

Spotlight on Reverse Morris Trusts

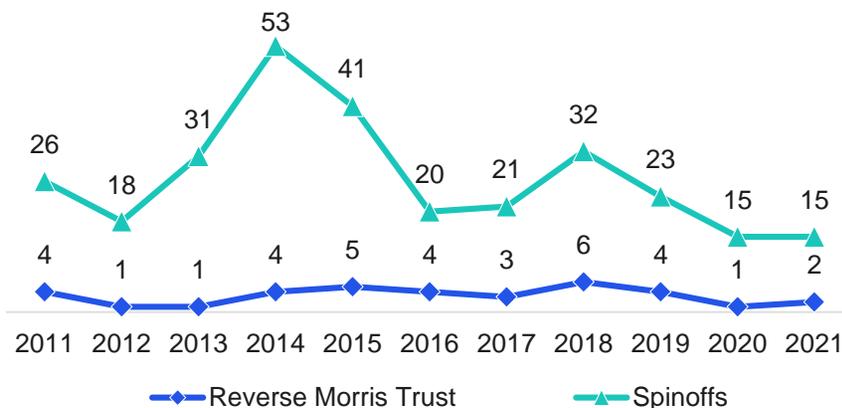
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Reverse Morris Trust Overview

The AT&T / Discovery deal to combine WarnerMedia and Discovery content has brought the tax-advantaged transaction known as a Reverse Morris Trust back in the headlines

In light of the challenges of meeting the requirements of the RMT structure, in a typical year, just a handful are announced

SPINOFFS AND REVERSE MORRIS TRUSTS



SELECT REVERSE MORRIS TRUSTS

DATE	PARENT NAME	SPINCO NAME	VALUE (\$B)
5/17/2021	at&t	WarnerMedia	\$43.0
2/16/2021	REXNORD	REGAL	\$3.7
12/15/2019	DUPONT	iff	\$18.4
7/29/2019	Pfizer	Upjohn	\$12.3
4/23/2018	HENRY SCHEIN	covetrus	\$2.5
2/2/2017	CBS	CBS NEWS RADIO	\$1.5
1/26/2016	LOCKHEED MARTIN	abacus	\$4.1
11/17/2015	citrix	GoTo	\$1.8

Source: Deal Point Data

What is a Reverse Morris Trust?

- ▶ A Reverse Morris Trust (RMT) is a structure in which a company spins off a business to its shareholders
- ▶ The divested business is then immediately acquired by another company with the shareholders of the spin-off business owning a majority of the combined entity

What are the Advantages of a Reverse Morris Trust?

- ▶ The principal advantage of the Reverse Morris Trust structure is that the separation, distribution and subsequent merger is tax free to Parent and Parent stockholders
- ▶ In other words, Parent is able to divest a business with significant built-in gain without the typical corporate-level tax leakage from a taxable sale

What is Required to Remain Non-Taxable?

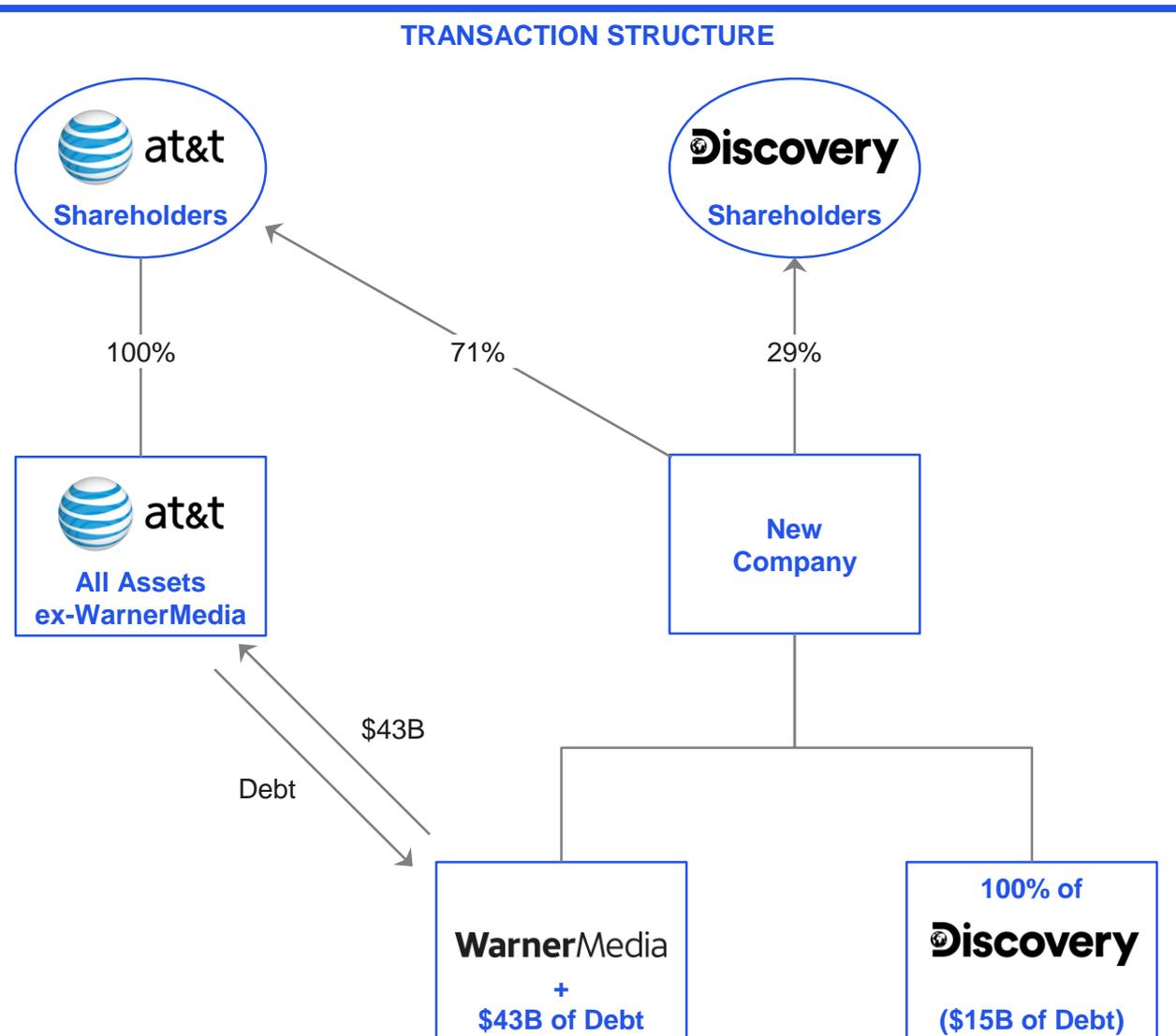
- ▶ In addition a number of technical requirements, for the transaction to remain non-taxable, Parent stockholders must own at least 50.1% of the combined entity. As a result, an RMT is typically practical only if the merger partner is smaller than the spun-off subsidiary
- ▶ There are various techniques for Parent to monetize and de-leverage as part of a tax-free spin-off of the stock of SpinCo (factors include Parent's tax basis in the assets to be spun off, and the desired resulting capital structure for Parent and SpinCo)

What is the History of the Name?

- ▶ The name stems from a transaction that withstood a challenge by the IRS in Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966)
- ▶ In ruling against the IRS, the court found that the Morris Trust and other stockholders had "realized no recognizable taxable gain" in becoming shareholders of the spun-off corporation

AT&T / Discovery Reverse Morris Trust (1/2)

The recently announced merger of the media operations of AT&T and Discovery will utilize the Reverse Morris Trust structure, which is intended to enable AT&T and its shareholders to complete the deal without generating any taxes



AT&T / Discovery Reverse Morris Trust (1/2)

Transaction Overview

- ▶ Structured as Reverse Morris Trust transaction, AT&T to spin / split out WarnerMedia, which will merge into Discovery
- ▶ Discovery to contribute 100% of its business and receive 29% of common equity
- ▶ AT&T will receive \$43B (subject to adjustment) in a combination of cash, debt securities and WarnerMedia's retention of certain debt
- ▶ AT&T shareholders to receive 71% of common equity distributed via shares of stock
- ▶ Unlocks value in WarnerMedia; shareholders can participate in potential upside of New Company

Conditionality

- ▶ The transaction is anticipated to close in mid-2022
- ▶ Subject to approval by Discovery shareholders and customary closing conditions, including receipt of regulatory approvals. Agreement in place with John Malone to vote in favor of the transaction
- ▶ No vote is required by AT&T shareholders

Financing

- ▶ WarnerMedia has secured fully committed financing for the purposes of funding the distribution to AT&T
- ▶ The new company expects to maintain investment grade rating and utilize the significant cash flow of the combined company to rapidly de-lever from ~5.0x to ~3.0x within 24 months

Post-Closing Governance

- ▶ Companies announced that Discovery President and CEO David Zaslav will lead the proposed new company
 - ▶ Discovery's current multiple classes of shares will be consolidated to a single class with one vote per share
 - ▶ The new company's Board of Directors will consist of 13 members, 7 initially appointed by AT&T, including the chairperson of the board; Discovery will initially appoint 6 members, including CEO David Zaslav
-

Summary of RMT Transactions

Reverse Morris Trust transactions involve what is essentially a carveout / subsidiary sale, spin-off and public company merger all in one negotiated transaction. Accordingly, they require significant time and resources to successfully plan, negotiate and execute a transaction

A Carveout

- ▶ Similar to a carveout sale, the assets and liabilities of of a corporation that holds a to-be-divested business ("Carveout Business") would be transferred from its existing parent corporation ("Parent") to a newly formed holding company ("SpinCo")
- ▶ The carveout of Carveout Business from Parent would be governed by a separation and distribution agreement, which an unrelated third party ("Acquiror") would typically comment on and negotiate with Parent
- ▶ SpinCo and Parent often have ongoing commercial relationships following the closing (e.g., transition services agreement, commercial agreements to the extent applicable, etc.)

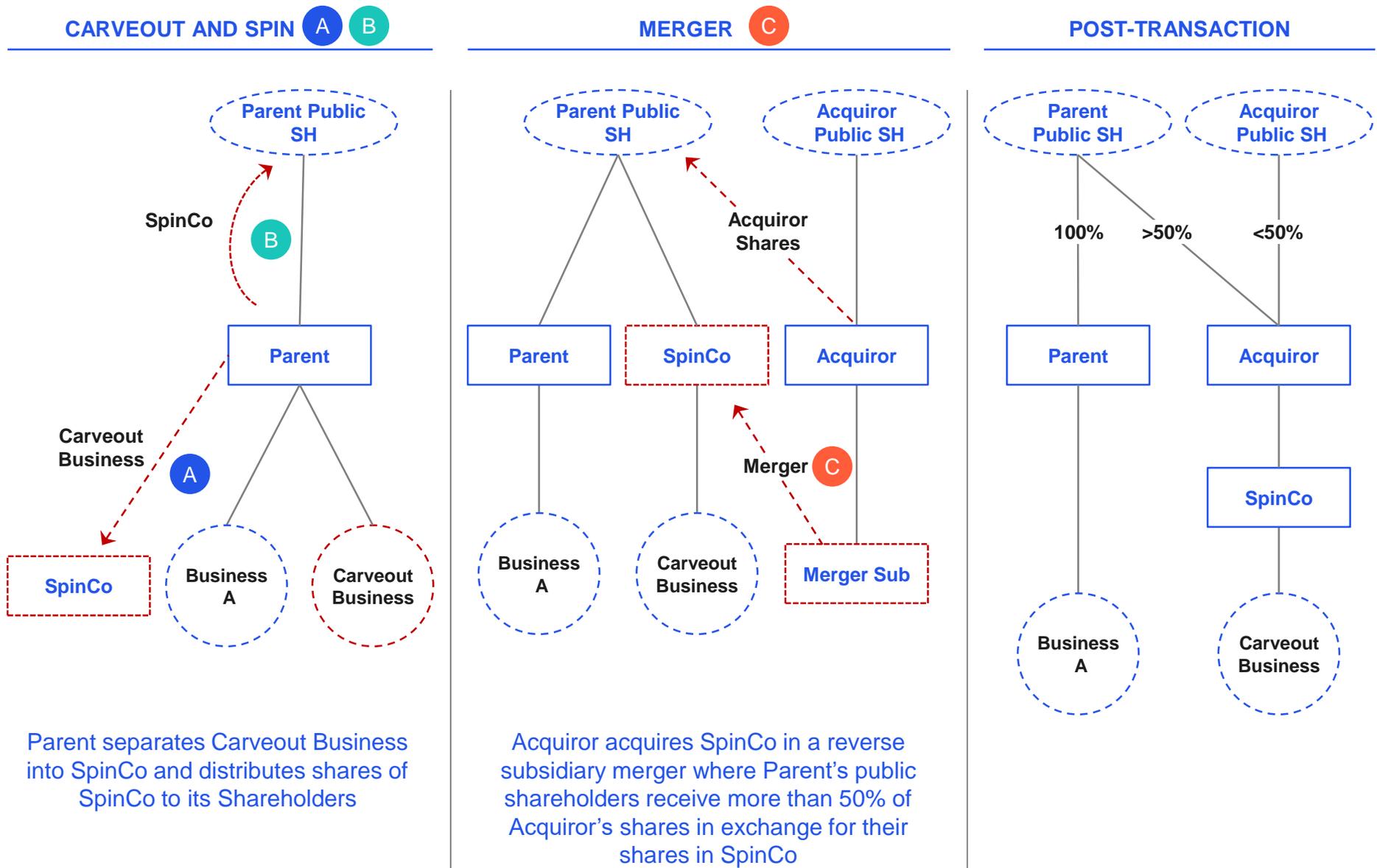
B Spin

- ▶ SpinCo, which holds the newly separated Carveout Business, would be "spun off" to the Parent shareholders by way of a tax-free distribution
- ▶ Shares of SpinCo to be distributed to Parent shareholders would typically be registered with the SEC on a Form 10 containing similar information to an IPO prospectus, including audited financial statements
- ▶ In Delaware, generally no vote would be required for the separation and distribution of SpinCo because spin-offs are considered a distribution of dividends by Parent, so only Parent board approval required

C Merger

- ▶ Immediately after the distribution of SpinCo shares to Parent Shareholders, SpinCo would be combined with Acquiror in a stock for stock transaction
- ▶ Former Parent shareholders (who owned SpinCo shares for a moment in time after the distribution) generally need to end up with a greater than 50% stake in Acquiror to preserve the tax free nature of the transactions
- ▶ Issuance of shares to Parent / SpinCo shareholders may require a vote of Acquiror shareholders (no Parent shareholder vote required for merger as Parent (as sole shareholder) approves the merger before SpinCo is distributed to Parent shareholders)
- ▶ A number of potential methods exist to "right-size" the two companies to achieve the desired ownership ratio between former Parent shareholders and Acquiror shareholders, including dividend to Parent funded by debt

Example RMT Structure



Key RMT Considerations (1/2)

The spin element of an RMT has key elements of a carveout sale and an IPO (elements A and B in the chart on the prior slide) and the merger element has similar elements to a stock for stock merger involving comparably sized companies (element C in the prior chart)

Preliminary Structuring / Scope	<ul style="list-style-type: none">▶ Scope of business that will be separated into SpinCo▶ Capital structure, financing and related tax analysis (in light of capitalization and value equalization considerations in context of broader transaction)
Detailed Asset and Liability Identification and Apportionment	<ul style="list-style-type: none">▶ Businesses and assets that need to be contributed to SpinCo▶ Liabilities to be assumed by SpinCo▶ Standard for transfer of assets and liabilities (e.g., “exclusively” or “primarily” related to the Carveout Business)▶ Treatment of shared assets (e.g., shared contracts) and liabilities (e.g., corporate liabilities)
Tax Matters	<ul style="list-style-type: none">▶ Evaluation of internal restructuring necessary to separate the business from a tax perspective, including any modifications to existing tax planning▶ Tax matters agreement between SpinCo and Parent to allocate tax liabilities and responsibilities▶ Tax opinion and IRS private letter ruling
Social Issues	<ul style="list-style-type: none">▶ Although RMTs, in contrast to merger of equals type deals, tend to have governance and management in favor of Acquiror (even with an approximate 50/50 equity split), governance and social issues can still be meaningful deal points (e.g., Board split, key executive positions, headquarters, etc.)
Valuation and Equity Split	<ul style="list-style-type: none">▶ Similar to a stock for stock transaction, valuation and equity split (with a focus on synergies analysis) will be a key initial deal point
Financing	<ul style="list-style-type: none">▶ Similar to the importance of financing for leveraging SpinCo, quantum and terms of debt financing (including use of committed financing) to be used to finance monetization events for former Acquiror shareholders will be an important part of valuation right-sizing and treatment▶ Existing Acquiror indebtedness may need to be refinanced or restructured to accommodate the RMT transaction
Employee Matters	<ul style="list-style-type: none">▶ As with a merger of equals type deal, understanding composition of executive team and key employee positions, as well as criteria for selection of post-closing general employee base, will be key issues▶ RMT parties may try to create a “level playing field” for employees of Acquiror and SpinCo (i.e., avoiding making it more expensive to terminate one employee population over the other)▶ Understanding existing incentive structures and equity awards is a key component of RMT planning
Superior Proposals and Conditions	<ul style="list-style-type: none">▶ No Solicitation / Board Change of Recommendation: parties will generally be restricted from soliciting a competing transaction, subject to customary exceptions with respect to an Acquiror superior proposal or for Acquiror Board to change recommendation in connection with an “intervening event”▶ Conditionality for Merger: typically similar to a stock for stock merger plus bespoke RMT elements (e.g., completion of spin-off and receipt of tax opinions / PLR)

Key RMT Considerations (2/2)

As RMTs involve multiple concurrent transactions, a number of deal items can create complexity and delay closing

Financial Statements

- ▶ RMT parties will need to file audited financial statements and pro forma financial statements, including audited financials for SpinCo
- ▶ These “carveout financials” for SpinCo are often a gating item for signing and/or filing of necessary registration statements with the SEC

Carveout Planning and Implementation

- ▶ Depending on how “clean” and separable the Carveout Business is from the rest of the business at Parent, carveout planning and implementation can also be a gating item for closing

Regulatory

- ▶ As with any deal, regulatory requirements like domestic and foreign antitrust can drive timing, with great variability created by jurisdictions involved as well as substantive analysis
- ▶ Tax PLR (if necessary) can potentially be a consideration

Shareholder Vote

- ▶ Acquiror shareholders will need to vote on the issuance of shares in the acquisition of SpinCo (and may need to amend Acquiror organizational documents if there are insufficient shares authorized)
- ▶ Shareholder vote cannot occur until after Acquiror’s Form S-4 has been filed with and cleared by the SEC (which in turn cannot happen until after audited and pro forma financial statements are completed)

Financing

- ▶ RMTs typically involve committed financing, which needs to remain in place for the duration of the anticipated sign-to-close period
 - ▶ E.g., there is often leverage associated with the separation of SpinCo, which is used to fund dividend payments to Parent and adjust the relative size of SpinCo compared to Acquiror
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Carveout Sale, Spin-Off or RMT?

- ▶ Processes can be run in parallel, with tax-free spin always available as an alternative transaction
- ▶ Participants in sale or RMT discussions likely precluded from post-spin takeover discussions for at least 1 year where a non-RMT spin is ultimately pursued

	Sale	Spin	RMT
Advantages	<ul style="list-style-type: none"> ▶ Immediate cash liquidity with unlimited use of proceeds ▶ Speed ▶ Wide group of potential counterparties ▶ No necessity to have a separate management team / back office (though may be desirable or necessary in certain circumstances, e.g., PE or SPAC counterparty) 	<ul style="list-style-type: none"> ▶ Tax-free ▶ Tax-advantaged monetization strategies available ▶ Limited takeover protection from covenants in Tax Matters Agreement ▶ No counterparty risk ▶ Can dictate terms of transaction 	<ul style="list-style-type: none"> ▶ Tax-free ▶ Tax-advantaged monetization strategies available ▶ Limited takeover protection from covenants in Tax Matters Agreement ▶ No necessity to have a separate management team / back office
Challenges	<ul style="list-style-type: none"> ▶ Taxable transaction to corporate seller ▶ Counterparty risk ▶ Negotiated transaction terms 	<ul style="list-style-type: none"> ▶ Limitations on post-transaction M&A and other actions in order to preserve tax-free nature of spin and tax advantages of monetization ▶ Monetization proceeds generally must be used to pay down debt or be distributed to shareholders ▶ Monetization debt terms may be restrictive for SpinCo / Acquiror ▶ Longer timeline, including if IRS ruling requested ▶ Need to have separate management team / back office 	<ul style="list-style-type: none"> ▶ Counterparty risk (including finding a counterparty of the correct size) ▶ Negotiated transaction terms (including for monetization debt) ▶ Limitations on post-transaction M&A and other actions in order to preserve tax-free nature of spin and tax advantages of monetization ▶ Monetization proceeds generally must be used to pay down debt or to distribute to shareholders ▶ Longer timeline, including if IRS ruling requested

Outline of Sequencing for an RMT Transaction

