



Key Differences Between Corporate Actions



What is a corporate action?

A corporate action is any transaction undertaken by a company that impacts its existing stock or the way it's traded.

Corporate actions cover everything from simple stock splits to complex Reverse Morris Trust transactions. Depending on the corporate action, a shareholder's stock ownership might:

- Increase in number or value.
- Be exchanged for a different class of stock or stock in a different company.
- The company might issue more shares or buy back existing shares.

This paper will dive into the major types of complex corporate transactions and explain the differences between them.

Shareholders have a say in some corporate actions, but not in others. Some are mandatory, others are voluntary. Many of the terms used to describe different corporate actions are used interchangeably. As a result, corporate actions can get confusing for those of us who aren't experts in corporate law or securities transactions.



Many ways to get the job done

There are as many ways to structure a corporate action as there are reasons to embark upon one. Regardless of structure, most corporate actions are driven by similar desires: to improve the company's overall performance and increase shareholder value.

An example of a simple, routine corporate action is a dividend, which doesn't require any action on the part of shareholders. When the company's performance is good, the board of directors can simply declare a cash or stock dividend – which is distributed by the company's transfer agent.

Other corporate actions, such as tender offers and some exchange offers, are voluntary. Shareholders elect to accept or reject the offer and how many of their shares to sell or exchange. Depending on the type of transaction, they may choose whether to receive a cash or stock distribution.

High-profile corporate actions, such as mergers and acquisitions, involve major structural changes to the company and require shareholder approval. If a vote is required, the company usually calls a special meeting. A quorum must be reached and the proposal must be approved by a certain margin as determined by the corporate by laws or by state law.

The company must also obtain regulatory approval from the states and countries in which they will operate. Depending on the type of companies involved and the type of corporate action being undertaken, companies may also be required to obtain approval from other regulatory bodies such as the IRS, U.S. Department of Justice or the various state departments that govern their sector.

Once approved, the transaction then becomes mandatory for all shareholders. Old shares are cancelled and new shares or cash payouts are issued in their place.

Most corporate actions are driven by the same desire: to improve the company's overall performance and increase shareholder value.

What are the major types of corporate actions?

Spin-off

A spin-off is the separation of a subsidiary or business unit from its parent company to create a wholly independent public company. The spun-off entity (SpinCo) retains its assets, employees and intellectual property.

There are two different ways to conduct a spin-off:

- **True spin-off** is the most common type of spin, during which all shares of the new company/subsidiary are distributed to shareholders of the parent company.
- **Carve-out** is a two-step spin-off, during which the subsidiary or business unit conducts an IPO first. A certain percentage of the shares are put into the IPO to be sold on the open market and the remaining shares (if any) are distributed to the parent company shareholders.

What happens to the stock?

During a true spin-off, the parent company distributes shares of the newly formed SpinCo to its existing shareholders, based on how many shares of the parent company they own, at a share ratio set by the company.

Quick fact

A spin-off is not a sale. Proceeds from a spin-off come in the form of stock shares of the new company, not cash. The value of parent company stock will drop, but shareholders now own stock in the new company to balance this adjustment. Over time, the value of both companies is expected to grow.

Why do companies do it?

- A company may be under pressure from activists to release the value of a high-demand subsidiary that is expected to perform better as a standalone company.
- A company may wish to divest an underperforming business unit to improve its overall performance.
- A company may decide to narrow its focus and separate itself from an unrelated part of its business that no longer fits its scope.
- A company may conduct a carve-out spin (as opposed to a true spin) when it wants to create a bigger splash in the market or when it needs to raise capital.
- Certain types of spin-offs may be tax free, further benefitting shareholders.



Basic steps to a spin

Spin-offs can be combined with other transactions as part of a more complicated corporate action, but the basic steps to a traditional spin are:

01

The new company is created and shares are created and registered.

02

A record date and payment date are declared.

03

A blackout period is typically observed wherein the parent company is prohibited from issuing and buying back shares. Executives are often prohibited from exercising their stock options. Shareholders can sell their parent company shares, but may be giving up entitlements to shares of the new SpinCo.

04

Shares of SpinCo are distributed to shareholders of the parent company on a pro rata basis, according to a share ratio set by the company.

Example of a spin-off

A shareholder owns 100 shares of parent company, ABC. ABC Company spins off XYZ SpinCo and distributes to its shareholders one share of XYZ for every two shares of ABC they hold. The shareowner now owns 100 shares of ABC and 50 shares of XYZ SpinCo.



Mergers & Acquisitions

A merger is when two or more companies agree to come together. They form a completely new company with new ownership and a new management structure. All assets are combined. An acquisition is the straight-up purchase of one company by another.

Why do companies do it?

- Companies can reduce expenses and strengthen their market position by combining resources, talent, proprietary technology and other assets.
- A company that has a perceived weakness, for example, a gap in its supply chain or product offerings, or an aging technological platform, may merge with a company that fills the gap.
- A company may wish to expand its market area by purchasing a similar company in another geographic location.

What happens to the stock?

In a merger of equals, shareholders of one or both companies surrender their shares in exchange for shares of the new company (and/or cash) resulting in 50/50 overall ownership. In the case of an acquisition, the acquired company shares are cancelled and those shareholders receive shares of the acquiring company and/or cash, depending on the agreement, but it will always be less than 50%.

Quick fact

The terms “merger” and “acquisition” are often used interchangeably. From a legal standpoint, they both require a Certificate of Merger to be filed with the state of incorporation – however, there are several key differences between the two. While a merger is technically “friendly” because both companies have agreed to it, mergers of equal companies are rare. The term “acquisition” is a friendlier way to describe a takeover. One company is legally identified as the acquiring company and the other as the acquired company.



Basic steps to mergers & acquisitions

Mergers and acquisitions are fairly routine – and one of the most common corporate actions. Some of the more complicated mergers involve structuring the deal with multiple steps, for example, or adding conditions to the distribution. These are the basic steps:

01

Regulatory approval must be obtained.

03

During a true merger, all shareholders are given their “merger consideration” – either shares of stock or a combination of cash and stock – depending on the terms of the agreement. During an acquisition, only the acquired company shares are cancelled.

02

Prior to an acquisition, shareholders of the acquired public company must approve the acquisition. In some states, shareholders have the right to dissent and must be given time to do so. Shareholders of the acquiring company do not need to approve the merger unless large quantities of new shares of stock are being issued as part of the agreement. In this case, shareholders must approve a charter amendment to issue additional stock.

Example of a merger

A shareholder owns 100 shares of parent company, ABC. ABC Company merges with DEF Company to form ABCDEF Company. The shareholder's shares of ABC are cancelled and he or she receives the agreed upon number of shares in ABCDEF Company.

Example of a acquisition

A shareholder owns 100 shares of DEF Company. ABC Company wants to acquire DEF Company and offers \$50 per share. Assuming the merger is approved, the shareholder receives a cash payout of \$5,000. He or she no longer has any ownership in DEF Company. Shares of ABC Company are not affected.



Tender offer/Exchange offer

A tender offer is an offer made directly to the shareholders of a company to buy their shares for a certain price at a certain time. The offer may be a “friendly” offer made by the company itself. There are also offers referred to as “hostile,” which are made by another company, hedge fund, private equity firm or a management-led investor group without the consent of the target company’s board of directors. The offer usually includes an incentive, such as a premium price and may be contingent on whether the investor/company is able to acquire a certain number of shares.

There are several different kinds of tender offers:

- **Full tender** (also known as a two-step acquisition) is an attempt to purchase all the shares of a company, either by an investor group or another company, or by the company itself in an effort to delist and go private. Hostile takeovers are usually conducted through a full tender offer.
- **Exchange offer** is a tender offer in which the shares are paid for with securities in place of cash. Payment may take the form of shares of a different class of stock, shares of another company’s stock or bonds.
- **Partial tender** is a tender made by the company to buy back a limited number of its outstanding shares. These can be set up to go into effect whenever the stock goes down to a pre-determined price or net asset valuation (NAV).
- **Odd-lot tender.** Stock is usually sold in “lots” of 100 shares by the Exchanges. If a shareholder owns less than 100 shares, he or she owns an “odd lot.” An odd-lot tender is an offer made solely to holders of odd lots, during which they may be given an incentive to sell those shares back to the company or buy more shares to reach 100 shares or more, known as a “round lot.”
- **Dutch auction** is a tender made by a company to buy back its shares by offering its shareholders a price range rather than a specific price. Interested shareholders then choose the price at which they will sell their shares. The company will usually accept bids starting at the lowest price until they’ve bought the total number of shares stated in the buy-back, or have reached their spending limit. All shares accepted in the offer are paid at the same price.

Quick fact

Tender offers are voluntary, meaning shareholders are under no obligation to sell their shares. Likewise, the acquiring investor/company is under no obligation to honor the offer until all conditions have been met and the target number of shares have been tendered. For a two-step acquisition, once the target number has been reached and there are no regulatory concerns, the transaction becomes mandatory.

Why do companies/investors do it?

- An investor who wishes to exert some control over a company needs to acquire at least 5% of the company's stock to submit a bid to acquire additional shares at a specified price, or a majority of its stock to succeed at a takeover attempt.
- A company may submit a tender offer to buy back all of its shares in order to de-list and go private.
- Tender offers are often the first step of an acquisition, usually a cash offer made directly to shareholders of the soon-to-be-acquired company to voluntarily tender their shares.
- Exchange offers are popular when used in lieu of a spin-off distribution. The parent company's shares are not discounted for the value of the assets being distributed, as the number of outstanding shares will be reduced to offset the value of the spin-off.
- Odd-lot tender offers are used to reduce the costs associated with maintaining those accounts.

What happens to the stock?

Shareholders can elect to tender all, some, or none of their stock. The acquiring investor or company may accept all or a portion of the shares tendered, depending on how many they need. As soon as conditions for the offer have been met, shares are transferred to the new owner and the selling shareholder receives a cash payout or shares of the acquiring company's stock, depending on the offer.

Example of a tender/exchange offer

ABC Company's stock is trading at \$18 per share. An investor submits a tender offer of \$20 per share, under the condition that he acquires at least 5% of the shares within 20 days. A shareholder owns 100 shares of ABC Company stock and elects to tender 50 shares. 20 days later the investor has reached the 5% threshold. The transaction proceeds and the shareholder receives \$20 per share, or \$1,000.

Basic steps to a tender/exchange offer

01

Shareholders are notified of the offer, usually in the form of a letter or electronic notification from a broker-dealer. The offer will include the price per share, any conditions that need to be met before the transaction will occur and a letter of transmittal, which shareholders can return to notify the investor of their desire to participate.

02

Shareholders who wish to accept the offer return the letter of transmittal and indicate how many shares they want to sell.

03

The depositary or tender agent tabulates number of shares tendered.

04

Once the conditions have been met, participating shareholders receive cash or new shares for their existing shares. The purchasing company or activist investor must publish a press release, notifying shareholders of the preliminary results of the offer.

05

If the offer expires before the conditions have been met, the offer may be changed and re-submitted, extended or terminated.

Quick fact

Mergers and acquisitions are considered mandatory exchanges, but this type of corporate action may also include unique, standalone events, such as a reverse stock split. A reverse split is a mandatory exchange during which shareholders are required to surrender their shares in exchange for a lesser number of shares, which will then be valued at a higher price.

Mandatory Exchange

A mandatory exchange requires shareholders to turn in their shares in exchange for new shares, or new shares plus other assets, such as cash.

Why do companies do it?

- A company may conduct a reverse stock split to increase its share price in order to gain respectability or avoid being delisted for falling below the Exchange's required price per share.
- A company may want to de-classify a type of stock, for example convert its preferred stock to common stock, and will force holders of the preferred stock to do so by declaring a mandatory exchange.
- A company wants to reduce the number of shares it has outstanding without devaluing its stock. It declares a mandatory exchange for all shareholders to turn in their stock in exchange for a lesser number of new shares + cash.

What happens to the stock?

Shareholders receive new shares in exchange for their old shares, according to the terms of the exchange.

Example of a mandatory exchange

A shareholder owns 100 shares of ABC Company stock, which is currently trading at \$10 per share. ABC Company decides to do a reverse 1-for-2 split. The shareholder's 100 shares are cancelled and he receives 50 shares in exchange. Those 50 shares are now worth approximately \$20 each.

Basic steps to a mandatory exchange

01

Shareholder approval is not needed unless the company needs a charter amendment to issue a new class of stock.

02

New stock is issued and registered.

03

New shares are distributed to shareholders on a pro rata basis, according to the share ratio set by the company.

Reverse Morris Trust

A Reverse Morris Trust is multi-step transaction that combines a spin-off with a prearranged merger, allowing a company to sell an asset tax free. After the spin, the SpinCo is immediately acquired by a smaller publicly traded company. The size difference is key, because as long as the transaction is structured so that the parent-company shareholders own the majority of the stock in the newly merged company, the IRS considers the transaction tax free to the parent company.

Why do companies do it?

- The parent company can sell off unwanted assets tax free.
- Shareholders of the parent company gain stock in the newly merged company, also tax free, and then reap the benefits of any post-merger gains in stock value.
- The third-party company acquires all the assets of the SpinCo and retains management of the newly merged company as part of the merger agreement.

What happens to the stock?

The parent company launches an exchange offer, allowing its shareholders to exchange their parent company shares for "merger consideration," an agreed-upon number of shares in the newly merged company. Those holders who elect to participate will receive shares of the merged company when the deal is finalized. Meanwhile, the third-party public company issues new shares, which it uses to "acquire" the larger asset. Its shareholders retain their existing shares, but the value of those shares are diluted.

What's important to remember?

In a Reverse Morris Trust transaction, a smaller publicly traded company is acquiring a much larger, not-publicly-traded subsidiary of another public company. Shareholders of the smaller third-party company agree to a minority ownership in the newly merged company, but get to keep their shares and usually retain management of the newly merged company. From a legal perspective, a new company has been created, but from a trading standpoint, their company survives.

Basic steps to a Reverse Morris Trust

01

A parent company is interested in divesting its asset to another company, usually a third-party company that is smaller in size than the asset itself.

02

Shareholders of the third-party company must approve the merger for two reasons: 1) They will be giving up majority ownership in the NewCo; 2) The company will most likely need to issue new shares of stock (requiring a charter amendment) as part of the merger agreement with larger SpinCo, diluting the value of its existing shares in the process.

03

The parent company launches an exchange offer, during which it offers an incentive to its shareholders to exchange their shares for merger consideration.

04

Once the required number of shares have been exchanged, the SpinCo, which is now owned by the parent company shareholders, immediately merges with the smaller third-party company to form the newly merged company.

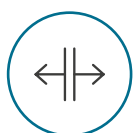
05

Newly issued shares of the public company are distributed to participating parent-company shareholders in a ratio that ensures that they will own more than 50% of the new company.



Other types of corporate actions

In addition to the corporate actions mentioned in this paper, these transactions are also considered corporate actions, although they are not nearly as complex:



Stock split



Dividends and cash distributions



Bonus issue



Rights issue



Change of incorporation



Name change

01

Stock split

In an effort to reduce the price per share of its stock and make it more accessible for the average investor, a company issues a predetermined number of new shares for every one share owned by the shareholder.

02

Dividends and cash distributions

Are issued to shareholders when the company's performance warrants it, at the discretion of the company's board of directors.

03

Bonus issue

Additional shares of stock are issued and distributed free to shareholders as an alternative to paying a cash dividend. A bonus issue increases the number of shares outstanding. It is also known as a scrip issue or capitalization issue.

04

Rights issue

An offer is extended to existing shareholders to buy newly issued shares not offered on the open market. The company can use a rights issue to raise capital directly from its shareholders.

05

Change of incorporation

A company changes its state or country of incorporation, which may or may not require an exchange of shares.

06

Name change

If a company changes its name, any shares issued after the name change will bear the new name. Existing shares do not need to be exchanged.



What is not a corporate action?

Initial Public Offering (IPO) is a transaction that involves stock and ownership of a company, but is not technically a corporate action.

Communicating the event

During a corporate action, the details of the event are communicated to shareholders. Offer materials are sent directly to registered shareholders, and indirectly to broker-dealers and beneficial shareholders through The Depository Trust & Clearing Corporation (DTCC).

Materials may include proxy voting material in advance of a special meeting, election forms for tender offers and letters of transmittal for exchanges. The depository or tender agent must be capable of

handling a high volume of customer service calls and requests by shareholders who have questions or need assistance with the transaction. Companies may also engage the expertise of an information agent to notify shareholders and facilitate participation during voluntary corporate actions.



When to call in the experts

Most companies rely heavily on their legal advisors to guide them through a corporate action. While law firms may fully understand a company's objectives and the legalities of the transaction, they may not always be familiar with the trading or settlement aspect. That's where a transfer agent comes in.

In the case of a simple stock split or issuance of new shares, the transfer agent usually handles the entire transaction on behalf of the company. For more complex transactions, a transfer agent usually engages its own dedicated team of experts to work with the company's legal counsel, underwriter and other advisors.

When brought in early, a corporate actions team can sit down and work out the mechanics of the transaction with the company's legal counsel.

For this reason, it's important to have people on your corporate actions team with extensive knowledge and securities expertise.

There may be several different ways to accomplish the same goal. Some ways are better than others. What seems feasible might not be practical in terms of timing, or might cause liability issues for broker-dealers and other Depository Trust Company (DTC) participants.

A good corporate actions team will advise companies as to what is or isn't possible, the timing needed to accomplish each step and all the pieces that need to come together to make the transaction happen.

ABOUT EQ

EQ are specialists in helping you better understand and manage the ownership of your company through critical events across the corporate lifecycle. As trusted advisors, we provide strategic insight and operations expertise through our core business units in Private Company Services, Transfer Agent Services, Employee Plan Solutions, Proxy Services, and Bankruptcy. Globally we serve 6,700 clients (47% of the FTSE 100 UK and 35% of the S&P 500), with over 30 million shareholders, through 6,500 employees in 5 markets around the world.

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