distributes the high-vote stock to the public and retains the low-vote stock, which is then used to redeem existing debt to a creditor.[177] The ruling in principle requires a company to maintain the dual-class structure for 24 months or more after the spin-off.[178] A significant exception to this requirement, however, is that SpinCo may unwind the dual-class structure within 24 months if it merges with a third-party acquirer. This unwinding can take place as long as there were no negotiations during the 24-month period prior to the distribution, and as long as no more than 20% of the interest in vote or value is acquired by any existing shareholder who owns more than 20% of stock in vote or value.[179] These "safe harbors" for unwinding a dual-class structure reiterate the safe harbors in Revenue Procedure 2016-40.

A practitioner interprets this ruling as the IRS basically blessing the dual-class structure for tax-free spin-offs.[180] However, such an interpretation of the IRS' position may be overly positive and perhaps misleading. First, the Revenue Procedure limited its discussion on the 80% control requirement when the SpinCo adopts dual-class stock which ParentCo distributes in a transaction that otherwise qualifies the remaining requirements under Section 355 of the Code. Second, the ruling at issue involves a creditor for whom the low-vote class stock is to be used to redeem the ParentCo's debt, so it makes sense to require maintaining dual-class structure for certain periods of time after the spin-off to protect the interests of high-vote shareholders of

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[175] Yin, *supra* note 173, at 296. Yin briefly mentions that the ownership change among the existing shareholders does not disqualify the transaction by illustrating the situation where ParentCo shareholders receive SpinCo stock proportionally when SpinCo stock is distributed, which is obviously a different context from the discussion in this paper. *Id.* at 297.

[176] Rev. Proc. 2016-40, 2016 32 I.R.B. 228; I.R.S. Priv. Ltr. Rul. 201731004 (Feb. 16, 2017).

[177] The creditor immediately sells those low-vote stock to unrelated third parties in public of private offerings. I.R.S. Priv. Ltr. Rul. 201731004, 7 (Feb. 16, 2017).

[178] *Id*. at 9.

[179] *Id*.

[180] *See generally* Alston & Bird, *Federal Tax Advisory: Dual-Class Stock Blessed for Spin* (Sep. 1, 2017), *available at* https://www.alston.com/-/media/files/insights/publications/2017/08/dualclass-stock.pdf.

ParentCo.[181] Moreover, both Revenue Procedure and the ruling describe the fact patterns of ownership change between shareholders and a third party after the spin-off, with which the extant rule is familiar.

Therefore, it is likely more proper to note that neither the IRS nor the Treasury have noticed the potential problems with continuity of interest arising from the ownership change between historic shareholders derived from dual-class stock. We urge the IRS to consider this issue, as discussed further in Part III.C. More fundamentally, it is necessary to update the rule to consider post-distribution continuity within historic shareholders.

III. LEGAL IMPLICATIONS

In this Part, we propose legal solutions to the problems we have identified above. As what we believe is the first paper to integrate corporate and tax law considerations simultaneously on the issue, we argue that neither corporate nor tax laws have caught up with the evolution of spin-off practice in the real world. This gap between law and practice creates an unexpected legal loophole that solicits agency problems. In particular, managers' unfettered discretion in modifying corporate governance arrangements in spin-offs needs to be checked, and both corporate law and tax law can play that role by making necessary changes to the current framework.

A. Constructive Cooperation of Corporate Law and Tax Law

Spin-offs are corporate law transactions, but the completion of spin-offs is often conditioned on obtaining tax-free treatment of those spin-offs. Given that both corporate law and tax law are key elements of spin-off transactions, a cooperative solution of corporate law and tax law would provide more holistic normative policy implications for the unique problem (i.e., unilateral governance changes) revealed earlier in this Article.

A potential concern for invoking tax law to address the problems relating to changes in voting rights through spin-offs is that tax law is an imperfect instrument for addressing agency costs incurred by managers.[182] Although there are some topics that policymakers may seek in order to correct problems in corporate governance and managerial opportunism,[183] there is significant

[181] If not, a third party that acquires a low-vote stock may unwind the dual-class structure immediately after the tax-free spin-off, which would harm the voting rights of the high-vote shareholders of ParentCo.

[182] David M. Schizer, *Tax and Corporate Governance: The Influence of Tax on Managerial Agency Costs*, THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 1 (Jeffery N. Gordon & Wolf-Georg Ringe eds., July 2015), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2501706.

[183] For example, there are certain tax rules to discourage pyramidal business structure

hesitation to introduce tax law as a tool to mitigate the problems in non-tax areas.[184] Despite the general reluctance of using tax law as a tool for non-tax problems, there are in fact only a few examples of literature by tax scholars particularly discussing the efficacy of tax law influencing corporate governance.[185] As Schizer has provided, it might be due to the fact that neither tax experts nor corporate experts usually have detailed knowledge of the other field to embark on the interdisciplinary research.[186] Moreover, it is difficult to find any substantial discussion about tax-free reorganizations and managerial agency costs, with the exception of Schizer's admission that managers might not always be faithful to shareholders when they plan tax-oriented corporate structuring, and that it is difficult for shareholders to monitor whether managers are pursuing shareholders' interests or their own due to the cryptic tax law and competing considerations.[187] However, instead of offering further analysis, Schizer concludes that the "influence of tax on corporate governance—tax structuring that camouflages self-interested deal terms—is new to the academic literature."[188]

We have demonstrated that the change in voting rights through spin-offs is a good example of how managers may disguise their self-interested corporate restructuring in the esoteric corporate reorganization processes.[189] Most importantly for managers' purposes, the restructuring should be a divisive reorganization, such as spin-off, to block shareholder monitoring and to avoid realizing any taxable gain. To address this problem, we argue that not only corporate law but also tax law should exert such efforts. Given that sophisticated managers already take advantage of tax law to camouflage their

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and excessive golden parachutes and to encourage performance-based compensation. *See, e.g.*, I.R.C. §§ 280G, 4999, 162(m).

[184] *See, e.g.*, Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L. REV. 1673 (2015) (arguing that corrective taxation may not efficiently address various negative externalities caused by different agents); Giorgia Maffini & John Vella, *Evidence-based Policy Making? The Commission's Proposal for an FTT 20* (Oxford University Centre for Business Taxation, WP 15/15, 2015) (opposing the Financial Transaction Tax introduced to deter transactions that do not enhance market efficiency because it does not distinguish "bad" transactions from "good" transactions).

[185] *See, e.g.*, Noam Noked, *Can Taxes Mitigate Corporate Governance Inefficiencies?*, 9 WM. & MARY BUS. L. REV. 221, 224 (2017) (arguing that tax law has limited ability to "effectively mitigate corporate governance problems and increase efficiency"); Schizer, *supra* note 182, at 2 (contending that "tax is a poor fit" to tackle corporate governance problems due to the lack of expertise by tax authorities); Richard M. Hynes, *Taxing Control*, 38 J. CORP. L. 567, 584 (2013) (implying that introducing the corrective tax on the firm control would be inefficient, but in a less critical way).

[186] Schizer, *supra* note 182, at 1.

[187] *Id.* at 20.

[188] *Id.* at 21.

[189] *See supra* Part II.C.

self-interested corporate deal terms, it is less convincing to maintain antipathy toward tax law in addressing corporate problems.

Furthermore, the concern of scholars who disapprove of using tax law as a tool to address corporate issues perhaps reflects the imposition of "uniform and mandatory rules" that have poorly tailored scope and result in unintended negative effects.[190] By contrast, what we propose in this Article is to revoke the tax-free benefits for certain restructuring transactions and to revert to the default rule where those transactions would have realized taxable gain, provided that those transactions are likely to be used as camouflage for managerial entrenchment. Corporate law would be the most direct instrument to challenge this issue, but tax law might be used as an additional stick by revoking the exceptional tax-free benefit in such unusual situations. It is not persuasive for tax law to neglect an issue essential to one of its established requirements for tax-free reorganization, i.e., continuity of interest. Hence, we expect that tax authorities' willingness to closely examine the problem will facilitate a more fundamental action by other agencies in charge of managerial entrenchment. Encouraging the constructive cooperation between the two agencies will eventually fill the gap between tax law and managerial agency costs in corporate law.

B. Corporate Law: Need for Shareholder Approval Requirement

Once ParentCo managers unilaterally amend a SpinCo charter deviating from ParentCo's charter, it becomes extremely difficult for low-vote shareholders to reverse the amendment. The low-vote shareholders' voting rights to amend corporate charters face two large, perhaps insurmountable, hurdles. First, state corporate laws mandate that only directors have a right to initiate a charter amendment. Shareholders can only vote on what directors propose and do not have the power to initiate a charter amendment process no matter how desirable they find one.[191] Second, especially when their voting power has been substantially diluted through the use of dual-class stock as discussed in the NACCO-HBB case in Part II.C., shareholders may no longer have the requisite voting control to dictate or influence the outcome. For instance, if the manager and the insiders have more than 50% of the voting power through dual-class stock, the public shareholders will be simply out of luck in being able to have any meaningful say in the corporate

[190] Schizer, *supra* note 182, at 4–6; Noked, *supra* note 185, at 263 (opposing the use of corrective tax to reduce agency costs from entrenchment because it is hard to assess the benefit and cost associated with the tax); Hynes, *supra* note 185, at 569–70 (implying that introducing the corrective tax on the firm control would be inefficient in a less critical way).

[191] *See, e.g.*, DEL. CODE. ANN. TIT. 8, § 242.

governance arrangement.[192]

1. Limit of Ex-Post Mechanisms

As such, unilaterally amended charter provisions are extremely difficult for shareholders to remove and ParentCo's shareholders can think of their freedom to sell their stock if they are dissatisfied with the new corporate governance arrangements of SpinCo. Although the right to sell stock is unconstrained, the stockholders may be forced to sell it at a depressed price when the distributed stock comes with a suboptimal governance structure. Since shareholders have to bear the loss from the depressed stock price, being able to sell the stock itself is not a reasonable option for the dissatisfied shareholders. As a result, this option may provide little or no deterrence against managers' adoption of suboptimal governance regime through spin-offs.

When shareholders choose not to sell their stock, traditionally the shareholders can express their dissatisfaction by exercising their voting rights or by bring a suit against managers. But in companies with dual-stock structure, the majority voting power is held by the insiders and often it is impossible to obtain enough votes to remove directors or pass shareholder proposals.

Another possible mechanism for shareholders is to bring a shareholder lawsuit against managers who changed governance structure. In corporate spin-offs, managers have the unfettered discretion in deciding 1) whether to divide a company into separate entities ("business decision"); and 2) how to set up a corporate governance structure of a new SpinCo separated from ParentCo ("governance decision"). Exempting spinoffs from shareholder voting is intended to maximize the efficiency of a "business decision." But

[192] It is worth noting that the Institutional Shareholder Services ("ISS"), the most influential proxy advisory firm, made a new voting guideline on unilateral bylaw/charter amendments in 2014. The guideline recommends that shareholders vote against directors who become involved with unilateral bylaw/charter amendments that could adversely impact shareholders after IPO. The fact that the ISS takes the potential risk of unilateral bylaw/charter amendment is welcoming, but the ISS's guideline has its own limitation to monitor unilateral *charter* amendments made through spin-offs. After all, the ISS only deals with a post-IPO charter amendment—but SpinCo's charter is technically neither an IPO charter nor a post-IPO charter. There has been no incidence of the ISS's negative voting recommendation based on unilateral charter amendment through spin-offs yet. Also, most companies that could significantly amend charters through spin-offs have controlling shareholders who already exercise a significant voting control. Thus, they are relatively less influenced by institutional shareholders' vote and largely guided by proxy advisors instead, including the ISS. *See* ISS, United States Proxy Voting Guidelines, Benchmark Policy Recommendations 14 (2018), a*vailable at* https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

when such special treatments extend to "governance decisions," particularly implementing a dual-class structure in SpinCo, unexpected agency costs may arise. Thus, under current corporate law regime, both decisions are bundled and subject to the business judgement rule ("BJR") presumption in favor of managers' actions.[193]

Possibly, despite the BJR protection, low-vote shareholders still can bring a suit against managers or high-vote shareholders regarding spin-offs based on the breach of duty of loyalty.[194] The fiduciary duty of loyalty mandates that fiduciaries act in the best interests of shareholders rather than their own interests.[195] Even if ParentCo managers' discretion to declare dividends and set SpinCo's charter provisions has been generally protected by the business judgment rule, these managers are still subject to the fiduciary duty of loyalty owed to ParentCo's shareholders.[196]Thus, when the managers' declaration of dividends becomes an obvious conflict of interest, the managers may become liable for violating the fiduciary duty of loyalty. Nonetheless, these types of shareholder litigation have been extremely rare, and spin-offs have been strongly regarded as business decisions as a whole. Thus, the court needs to discern "business decisions" and "governance decisions" elements in spin-offs and limit the business judgment protection only to the "business decisions" element. The court may then monitor management's unilateral governance changes under the heightened judicial scrutiny, as courts do in other contexts of corporate law, even when those changes do not necessarily violate the fiduciary duty of loyalty.

2. Benefits of Ex-Ante Shareholder Approval

As discussed above, once management unilaterally adopts management-empowering provisions (including anti-takeover provisions) in corporate charters, it may be nearly impossible for shareholders to reverse those charter provisions by using their rights under the current corporate law regime. Thus, we need to turn to possible new legal constraints against management's discretion in spin-offs. More direct and meaningful checks on the managerial opportunism in governance changes through spin-offs may be imposed by requiring a shareholder vote for certain spin-off transactions. Currently shareholders do not have any right to vote on a spin-off decision made by

[193] *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

[194] The Delaware Supreme Court confirmed that corporate officers owe the same fiduciary duty as directors. *See* Gantler v. Stephens, 965 A. 2d 695 (Del. 2009).

[195] *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993), Weinberger v. UOP Inc., 456 A. 2d 701 (Del. 1983), aff'd, 497A. 2d 792 (Del. 1985).

[196] The fiduciary duty is owed only to shareholders of ParentCo, not to SpinCo shareholders or potential investors.

management. This voting right differs from the shareholders' voting rights to amend corporate charter in the sense that voting requirement for a spin-off itself can be an ex-ante preventive mechanism to management's unilateral governance changes.

Shareholder approval requirement would mitigate agency costs that could arise from the potential managerial entrenchment associated with their unilateral governance changes. In order to obtain a shareholder approval, managers may not propose antitakeover provisions unless there is a convincing need for the change. Thus, the existence of shareholder approval requirement itself has an ex-ante deterrence effect on the entrenching governance changes. Along with this benefit, a shareholder approval requirement may incur some costs such as the delay in completing a spin-off transaction in order to obtain shareholder approval separately, the costs associated with shareholder vote process, or the risk of remaining with less efficient governance arrangements when managers fail to obtain shareholder approval.

These costs, however, would not be prohibitively high compared to the benefits, because the requirement does not ban managers' changes entirely, but constraints to a certain degree. If the proposed changes increase shareholder value, a managers' proposal to amend organizational documents would be more compelling to shareholders and more likely to get shareholder approval. Also, the shareholder approval would not unevenly constraint spin-offs, but rather align governance changes during spin-offs with those of the other context of corporate law because Managers have enjoyed the over-inclusive privilege in making governance changes during spin-offs.

There are multiple ways to implement a shareholder approval requirement for spin-offs. First, we can require shareholder voting when the relative size of the spun-off company is substantially large. This is similar, in spirit, to excusing a shareholder vote in a merger transaction when the acquiring company issues less than 20% of the outstanding stock.[197] In a spin-off, given that a new stock is being distributed to the ParentCo shareholders, the law will instead have to examine the relative valuations of ParentCo and SpinCo. The law will require a ParentCo shareholder to vote when SpinCo constitutes a large fraction of the combined valuation. Second, we can impose a shareholder vote in case the governance arrangements of the SpinCo in its charter are substantially different from the ParentCo's.

Activist shareholders may have a particular role to play in exercising shareholder power. Those who have enough capital to threaten managers of a target company have a virtual shareholder approval right. For instance, when Darden announced a business plan to spin-off Red Lobster, the activist

[197] *See, e.g.,* DEL. CODE. ANN. TIT. 8, § 251.

hedge fund Starboard opposed the spin-off plan.[198] After Darden ignored this opposition, Starboard initiated a proxy fight to turn over the entire board members of Darden.[199] As such, powerful individual and institutional investors can effectively constrain managerial discretion by overcoming the collective action problems associated with shareholder action and ensure managerial accountability in the spin-off context.

C. Tax Law: Revisit Continuity of Interest Requirement

In addition to the attempt to address the problem in corporate law, this Article proposes that tax law should support such an attempt. The Article proposes that tax law should do so by disqualifying certain spin-off transactions with material changes in corporate governance structures from tax-free treatment by way of considering both the quantity and quality of interest when it applies the continuity of interest requirement. Specifically, the Article urges the IRS to consider issuing a letter ruling or guidance on certain spin-offs with material changes in corporate governance for the recently introduced 18-month pilot program on spin-offs, effective until March 21, 2019.[200]

1. Time to Revisit Continuity of Interest

The continuity of interest requirement in spin-offs is a simple reiteration of that requirement in mergers and acquisitions. It has not been revisited since the regulations on the continuity of interest were amended in 1998 with respect to acquisitive reorganizations.[201] However, there are many differences between acquisitive reorganizations and divisive reorganizations both in corporate law and tax law. As a result, referring to or applying the rules for the continuity of interest requirement for acquisitive reorganizations

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[198] Siddharth Cavale & Varun Aggarwal, *Starboard Wants to Put Darden's Red Lobster Spinoff Plan to Vote*, REUTERS, (Feb. 25, 2014), https://www.reuters.com/article/us-darden-starboard/starboard-wants-to-put-dardens-red-lobster-spinoff-plan-to-vote-idUSBREA1N1MT20140224. Since there is no mandatory shareholder approval requirement for spin-offs, Starboard was seeking to "solicit support for a *non-binding* resolution urging the Darden board not to approve a Red Lobster separation." (emphasis added).

[199] Alexandra Stevenson, Activist Hedge Fund Starboard Succeeds in Replacing Darden Board, N.Y. TIMES, (Oct. 10, 2014), https://dealbook.nytimes.com/2014/10/10/activist-hedge-fund-starboard-succeeds-in-replacing-darden-board/ ("Before the shareholder meeting on the spinoff, Darden's board abruptly made a deal in May to sell Red Lobster for $2.1 billion to Golden Gate Capital. The move infuriated shareholders led by Starboard, which immediately embarked on a campaign to try to replace Darden's directors.").

[200] Rev. Proc. 2017-52, 2017-41 I.R.B. 283.

[201] *Supra* texts accompany notes 167.

to divisive reorganization has various conceptual and practical limitations.[202]

The agency problem arising from the corporate governance discrepancy between ParentCo and SpinCo examined in this Article illustrate such problems. Taxpayers not only create agency problem in corporate law but also enjoy tax-free benefits by taking advantage of outdated tax rules regarding the continuity of interest requirement. Thus, we urge the tax authorities to consider newly emerged problems in relation to the continuity of interest requirement.

2. The IRS Pilot Program on Spin-offs

One way for tax authorities to review the newly emerged problems and revisit continuity of interest requirement is the private letter ruling process. Having limited resources, however, the IRS tends not to issue private letter rulings or determination letters on transactions with a large number of complex data points.[203] It is too costly for the IRS to review hundreds of pages of financial reports to come to a decision.[204] Spin-offs are among the transactions for which the IRS has a no-rule stance because the agency considers that some cases surrounding spin-offs may be too fact-intensive for the agency to issue a ruling.[205] The agency further hesitates to incorrectly signal to the market that issuing a ruling on certain type of deals implies the agency's blessing on them.[206]

However, since spin-offs have become a topic of much discussion between corporations and the IRS in recent years, the IRS has slowly been opening up its corporate ruling programs in the past year. For example, Revenue Procedure 2016-40 lifted its ban on private letter ruling requests with respect to the control requirement when dual-class structure is involved. The document offered safe harbors for unwinding the dual-class structure

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[202] Yin, *supra* note 173, at 298.

[203] *See, e.g.*, Rev. Proc. 2013-3, 2013-1 I.R.B. 113; Rev. Proc. 2013-32, 2013-28 I.R.B. 55; Rev. Proc. 2015-43, 2015-40 I.R.B. 467; Laura Davison, *IRS Outlines Rules for M&A Activity Surrounding Spinoffs*, DAILY TAX REP. (BNA) (Dec. 19, 2016).

[204] Laura Davison, *'No Rule' Spinoffs Aren't Necessarily 'Nefarious,' IRS Official*, DAILY TAX REP. (BNA) (May 13, 2017).

[205] Rev. Proc. 2017–3, Sec. 1.01, 2017-1 I.R.B. 130; Rev. Rul. 2017-09, 2017-21 I.R.B. 1244; Davison, *supra* note 204. The IRS does not issue rulings or determination letters if, for example, the problems involved are inherently factual in nature, and instead releases a list of specific areas with no ruling stance. It further releases a list of certain areas in which (i) rulings or determination letters will not ordinarily be issued, (ii) the IRS is temporarily not issuing rulings or determination letters because those matters are "under study," and (iii) the IRS will not ordinarily issue rulings because it has provided automatic approval procedures for these matters. Rev. Proc. 2017–3, Sec. 2.01, 2017-1 I.R.B. 130.

[206] Davison, *supra* note 204.

after the distribution.[207] On July 14, 2016, the IRS released proposed rules on device and active trade or business requirements under Section 355 – i.e., whether a spin-off is a device of distributing earnings and profits to shareholders, which could make the deal taxable, and whether the spin-off has a valid business purpose.[208] It subsequently released Revenue Procedure 2016-45, providing that it would accept ruling requests on the device and active trade or business requirements under Section 355.[209] Furthermore, in May 2017, the IRS released two sets of guidance to resume issuing rulings. First, Revenue Ruling 2017-09 provided that the IRS would issue rulings on so-called "north-south transactions," in which a parent co. (P)'s property is transferred to its subsidiary (D) in exchange of the subsidiary (D)'s share, followed by a distribution by the subsidiary (D) of the stock of its controlled subsidiary (C) to P.[210] Second, Revenue Procedure 2017-38 lifted the ruling restrictions on transactions involving debt issued in anticipation of a spin-off.[211]

Finally, on September 21, 2017, the IRS introduced a pilot program ("Pilot Program") in which it is willing to issue letter rulings on full spin-off transactions generally for the next 18 months.[212] The Pilot Program expires on March 21, 2019, but taxpayers may now obtain rulings on various issues involved in spin-offs that have not been previously available. The agency explained the change of position as an attempt to provide a better view into what types of deals are happening in the marketplace.[213] The IRS also seemed to worry that a no-rule position on certain types of transaction implied that such transactions were nefarious, resulting in a chilling effect.[214] This Pilot Program is a great opportunity for the IRS to consider newly emerged problems in relation to the continuity of interest requirement.

Unfortunately, however, there is no sign of efforts to update or discuss the outdated continuity of interest doctrine in the course of the recent developments. The continuity of interest requirement has not been revisited

[207] Rev. Proc. 2016-40, Sec. 1, 2016 32 I.R.B. 228.

[208] Prop. Treas. Regs. §§ 1.355-0 – 1.355-9, 81 Fed. Reg. 46004 (Jul. 15, 2016).; Lisa Zarlenga, Cameron Arterton & John Cobb, *New Spinoff Standards Proposed in IRS Regulations On Device and Active Trade or Business Under Section 355*, DAILY TAX REP. (BNA) (Aug. 18, 2016).

[209] Laura Davison, *IRS Resumes Advising Corporations on Some Tax Free Spinoffs*, DAILY TAX REP. (BNA) (Aug. 29, 2016).

[210] Rev. Rul. 2017-09, 2017-21 I.R.B. 1244; *Laura Davison, IRS Discusses North-South Spinoff Issues in New Guidance*, DAILY TAX REP. (BNA) (May 3, 2017).

[211] Rev. Proc. 2017-38, 2017-22 I.R.B. 1258; Laura Davison, *IRS Resumes Rulings on Deals with Debt Issued Before Spinoff*, DAILY TAX REP. (BNA) (Aug. 29, 2016).

[212] Rev. Proc. 2017-52, 2017-41 I.R.B. 283.

[213] Davison, *supra* note 204.

[214] *Id*.

since the regulations on the continuity of interest were amended in 1998 with respect to acquisitive reorganizations.[215] Furthermore, there are many differences between acquisitive reorganizations and divisive reorganizations both in corporate law and tax law. As a result, referring to or applying the rules for the continuity of interest requirement for acquisitive reorganizations to divisive reorganization has various conceptual and practical limitations.[216] The agency problem arising from the corporate governance discrepancy between ParentCo and SpinCo examined in this Article illustrate such problems. Taxpayers not only create agency problem in corporate law but also enjoy tax-free benefits by taking advantage of outdated tax rules regarding the continuity of interest requirement. Thus, we urge the IRS to consider adding newly emerged problems in relation to the continuity of interest issue to the new list of rulings in the Pilot Program.

3. A Task After the Pilot Program

Although the end of the Pilot Program approaches, there are unfortunately no sign of efforts to update or discuss the outdated continuity of interest doctrine in the course of the recent developments. Part of the reason is that the Tax Cuts and Jobs Act of 2017 brought major tax reforms during the Pilot Program so that the majority of the resources in the IRS have been reverted to many topics that the TCJA is focused on, including a large corporate rate cut and an array of individual tax cuts and increases.[217] As a result, the attention to the Pilot Program has faded away compared to the start of the Program.

However, there is a silver lining. While wrapping up the result of the Pilot Program at the end of 2018, the IRS plans to provide a modified and combined Revenue Procedure for private letter rulings on spin-offs.[218] In the new Revenue Procedure, the IRS expects to make the Pilot Program permanent, meaning that it will continue to consider full transactional rulings in addition to its significant issue rulings on spinoffs.[219] Thus, we once again urge the IRS to consider adding newly emerged problems in relation to the continuity of interest issue to the new list of rulings on spin-offs.

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[215] *Supra* texts accompany notes 167.

[216] Yin, *supra* note 173, at 298.

[217] *See e.g.*, Wilson Andrews & Alicia Parlapiano, *What's in the Final Republican Tax Bill*, N.Y. TIMES (Dec. 18, 2017), https://nyti.ms/2kxGStH.

[218] Emily Foster, *Modified and Combined Spinoff Guidance Coming Soon*, 161 TAX NOTES 1533 (Dec. 17, 2018).

[219] *Id.*

CONCLUSION

As one of the first research articles that reveals a potentially toxic interplay between governance changes and corporate spin-offs, focusing on dual-class stock adoption as an extreme form of corporate governance change, this Article claims that purported justifications for giving the managers of ParentCo unfettered authority to choose SpinCo's governance arrangements are significantly attenuated. As a solution, the Article offers cooperative measures between corporate law and tax law. Since the assumption for the special treatments of corporate spin-offs—no fundamental changes before and after a spin-off—have been deviated by managers over time, a legal prescription for state corporate laws and federal tax laws on corporate spin-offs should evolve accordingly. From a corporate law perspective, the Article proposes a shareholder approval requirement for corporate spin-offs when a spin-off company is sizable or when a spin-off results in corporate charter amendments. Meanwhile, tax law needs to revisit the continuity of interest requirement to confirm whether a spin-off with corporate governance changes still meets this requirement. Furthermore, this Article offers new insights to a long-standing debate on dual-class stock by explaining how dual-class stock may be vulnerable to agency problems when it meets actual corporate deals.