The Curious Case of Reverse Morris Trusts

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I. Introduction

The term Reverse Morris Trust (RMT) refers to transactions used for divesting assets of a corporation without incurring tax liability. These transactions originated about sixty years ago.[2] In the last decade there has been an increased interest in RMTs. Pressure from hedge fund activists[3] and the recent limitation on interest deduction[4] have contributed to the RMTs' appeal.

In a Reverse Morris Trust transaction, a company divests part of its assets in a complex transaction that starts with the transfer of assets to a wholly owned subsidiary. The subsidiary is then either split off or spun off to the shareholders and immediately merges with a third-party company, the partner-acquirer, in a stock for stock transaction. As part of the transaction, liability of the parent company is assumed by the merged company and the parent company may receive debt securities and cash in the exchange. Subject to specific requirements of the tax code, a Reverse Morris Trust transaction allows the company to divest part of its assets with neither the company nor its shareholders incurring tax liability. In fact, the company can receive cash and lower its debt level as part of the RMT transaction without recognizing capital gains tax.

The RMT transaction presents a curious case of divergence of interests between management and the shareholders. Generally, the RMT does not involve a self-dealing transaction, as the managers

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[1] Judge Solomon Casseb, Jr. Research Professor in Law, University of Texas School of Law. I am indebted to Zohar Goshen for invaluable discussions at an early stage of the project. I would also like to thank participants at the Fordham University's conference on the Enduring Influence of The Essential Role of Securities Regulation. [Further acknowledgements TBA.] Comments are welcome and can be sent to me at mganor@law.utexas.edu.

[2] See Section II infra.

[3] Liz Hoffman, MONEYBEAT BLOG, *What's a 'Reverse Morris Trust' and Why Is EverybodyDoing One?*, (March 27, 2015) ("They have grown more popular in recent years as companies, often spurred by activist hedge funds, are focusing on what they do best and looking to shed pieces that might not fit.") https://www.wsj.com/articles/BL-MBB-34994

[4] Lydia O'Neal, *Why a Reverse Morris Trust Is Path for AT&T-Discovery: QuickTake*, ("[S]ince the …overhaul of the tax code in 2017, tax professionals have expected reverse Morris Trust transactions … would gain traction. …Congress placed a cap on the amount of debt interest expenses that companies can write off. That effectively increased the cost of debt financing for some highly leveraged companies") https://news.bloombergtax.com/daily-tax-report/why-a-reverse-morris-trust-is-path-for-at-t-discovery-quicktake

(directors and officers) are not on both sides of the transaction, rather they negotiate at arm's length with an independent third party. However, the RMT transaction puts the shareholders on both sides of the transaction. Thus, we face a misalignment of interests, but not one that triggers a duty of loyalty scrutiny.

This paper studies the special structure of the RMTs and raises the concern that an overlooked shareholder vulnerability is possible. It shows that management incentives may motivate it to enter into less than optimal, and potentially inefficient, RMT transactions. Specifically, the RMT special structure divides the consideration received for the divested assets between consideration that benefits the company and consideration that is received directly by the shareholders. The part of the consideration for the divested assets that goes to the shareholders directly takes the form of shares in the merged company; and the other part of the consideration, which goes to the company directly, is in the form of assumption of debt, debt securities, and cash. Thus, positioning the shareholders on both sides of the transaction and the managers on only one side. Rationally, management may agree to reduce the size of the shareholders' direct consideration in exchange for a more modest increase in the company's direct consideration.

The paper further argues that informed shareholders cannot be relied upon to prevent an undesired outcome; and raises concerns about the role of fiduciary duties in the case of RMT transactions. Mismanaging the RMT is hard to police since the transaction is commingling a few potential benefits, such as the tax prevention. These benefits may obscure a distorted consideration allocation. Even if the benefits are not sufficient to cover the loss from the exchange of the divested assets for a suboptimal consideration, the transaction may still gain the support of sophisticated shareholders. The paper shows that in certain circumstances, when the company uses a split off to distribute the shares of the merged company to its shareholders, sophisticated investors may gain from an RMT transaction at the expense of unsophisticated investors.

The paper proceeds to examine solutions for the vulnerability of the shareholders and ways to strengthen the efficacy of RMT transactions. To address this deficiency, I put forward a proposal to amend the tender offer default rules. The new proposed rule will prevent taking advantage of the unsophisticated investors and force the sophisticated and informed shareholders to consider the effect of the RMT transaction on the entire shareholder body. Nonetheless, the proposed rule allows investors to opt out of the default rule, so that it is not overprotective and allows for divergence of opinion regarding the RMT and the valuation of the company.

The paper proceeds as follows: Section II describes the structure of the RMT transaction. Section III explains the divergence of interest resulting from the RMT structure and analyzes the limits of the existing safeguards to assure an optimal result. The following Section IV illustrates the possibility of a suboptimal outcome with a numeric example. In Section V, I consider strategies aimed at lowering the likelihood of a suboptimal RMT transaction and conclude with a proposal for a new tender offer rule, a default contingent automatic tender rule.

II. Reverse Morris Trusts – Structure and Key Tax Requirements

The Reverse Morris Trust transaction is named after a 1966 fourth circuit case in which the court ruled that a series of transactions, which included a spin-off and a merger, qualified as a tax-free reorganization.[5] In an RMT transaction the company divests assets in a sequence of two coordinated transactions. The RMT transaction combines a distribution transaction with a subsequent stock-for-stock merger that is approved by the company simultaneously. The RMT also reduces the debt level of the company as the acquirer of the divested assets assumes part of the liability of the company including new debt created as part of the distribution transaction.

In the initial distribution transaction, the company transfers assets and liabilities, or a business unit, that it plans to divest to a special wholly owned subsidiary, SpinCo; and approves the subsequent stock-for-stock merger of SpinCo. Once SpinCo is formed, it may take out debt and distribute the cash consideration to its parent company and issue debt securities to the parent Company.[6] The company will use the new debt securities and cash to retire its own debt.[7] Thus, the deal allows the company to lower its debt level through the receipt of cash and debt securities and through the direct assumption of existing debt by SpinCo and the acquiring company.

After the distribution of assets to SpinCo, the Parent company distributes SpinCo's shares to its shareholders. The company can distribute the shares of SpinCo to its shareholders pro-rata to their percentage holding in a spinoff transaction. Alternatively, the company can conduct a split-off and use an exchange-offer to distribute SpinCo's shares to shareholders who elect to participate in the offer. If the company uses a split-off, then its shareholders get the right to choose whether to participate in the exchange offer and convert their shares to SpinCo's shares. In accordance with the tender offer rules, an oversubscribed offer will be prorated.[8]

The final step of the RMT transaction is a merger between SpinCo and the acquiring company. The merger is a stock-for-stock merger, usually a reverse triangular merger in which SpinCo becomes the wholly owned subsidiary of the acquiring company. Ultimately, the shareholders of SpinCo will become the majority shareholders of the acquiring company. Chart A illustrates the basic RMT transaction.

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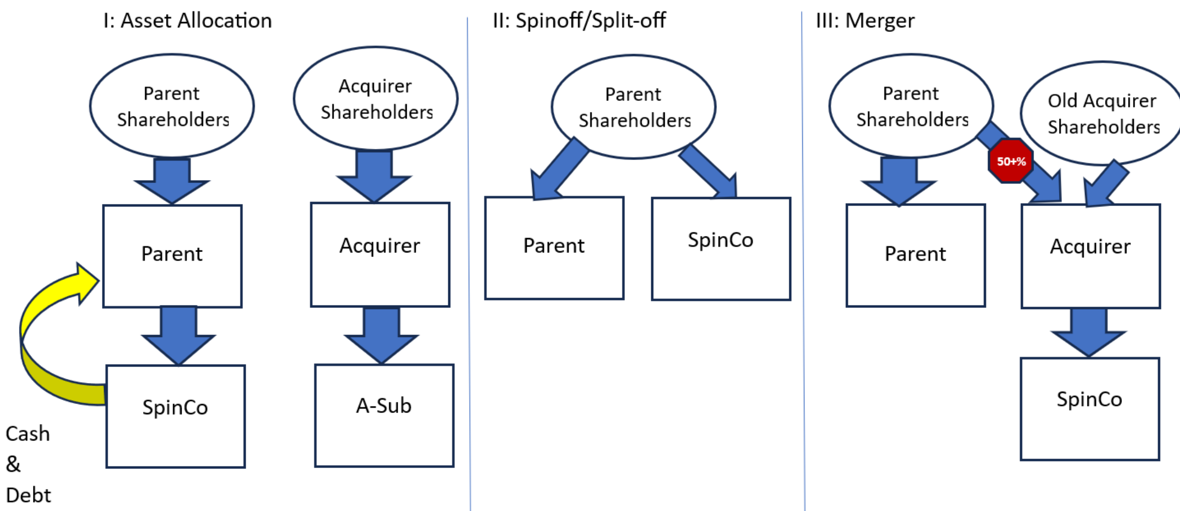
[5] [CIR v. Morris Trust, 367 F.2d 794 (4th Cir. 1966)].

[6] [eg ("Newco has obtained financing commitments … in an aggregate principal amount of up to $12 billion. … Newco expects to use the proceeds of such financings to make the Cash Distribution to Pfizer.") https://www.sec.gov/Archives/edgar/data/1792044/000119312519274897/d781435dex991.htm] [("AT&T said it will use the $43 billion proceeds from the tax-free spin-off of its media assets to pay down its more than $160 billion of debt.") https://www.reuters.com/technology/att-merging-media-assets-with-discovery-create-streaming-powerhouse-2021-05-17/]

[7] [FN:Other usage of the cash, except for distributing to the shareholders, may be limited as it may trigger tax liability. Also, the IRC limits the amount of cash that can be transferred to the parent company tax free based on the tax basis, the boot.]

[8] [Rule 240.14d-8 under the Securities Exchange Act of 1934. A registration of the offer is also required under the Securities Act of 1933.]

Chart A: Illustration of the Basic RMT Transaction



The shareholders of the divesting, parent, company do not have the right to vote on the transaction, nor do they receive appraisal rights. SpinCo shareholders do not vote on the merger transaction since it is approved by the parent company before the split-off or spinoff distribution.[9] While the shareholders of the parent company are not required to approve the transaction, the shareholders need to opt in to participate in the exchange offer if the distribution is done through a split off. If the offer is undersubscribed, any remaining shares will be distributed to all the shareholders pro rata.[10] The Parent company sets the exchange rate for the split-off based on the relative market prices of the acquirer and the parent company and adds a discount. The discount is given by the Parent, not the acquirer, and increases the likelihood that the offer will be fully subscribed.[11] If all the shareholders participate and tender all their shares, then the distribution will be pro rata, otherwise, the shares will be prorated in relation to the number of shares tendered.[12]

The RMT transaction is generally not a self-dealing transaction, the management is not on the other side of the transaction, unless the acquirer is owned by the management of the parent company. Neither is it an end of the game Revlon transaction, nor are substantially all of the Parent's assets being divested, rather the Parent company is trimmed of non-core business. Thus, the decision of the Parent board will be awarded the business judgment rule protection, and the court is not likely to replace the

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[9] [See, e.g., ("No vote of Pfizer stockholders is required for the Distribution or the Combination. Pfizer, as sole stockholder of Newco before the Distribution, has approved of the issuance of Newco common stock in the Combination. … "Pfizer stockholders are not entitled to appraisal rights…") https://www.sec.gov/Archives/edgar/data/1792044/000119312519274897/d781435dex991.htm]

[10] See, e.g., 3M press release, *3M Commences Split-Off Exchange Off er for Food Safety Business,* Aug. 4, 2022 ("If the exchange off er is consummated but is not fully subscribed, 3M will distribute the remaining shares of SpinCo Common Stock owned by 3M on a pro rata basis to 3M stockholders whose shares of 3M Common Stock remain outstanding after completion of the exchange offer")

[11] [for an analysis of potential effects of the discount on the exchange rate, see infra notes XXX and accompanying text.]

[12] [as per the tender offer rules.]

board's business judgment with its own. The shareholders could of course sell the shares if they believe the transaction is not good for them. However, this solution is not satisfactory on several fronts: the deal may be good yet not optimal, the deal may be bad yet the market may have already incorporated the negative information about the anticipated RMT transaction and depressed the price in the market.[13] On the other hand, the shareholders of the acquiring company will have to approve the merger transaction, even if the transaction is structured as a triangular merger, when the company is traded on NYSE or Nasdaq because of the significant number of shares that the acquirer will issue in the transaction.[14]

Generally, in a RMT, neither the shareholders[15] nor the company incurs a tax liability. In contrast, when a company sells assets, it ordinarily must recognize capital gains and pay tax accordingly. When a company distributes the proceeds of the sale as dividends to its shareholders, its shareholders incur a tax liability.[16] The RMT transaction is structured in a way that will qualify as a reorganization under the statute[17] and thus no tax will be recognized. Specifically, Section 355 of the Internal Revenue Code permits a tax-free separation of business and distribution,[18] provided that the transaction is not used as a "device" for the distribution of earnings and profits.[19] For the RMT to qualify as a tax-free transaction, the transaction must comply with a few requirements set forth in the Internal Revenue Code.[20] The main requirements state that the shareholders of the Parent company must own the majority of the shares of the acquiring-merging company for two years following the consummation of the merger.[21]

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[13] [Cf., Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 Duke L. J. 711-782 (2006), the role of information traders and the stock price…]

[14] [issuing more than 20% triggers voting rights under SROs rules]

[15] [assuming US companies, otherwise might trigger inversion rules]

[16] [("[O]rdinary dividends are taxable as ordinary income, qualified dividends that meet certain requirements are taxed at lower capital gain rates.") https://www.irs.gov/taxtopics/tc404#:~:text=Dividends%20can%20be%20classified%20either,at%20lower%20capital%20gain%20rates.]

[17] [Section 368(a)(1) of the IRC]

[18] [(The purpose of Section 355 of the IRC is "to permit the tax-free division of existing business arrangements among existing shareholders." *See* S. Rep. No. 105–33, at 139 (1997).")]

[19] [26 CFR § 1.355-2(2)]

[20] ["[T]he Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788 (1997)), added section 355(e) to the Code… stock or securities of Controlled [SpinCo] generally will not be treated as qualified property for purposes of section 355(c)(2) or section 361(c)(2) if the stock or securities are distributed as part of a plan or series of related transactions (Plan) pursuant to which one or more persons acquire directly or indirectly stock representing a "50-percent or greater interest" in the stock (Planned 50- percent Acquisition) of Distributing [the parent company] or Controlled." ""the Distribution effected a division of existing business arrangements among existing shareholders, and Congress intended section 355 to afford tax-free treatment to such a transaction" https://federalregister.gov/d/2019-27110]

[21] [IRC 26 U.S. Code § 355(e)(2)(A)(ii), "defined in section 355(e)(4)(A) by reference to section 355(d)(4), means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock."][This requirement leads to the inclusion of covenants that restrict the acquirers ability to enter into certain transactions, such as buybacks, without the approval of the parent company, for a period of at least two years following the consummation of the transaction.]

One of the Code's requirements for a tax-free distribution is that the parent company has been an operating business for at least five years.[22] Another requirement is the independent business purpose of the distribution.[23] For example, a separation and distribution of a business that is motivated in a substantial part by the enhancement of the business through an efficient allocation of managerial attention to each part of the business is an independent business purpose under the Code, which supports the nonrecognition of tax.[24]

The value of the merged company is the combination of the business that was spun off of the parent company and the value of the business merged into it including any synergies and subtracting the debt liability incurred by the new company to secure the cash given to the parent company. The cash received is less than the value of the business transferred to the new company because the shareholders end up owning more than 50% of the combined new merged company.

Thus, the RMT transaction is structured as a tax-free exchange of some of the assets of the company for a consideration that is bifurcated between two recipients. One part of the consideration is stock of the acquiring company that is given directly to the shareholders of the parent company. The other part of the consideration is a decrease in the debt burden of the parent company through cash and debt securities transfers to the parent company.

III. Divergence of Interests and Potential Misaligned Incentives

As the previous Section describes, the consideration for transferring the assets to the acquirer in the RMT transaction is divided into two baskets: one basket goes to the parent company and the other goes directly to its shareholders.[25] The basket of the shareholders consists of shares of the acquirer. Thus, the shareholders of the parent company are placed on both sides of the RMT transaction: they will continue to be shareholders of the parent company[26] and also become shareholders of the acquirer.[27]

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[22] [§ 1.355-1 (b)]

[23] [1.355-2(b)(2)]

[24] [1.355-2(b)(5)(Example 2) ("the operations of each business will be enhanced by the separation because each shareholder will be able to devote his undivided attention to the business in which he is more interested and more proficient")]

[25] [See, e.g., ("the transaction, which is structured as an all-stock, Reverse Morris Trust transaction, AT&T will receive $43 billion … in a combination of cash and other consideration, and AT&T's shareholders will receive stock representing approximately 71% of the new company, Warner Bros. Discovery, Inc.") https://www.sec.gov/Archives/edgar/data/732717/000119312522023926/d297230dex991.htm]

[26] The shareholder will not be on both sides of the transaction in the unlikely case where the RMT transaction includes a split-off that is undersubscribed and the particular shareholder chose to tender all its shares, in which case it will no longer be a shareholder of the parent company following the consummation of the RMT.

[27] If the RMT transaction uses a split-off that is fully-subscribed or oversubscribed and a particular shareholder does not tender any shares, then this shareholder will not be on both sides of the transaction.

Everything else being equal, the management[28] of the parent company will be interested in maximizing the aggregate value of the two baskets.

However, rationally, management cares more about the company's basket than about the shareholders' basket, as the personal evaluation and compensation of management is more directly linked to the company's basket. Thus, a transfer from the shareholders basket to the company's basket is benefiting management. Since the shareholders are on both sides of the transaction, they benefit from the company's basket as well as from their own basket, and they could be indifferent about such a transfer. If the decrease in one basket is smaller than the corresponding increase in the value of the other basket, the parent shareholders are even better off.[29]

On the other hand, management can use the shareholders' basket as cheap currency in the negotiations with the acquirer in an effort to increase the Company's basket. An increase in the basket of the company, even if it comes with a relatively larger decrease in the value of the shareholders' basket, can be preferred by management. For example, the deal can give the parent company more cash and give the parent's shareholders fewer shares in the acquiring company;[30] if the value of the shares that the parent's shareholders lose is worth more than the increase in cash the Parent company receives the total consideration is smaller but can be more attractive to Parent's management.

The effect of this misalignment of interests between management and the Parent's shareholders can be simply distributive between the group of shareholders who own the Parent company and the group of shareholders who own the acquirer. However, it may also be inefficient and prevent a higher value user from owning the distributed assets. In order to increase the Company's basket, the acquirer should be able to assume more debt, and the highest value user may not be permitted to increase its debt level to compete successfully for the assets. It should be noted that in general, the tax-free status of the RMT may distort the allocation of assets, since not all potential buyers may be able or willing to participate in a RMT transaction. Such participation requires the issue of the majority of the shares to Parent's shareholders, and thus, potentially, the management of the buyer and its shareholders will have to relinquish control. The size of the acquirer needs to fit, it cannot be too large in relation to the assets acquired, in order to allow for the transfer of the majority of the shares to the parent shareholders in the exchange.[31] These requirements, imposed by the tax code, limit the pool of candidates for a tax-free RMT transaction and

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[28] I use the term management to refer to both officers and directors.

[29] If the decrease and increase of the baskets are equal in value then the parent company's shareholders are indifferent about the transfer.

[30] To qualify for the tax-free status, in accordance with IRC 355(e), the shareholders of the Parent company need to own the majority of the shares of the merged company, but they do not have to own more than a simple majority. Indeed, some RMT set the percentage ownership of the Parent's shareholders at 50.1%, which is the minimum threshold, see, e.g., *3M Commences Split-Off Exchange Offer for Food Safety Business* ("The aggregate number of shares of Neogen common stock to be issued in the proposed transaction by Neogen will result in holders of shares of SpinCo common stock prior to the consummation of the proposed transaction collectively owning approximately 50.1% of the outstanding shares of Neogen common stock"). To be sure, a higher value of A's original assets, relative to the value of the assets that are divested by P, will push down the percentage holding of P's shareholders in the merged company.

[31] [Transactions that scale down the acquirer's size, such as dividend distributions, can help to adjust the relative sizes sufficiently for the RMT if the sizes are not too far apart.]

make it difficult to compete for the assets using a conventional asset acquisition transaction that is not tax-free. Consequently, transacting with the higher value user may be less favorable to the Parent company and the assets may end up in the hands of a lower value user who is willing to enter into a RMT transaction and in particular one that involves the assumption of nontrivial debt.[32]

Thus, the RMT transaction may result in management accepting, or even initiating, a deal that is less favorable to the shareholders of the Parent company than it could have been. The crucial question is whether the shareholders could prevent such an outcome. However, the parent company approves the merger between SpinCo and the acquirer at the time when it wholly owns SpinCo, before the distribution of SpinCo's shares to the shareholders. As a result, formally, the shareholders of the parent company do not need to approve the transaction, and as they do not have the right to vote on the transaction, they also do not have appraisal rights.

To be sure, the management of the parent company owes fiduciary duties to the Parent company and its shareholders when negotiating the RMT transaction on behalf of the corporation. Personal interests, particularly self-dealing transactions, where managers are on both sides of a transaction, can give rise to enhanced judicial scrutiny.[33] In the case of RMT the managers are not on the other side of the transaction, unless they own the partner-acquirer company, and they do not stand to gain directly from the transaction. Thus, since the deal is not a self-dealing transaction (as long as management is not related to the acquirer), and as long as the Parent company does not incorporate anticompetitive mechanisms that will be considered draconian and will trigger an enhanced standard of review,[34] the decision to enter into the RMT transaction will be protected under the business judgement presumption.[35]

Furthermore, while the fiduciary duties of the Parent company's management may not deter the management from entering into a transaction that favors the acquirer's shareholders at the expense of the Parent shareholders, potential pressure from the shareholders of the acquirer may actually encourage such transaction. The shareholders of the acquirer company, who may gain from the transfer of the assets to the acquirer, will, nonetheless, lose control of the company as the Parent shareholders will receive the

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[32] Anecdotally, in the Pringles example, which involved a failed RMT transaction, the ultimate conventional acquirer was reported saying that it was difficult to compete with the RMT partner. P&G first agreed to sell Pringles to almond manufacturer Diamond in an RMT but ended up selling it to Kellog the following year because of accounting misstatements that caused the deal with Diamond to unravel. It could be argued that had P&G's management cared about the value of the 57% of Diamond's equity that P&G's shareholders were supposed to get, at least as much as it cared about the cash it contracted to receive in the failed RMT, it might have realized the financial problems and accounting challenges Diamond faced before signing with Diamond and thus preferred the deal with Kellog from the beginning. Of course, generally, making sure the deal closes is a good reason to perform a due diligence on the other side's financials before signing. *See, e.g.*, [ ] ("[W]hen an analyst asked Kellogg's Bryant why his company did not buy Pringles when it was up for sale last year, he said it was hard to compete with the Diamond offer.") https://www.reuters.com/article/us-kellogg-pringles/kellogg-to-buy-pringles-for-2-7-billion-idUSTRE81E0S620120215

[33] [Self-dealing transactions fall under the category of breaches of the fiduciary duty of loyalty.]

[34] [Unocal]

[35] [Missmanegement falls under the category of breaches of the fiduciary duty of care, see, e.g., Goshen & Parchomovsky, The Essential Role, at 750.]

majority of the shares.[36] And unlike the shareholders of the Parent, the shareholders of the acquirer get the right to vote on the transaction.[37] As a result, favoring the shareholders of the acquirer company may help prevent challenges to the transaction. Thus, uneven fiduciary duty pressures can influence the outcome of the transaction. Moreover, management of the parent company can relate to the fiduciary duty worries of the acquiring company's management and make them more amenable to protecting the latter by making sure that the deal is favorable to the acquirer's shareholders.

Nonetheless, the shareholders of the Parent company may have informal power that will affect management behavior. The shareholders have tools such as withholding the vote[38] and precatory resolutions[39] that may put pressure and deter management. However, for such shareholder power to work, the shareholders should perceive that they have been disadvantaged by the acts of management and generally disfavor the RMT transaction. Yet, the RMT transaction conveys a few benefits to the shareholders that may overshadow the excessive decrease in their consideration basket. Even with a reduced percentage holding of the acquirer, on balance the RMT transaction can be better for the shareholders of the parent company than the status quo. The RMT transaction's major benefit to the shareholders is the tax-free status, which may represent a significant saving for the shareholders. Both the Parent company and the shareholders will avoid a potentially significant tax liability.[40]

Another benefit of the RMT that may help camouflage management's undervaluing of the shareholders' consideration basket is the reduction, or even elimination, of the conglomerate discount of the Parent company. The market often discounts the stock of conglomerates, and their stock trades below the aggregate value of their business unit. The discount represents the lack of focus and loss of agility from which conglomerates, and their management, may suffer when the different business units are not complementary. Empirical studies of conglomerate discount estimate it at about 6% to 15%.[41] Divestiture of assets that are unrelated to the core business can eliminate, or at least reduce, the conglomerate discount. The resulting increase in the stock price, in its own, is valuable to shareholders regardless of the intrinsic value of the company. Thus, the RMT transaction can be favored by the shareholders, especially

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[36] The loss of control may subject the management of the acquirer to a heightened scrutiny, though the transaction is not likely to trigger the Revlon duty, unless the SpinCo has a controlling shareholder rather than dispersed ownership, [see QVC.]

[37] Even if a reverse triangular merger is used, which will circumvent the state corporate law voting requirement, the stock exchanges rules require a shareholder vote to approve the transaction, as more than 20% of the shares of eth acquirer will be issued to the Parent's shareholders.

[38] [eg Michael Eisner lost his chairman of the board of Disney position due to a withholding vote campaign.]

[39] [eg. Board de-staggering due to precatory resolutions.]

[40] [See Section II supra.]

[41] [("the market may discount the value of a multi-division corporation, giving less value to its earnings... It typically results in a 10%-15% discount in valuation for the conglomerate.") https://corporatefinanceinstitute.com/resources/valuation/conglomerate-discount/ CFI Team ("On Wall Street the typical conglomerate discount ranges from 6% to 12%. … CEO will be compelled to divest or let go of the opportunity, regardless of its promise, in order to retain the benefits of a focused enterprise. …broken up into more focused entities.") https://hbr.org/2013/12/why-conglomerates-thrive-outside-the-us Why Conglomerates Thrive (Outside the U.S.) by J. Ramachandran, K.S. Manikandan, and Anirvan Pant]

those not waiting for the long run to realize the intrinsic value of the investment. This can be true even if management forgoes some of the aggregate shareholder value in the negotiations with the acquirer.

On top of the tax benefit and the reduction in the conglomerate discount, which are specific to the RMT transaction, the merger between SpinCo and the acquirer can create synergies. The value of these synergies may be shared with the Parent company and its shareholders. Thus, even though management may have agreed to a lower equity stake for its shareholders, the value received by the shareholders from the transaction may well be positive.

Yet, even if the shareholders of the Parent company lose from a RMT transaction, where the aggregate consideration received by the Parent company and the shareholders directly does not cover the value of the assets divested, management most likely will not be adversely affected. In fact, the transaction may help improve management's perceived performance, if the assets divested contributed less to the total earnings of the company relative to the other, remaining, assets of the company. The earnings per share of the company may also improve as the number of outstanding shares of the company declines when a split-off is used to exchange shares of the Parent company with shares of the Acquiring company.[42]

The market is likely to approve of the choice to enter into a RMT transaction. Shareholders may view the RMT transaction as the preferred solution to divest non-core assets by the company, as it can be both profitable and tax free, and thus encouraged by activists.[43] As a result, the market is likely to be more lenient and scrutinize the transaction itself less.

Furthermore, despite the decline in the total shareholder value, sophisticated shareholders may well benefit from the transaction. Management can choose to conduct a split off, rather than a pro rata spin-off, for the distribution of SpinCo. A spinoff involves all the shareholders pro rata, while a split off is an exchange offer and it includes only the shareholders who choose to tender their shares. In the case of a RMT split off, the exchange rate often incorporates a discount of about 10% on the relative price of the Parent shares and the acquirer's shares.[44] The discount is offered by the Parent company, not the acquirer, and thus could come at the expense of the Parent's shareholders but does not affect the acquirer. If all the shareholders participate in the exchange offer, the discount does not matter, and the result of the split-off exchange offer is identical to a spinoff where the shareholders end up with a pro rata distribution of

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[42] See Infar Section IV.E.

[43] See, e.g., Liz Hoffman, *What's a 'Reverse Morris Trust' and Why Is Everybody Doing One?*, MONEYBEAT BLOG, (March 27, 2015) [("…often spurred by activist hedge funds, are focusing on what they do best and looking to shed pieces that might not fit. " "Outright sales are one option, but the cash received can be subject to heavy taxes. Spinning off a business to public shareholders is another, but IRS regulations can prevent the new company from engaging in M&A transactions for a certain period of time, robbing shareholders of a potential payday. Reverse Morris Trusts are an elegant, if complicated, solution.") https://www.wsj.com/articles/BL-MBB-34994]

[44] See, e.g., *3M Commences Split-Off Exchange Offer for Food Safety Business* ("The exchange offer is designed to permit 3M stockholders to exchange all or a portion of their shares of 3M common stock for shares of SpinCo common stock (which will convert into shares of Neogen common stock) at a discount of 7% to the per-share value of Neogen common stock…").

the shares of the acquirer. However, if not all the shareholders participate in the split off, the non-participating shareholders internalize the cost and pay for the discount to the exchange rate.

Thus, the sophisticated shareholders may choose to participate in the exchange offer, not because they think the RMT transaction is good for the whole group of shareholders of the Parent company, but rather because it is good for the shareholders who participate in the exchange offer at the expense of the non-participating shareholders. Tendering shares in the exchange offer may seem akin to a shareholder vote, especially if the majority of the shareholders do so, yet it may be coerced by a high discount applied to the offer that will leave the non-participating shareholders worse off.

The participating shareholders, who benefit from the RMT transaction, even if the non-participating shareholders do not, will also remain shareholders of the Parent company. The sophisticated shareholders may well understand that the shares of the Parent company will lose from the transaction but will not sell their Parent shares, rather, they would like to exchange all their shares for the acquirer's shares. However, as the exchange offer is likely to be oversubscribed by sophisticated shareholders, who will choose to tender all their shares in the offer, the offer will be prorated and following the consummation of the transaction the sophisticated investors will receive some of their parent company shares back. As a result, the shareholder body of the Parent company will include sophisticated investors who participated in the split off, benefitted from the RMT, and thus are satisfied with the performance of management. Rationally, management is concerned about active shareholders, as they may challenge it, and are less concerned about shareholders who are inactive or just sell their shares before the next shareholder meeting. Shareholders who do not participate in the split-off are also less likely to vote in the subsequent annual shareholder meeting, and thus even if they disapprove of management performance their disapproval has limited effect on management. Generally, unsatisfied shareholders may sell their shares and new shareholders replace them before the next annual shareholder meeting when the managers are potentially evaluated.[45]

On the one hand, it may still be that the outcome of the transaction is efficient. It may be that the result is merely distributive, a transfer of value from the shareholders of Parent company to the shareholders of the acquiring company, which supports an efficient transfer of assets to a higher value user, the acquiring company. In addition, despite the shareholders of the acquiring company potentially benefiting more from the surplus created by the transaction, the shareholders of the parent company may nonetheless be better off as well. The transaction is creating tax gains by preventing recognition of a potentially high capital gain, a liability the market may have already priced and incorporated in the stock price. The stock price of the Parent company may have also been reduced by a conglomerate discount; and indeed, the focus of management may have been impaired by the need to oversee assets that do not contribute to the company's core business. And the company may have been under pressure from activists to divest assets. The asset divestiture may mitigate these negative effects on the stock price, and will cause the price to increase, potentially camouflaging the efficacy of the transaction.

[45] Unsophisticated investors who do not participate in the split-off are likely to lack the funds and knowledge to initiate a proxy fight, a withhold vote campaign, or to vote against management on a say-on-pay, and thus their dissatisfaction from management performance pose no credible threat to management.

On the other hand, the result may be unfair to unsophisticated shareholders who do not participate in an exchange offer and may also be inefficient. The acquirer who is willing to take on more leverage may not be the higher value user of the divested assets and the parent company may not perform a satisfactory due diligence on the acquirer. Management may be willing to transfer the assets for less than they are worth, it could also agree to relinquish the control over the acquiring company by giving the acquiring shareholders and existing management potentially excessive entrenchment mechanisms at the expense of the parent shareholders who will own the majority of the shares.[46] In a free market with a large number of players there could be in theory a third party who will step in and be willing to pay more, but because of the strict requirements of the tax rules, including the cap on the size of the acquirer to allow for the more than 50% of ownership transfer and willingness to take a steep dilution, there is a limited number of firms that may qualify, and thus there is less competition and more leeway to transfer value to the acquirer at the expense of the Parent shareholders.

IV. Numerical Examples and a General Model

In this Section, using arithmetic examples, I explore the potential consequences of the structure of the RMT on the shareholders and demonstrate the potential for shareholder vulnerabilities and inefficiency. In general, the deal can be merely distributive in nature, and yet the shareholders may be affected by the deal as it transfers value from company P to company A. The deal may also be inefficient if the assets are moved to a company that is not the highest value user. Higher value users' leverage may be at a level that will prohibit them from assuming additional debt to compete with company A. Management may choose to merge SpinCo with company A, because company A agrees to lower P's debt obligations, even at the expense of P's shareholders who will receive less equity in the merged company (as long as the shareholders receive at least the majority of the shares to comply with the RMT tax requirements).

As argued in the previous Section, the deal itself, though not optimal, may be profitable for P's shareholders because of the synergies created by the deal, a surplus that the two managements will negotiate over its split. The RMT deal will also prevent the liability of recognizing capital gains tax on the sale of the assets; a liability that likely lowered P's stock price because the market may have incorporated

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[46] See, e.g., *Proxy Statement/Prospectus to Mylan Shareholders,* (Feb. 13, 2020), ("These [amended charter and bylaws] provisions include the division of the Newco Board into three classes of directors until the 2023 annual meeting of Newco stockholders, with each class serving a staggered three-year term, … rules regarding how stockholders may present proposals or nominate directors for election at stockholder meetings and the right of the Newco Board to issue preferred stock without stockholder approval.")
https://www.sec.gov/Archives/edgar/data/1792044/000119312520035755/d801850d424b3.htm To be sure, proponents of staggered boards would argue that Pfizer, the parent company in this RMT, agreed to the entrenchment mechanism of the merged company since it will benefit its shareholders who will own 57% of its shares, by providing stability and preventing the replacement of experienced directors. It is not clear, though, why would the majority of the shareholders want to hurt themselves by replacing the old board if indeed it is performing well, [cf., Bebchuk et. al.]

the anticipated future payment of the tax, now avoided through the RMT structure. Similarly, as the market may discount conglomerates, the stock price of P may be positively affected by the RMT, which divests assets from P. The market may indeed view the RMT transfer favorably as P may benefit from a centralized focus on core business enabled by the asset divestiture. All these benefits may camouflage and offset a low equity position of P's shareholders in A. In this Section, I assume none of these supplemental benefits exist and show that even without them informed sophisticated shareholders of P cannot be relied upon to protect the whole shareholder body from an unfavorable RMT transaction.

As demonstrated in the numeric model below, under certain circumstances sophisticated shareholders may support an RMT transaction even when it destroys value. Informed traders that customarily can be relied on to protect the shareholders through stock price changes and pressures on management,[47] may be able to benefit from the RMT transaction at the expense of the less sophisticated investors. At the end of the Section an analysis of the effect of the RMT on the earnings per share of the company will uncover the potential motivation of management to enter into an RMT that destroys shareholder value.

A. The Basic Model:

First, I consider the basic case of the Parent company ("P") conducting an exchange offer for SpinCo's shares, but without offering any discount to its shareholders. In this simple case SpinCo is merged with the Acquirer company ("A") in exchange for shares. I further assume that no synergies are expected to increase the aggregate value of the merged company. To comply with the tax requirements the shareholders of P should own the majority of the shares of the merged company following the RMT.

Table I illustrates this simple case with a numerical example where T=0 is the time before the RMT, T=1 is the time immediately after the exchange offer, and T=2 is the time the merger is effectuated, the completion of the RMT. I assume that the Parent company has 100 shares issued and outstanding and is worth $100 while the Acquiring company has 10 shares and is worth $10 at time T=1. In the RMT transaction assets that are worth $20 are transferred to SpinCo ("S") and eventually to the Acquiring company in exchange for 20 shares of the Acquiring Company. The assets are transferred from P to A through S. In the other direction cash, debt securities, and assumption of liability increase the value of P. In this Section, I refer to assets being transferred from P to A as the net assets, that is the value of the assets transferred to A in excess of the value transferred in the opposite directions.

[47] [Cf., Goshen & Parchomovsky ("Only information traders can detect and curtail mismanagement…")]

Table I			
	Asset distribution		
Period	Parent Company	SpinCo	Acquiring Company
T=0	$100	0	$10
T=1	$80	$20	$10
T=2	$80	0	$30
	Number of shares		
Period	P	S	A
T=0	100	0	10
T=1	80	20	10
T=2	80	0	30
	Price per share		
Period	P	S	A
T=0	$1	0	$1
T=2	$1	0	$1

One can easily see that the value of the shareholders of A, whether they have participated in the exchange offer or not, remained the same following the RMT in this initial example. The value of the Parent's shareholders was $100 before the RMT; following the RMT the Parent's shareholders own $80 worth of the Parent shares and $20 worth of the Acquiring shares, which equals $100. The value of the non-participating shareholders remained the same because the stock price of the parent company did not change in the transaction. While the value of the parent company decreased in the transaction as its assets were reduced, the number of shares issued and outstanding was reduced proportionally in the exchange offer, thus the company maintained its stock price. Similarly, the value of the shareholders who participated in the exchange offer also did not change in the transaction. This is because the equity received in exchange for the assets is equal in value to both the assets' value, and to the Parent's shares surrendered in the exchange.

B. Exchange Offer Discount:

In the second step, I consider the case of introducing a discount on the price of the exchange offer.[48] The Parent company is offering its shareholders to exchange their shares for shares in SpinCo that are worth more. The valuation of SpinCo shares for the purpose of the exchange is based on the value of shares of A that P's shareholders will receive for the SpinCo shares in the merger. If all the shareholders of P participate and all of P's shares are subscribed to the exchange offer, then the shares will be exchanged pro rata to their percentage holdings. Even though P uses a discount rate in order to calculate the number of shares that need to be tendered for SpinCo share, the only effect is on the number of shares remaining

[48] Formally, the discount is offered to induce participation in the exchange offer, see, e.g., Kraft no action letter.

in P after the exchange, because the shares are distributed pro rata based on the shares that are tendered.[49] I illustrate this scenario with the following numerical example.

I start with the same facts used in Table I, but instead of replacing 20 shares of P for 20 shares of SpinCo (which ultimately will be changed for 20 shares of A), only 10 shares of P will be replaced, in a ratio of 2 shares of SpinCo/A for a single share of P. Table II illustrates the new distribution. At time 2, T=2, following the RMT, P will be worth $80 and will have 90 shares issued and outstanding, with each share worth $0.89. As a result, there will remain more shares of P; and since the assumption is that all the shareholders are participating in the exchange offer, the shares of SpinCo are distributed to P's shareholders pro rata to their percentage holding in P. A former 10% shareholder of P had 10 shares worth $10 at time T=0; and will have 9 shares of P that will be worth (9 x $0.89) = $8 in addition to 2 shares of A that will be worth $2 at time T=2. Thus, the shareholders will maintain the aggregate value of the equity holding.

Table II			
	Asset distribution		
Period	Parent	SpinCo	A
T=0	$100	0	$10
T=1	$80	$20	$10
T=2	$80	0	$30
	Number of shares		
Period	P	S	A
T=0	100	0	10
T=1	90	20	10
T=2	90	0	30
	Price per share		
Period	P	S	A
T=0	$1	0	$1
T=2	$0.89	0	$1

C. Nonparticipating Shareholders:

At this stage, the assumption is that some of the unsophisticated shareholders are passive and do not participate in the exchange offer.[50] I assume that 10% of the shareholders do not tender any shares while the rest tender all their shares.[51] As in the previous example, a discount is applied to the exchange

[49] The exchange ratio does not change the allocation between A shareholders and P shareholders, that is determines by the boards of the two companies before the exchange offer.

[50] [This assumption is realistic, anecdotally, in the 3M RMT exchange offer less than 50% of the shares were tendered. The passivity of retail investors is not surprising, and we know this from studies about shareholder voting.]

[51] To be sure, some unsophisticated investors may well tender some of their shares and opt to keep the rest of their P shares. However, if the exchange offer is profitable, it is better for a shareholder to tender all the shares in order to maximize the number of shares that is accepted in the offer. If the offer is

rate of P's shares to SpinCo's shares. However, this time, the discount is a benefit that is shared by those shareholders who exchange their shares at the expense of those who do not.

As in the previous example, the Parent company offers a 50% discount, and is seeking to exchange 10 of its shares for 20 shares of SpinCo. The ratio of participation is 10/90, (10 shares will be accepted out of 90 tendered); for every 9 shares tendered in the exchange offer one share is exchanged for 2 shares of SpinCo. Thus, a sophisticated shareholder who owns 9 shares of P before the RMT, which are worth $9 at time T=0, will tender all her shares. Since the offer will be oversubscribed, the shareholder will get back 8 shares of P and 2 shares of the merged company A. The aggregate worth of the sophisticated shareholder will be 8 x $0.89 +$2 = $9.11 which includes a $0.11 increase in value. The value of the 8 shares goes down at the closing of the exchange offer, however the sophisticated investor will not sell those shares because in order to exchange 1 share of P for 2 shares of A she needs to tender at least 9 shares, as the exchange will be oversubscribed, and the shares will be prorated based on the number of shares tendered. In other words, the sophisticated investor would like to exchange as many P shares as possible for A shares, but even if only 1 out of 9 shares is accepted in the exchange, in this example, she benefits in the aggregate. On the other hand, the 10 shares held by the unsophisticated shareholders who did not participate in the exchange offer were worth $10 before the exchange and following it the shares will be worth only $8.9, reflecting a loss of $1.1 that was transferred to the sophisticated investors.

D. Fewer Shares:

In the following scenarios the management of the Parent company agrees to a RMT in which the assets of SpinCo are acquired by A for equity rights that are worth less than the value of these assets. In order to comply with the RMT requirements, P's shareholders will still own more shares than the original shareholders of A. For example, as illustrated in Table III below, P transfers assets that are worth $20, twice as much as the value of the assets of A before the transfer, $10. This time, however, A issues only 15 shares to P's shareholders in return for the assets, and yet these shares are sufficient for the purpose of complying with the tax rules as they will represent the majority of the shares of A following the RMT. While the value of A is the same as in the previous example, this time it is divided into fewer shares, as P's shareholders receive fewer shares. As a result, the price of a single A share increases from $1 to ($30/25) = $1.2.

First, the assumption is that the company does not offer any discount on the exchange price and offers to exchange the shares based on the relative stock prices before the announcement of the RMT transaction: each share was worth $1, so for one share of P the shareholders will receive one share of A.[52] After the exchange 85 shares of P will remain with a new price per share of ($80/85) = $0.94.

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oversubscribed rule 240.14d-8 instructs that tendered shares will be prorated "according to the number of securities deposited by each depositor."

[52] If the exchange rate is based on the new, higher price of the acquiring company following the RMT, then more shares of the Parent company will be required for the 15 shares of A. The new price of A is 1.2 and thus the 15 shares will be worth $18, and using the price of P before the exchange that will mean 18 shares of P will be required to be surrendered for the 15 shares of A. If the exchange ratio uses the new price of P, as it will be after the RMT, or 80/(100-n) with n being the number of shares participating in the exchange offer, then about 18.37 will convert to 15 shares of A.

Table III			
	Asset distribution		
Period	Parent	SpinCo	A
T=0	$100	0	$10
T=1	$80	$20	$10
T=2	$80	0	$30
	Number of shares		
Period	P	S	A
T=0	100	0	10
T=1	85	15	10
T=2	85	0	25
	Price per share		
Period	P	S	A
T=0	$1	0	$1
T=2	$0.94	0	$1.2

Further I assume that all the shareholders are participating in the exchange pro rata to their percentage holdings. For example, a 20% holder, who owned 20 shares of P, which were worth $20, before the RMT, will exchange (20*15/100) = 3 shares of P for 3 shares of A. As a result, it will own 17 shares of P worth (17 x $0.94) = $16,[53] and 3 shares of A worth $3.6, for a total value of only $19.6. This result is clearly putting the shareholder in a worse position than where it was before the RMT, and to the extent that it is sufficiently sophisticated to realize in advance that the RMT will cause it to lose value it would like to sell all of its P shares ahead of the RMT; this sale will depress the stock price as the market will incorporate the information about the value reducing transaction in the stock price.[54]

However, since it may well be expected that not all of the shareholders will participate in the exchange pro rata to their percentage holdings,[55] participating shareholders may benefit from the exchange, depending on the exchange ratio. This is especially the case when the Parent company applies

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[53] Since all the shareholders participate pro rata in the exchange offer, the 20% shareholder will maintain its percentage holding in P and will own 20% of the new value of P, which is 20% of $80, which is $16.
[54] See, e.g., Zohar Goshen & Gideon Parchomovsky, The Essential Role of Securities Regulation, 55 Duke L. J. 711-782 (2006) ("When they [Insiders and information traders] observe an undervaluation, they buy, thereby raising the price; conversely, when they spot overvaluation they sell, thereby causing the price to drop."); Merritt B. Fox et al., Law, Share Price Accuracy and Economic Performance: The New Evidence, 102 MICH. L. REV. 331, 367–68 (2003) ("The roles that share prices can play in the functioning of the real economy relate to their capacity to signal which firms' proposed investment projects promise the highest returns and which firms' managers are doing a good job").
[55] [e.g., in the 3M RMT of 2022 less than half of the shares were tendered. See, e.g., ("As of August 1, 2022, 569,824,139 shares of 3M common stock were issued and outstanding.") https://www.sec.gov/Archives/edgar/data/66740/000114036122028182/ny20004937x2_sctoi.htm ("[A] total of approximately 203,610,687 shares of 3M common stock were validly tendered and not properly withdrawn in the Exchange Offer") https://www.sec.gov/Archives/edgar/data/66740/000114036122032385/ny20004937x37_sctoia.htm

a discount to the exchange ratio, as is customary.[56] The parent company sets the exchange price of the exchange offer, the number of P's shares required for a single SpinCo share, based on the relative trading price of the shares of P and A on the last days before the closing of the tender offer. The ratio of the value of P's shares and A's shares is calculated using the volume weighted average trading price of the relevant shares for the last two or three trading days of the exchange offer.[57] This method may appear to provide a fair exchange, since the market prices of the shares are based on their value taking into account the soon to be consummated RMT transaction. However, as shown in the numeric examples above, while the exchange ratio may reflect a fair exchange, the transfer of assets for stock may not represent a fair exchange and thus the deal may not be favorable to P's shareholders.

Thus, under certain terms a deal that destroys value for the shareholders as a group may nonetheless be favored by informed and sophisticated investors who benefit at the expense of the non-sophisticated investors who do not participate in the exchange offer. For example, following the example illustrated in Table III, suppose 15 shares of P will convert to 15 shares of A following the exchange offer. Since 15 shares of A will be worth ($1.2*15) = $18, which is more than the value of 15 shares of P, both before and certainly after the RMT consummation, it is easy to see that the exchange ratio includes a discount. I assume, further, that only 40 shares of P are tendered in the exchange offer and 60 shares do not participate in the offer. As a result, the participating shareholders, who owned 40 shares of P that were worth $40 before the transaction, will own 15 shares of A worth $18 and 25 shares of P worth ($0.94*25) = $23.5 for a total of $41.5, which includes a gain of $1.5. On the other hand, the non-participating shareholders will continue to own 60 shares of P that were worth $60 and following the RMT will be worth only ($0.94*60) = $56.5. Thus, the non-participating shareholders of P lose while both the participating shareholders of P and the shareholders of A win.

The value of the Parent company is not affected by the exchange offer or by the exchange rate, but the exchange rate determines the number of P shares that remain after the exchange. If the exchange is not done pro rata among all P's shareholders, the relative percentage holdings of P's shareholders will change. An exchange rate that requires fewer P shares in exchange for A shares will leave the participating shareholders with more P shares and, thus, with a higher percentage holding of P. At the same time, the non-participating shareholders will own a relatively lower percentage holding of P than they would have owned had the exchange rate been lower, and not discounted. Sophisticated investors that understand that not all of P's shareholders will participate in the exchange offer and that the exchange rate is discounted by P may increase in the demand for P's stock so that they could participate in the exchange, thus increasing P's price in the market. The increase in P's price following the announcement of the

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[56] [see, e.g., Kraft's no action letter "This value relationship will reflect a premium … in order to encourage participation in the Exchange Offer. The senior management of Kraft has set the premium at 10%, such that for each $1.00 worth of Kraft Common Stock accepted in the Exchange Offer investors will receive $1.11 worth of Splitco Common Stock")]

[57] [see, e.g., Kraft's no action letter to the SEC ("the calculated per-share values of Kraft Common Stock and Ralcorp Common Stock will be determined by reference to the simple arithmetic average of the daily volume-weighted average price (or daily "VWAP") of each stock on each of the last three trading days of the Exchange Offer""the McDonald's-Chipotle Pricing Mechanism was based on a two-day averaging period.")]

planned deal might be interpreted as if the market is supporting the transaction, rather than informed shareholders' attempt to take advantage of passive shareholders.

E. The Effect on the Parent Company's Earnings per Share:

As we saw in the numeric examples above, when management agrees to exchange the divested assets of P for fewer shares of A than the assets are worth, the price per share of P should go down because the assets of P decrease in value more than the number of P's shares. However, management may focus on the earnings per share more than on the price per share.[58] This is because management's compensation is often tied to the earnings per share of the company.

I denote as "E_x" the earnings of the whole P company before the exchange, at time T=0; and "E_y" as the earnings that stem from the divested assets only. "SHs" is the number of shares before the exchange offer, and "n" is the percentage of the parent's shares that are exchanged for SpinCo shares and ultimately for the shares of the merged company. The earnings per share of the parent company before the transaction are: $\frac{Ex}{SHs}$ and the earnings per share after the transaction are: $\frac{(Ex - Ey)}{(1-n)SHs}$. The transaction will increase the earnings per share of the parent company, that is: $\frac{Ex}{SHs} < \frac{Ex - Ey}{(1-n)SHs}$,[59] as long as $E_y < nE_x$. This means that the transaction will increase the earnings per share of the parent company when the earnings attributed to the divested assets account for less than "n" of the earnings of the company, where "n" is the percentage of P's shares that is converted to SpinCo's shares. Thus, if following the exchange offer, the number of shares decreases by "n", then as long as the earning of the divested assets represent less than n% of the earning of the whole company, the earnings per share of the parent company will increase as a result of the RMT.[60] For example, if the number of shares declines by 10% then earnings of the company that were derived from the divested assets should represent less than 10% of the total earnings of the company before the transaction for the RMT to improve the earnings per share ratio.

The previous equation assumes that the earnings of the remaining assets of the parent company are not affected by the RMT. The earnings of the remaining assets of the parent company may decline following the transaction, for example, because of loss of synergies in the parent or decline in reputation due to the divestiture of the assets. On the other hand, the earnings of the Parent company may increase after the transaction, for example, because of improved reputation, decreased debt load, and increased management focus on core business, which may result in higher earnings per share even with relatively more shares issued and outstanding. The latter scenario further improves the earnings per share of the Parent company and management's motivation to divest the assets through a RMT.

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[58] See, e.g., Heitor Almeida, *Is It Time to Get Rid of Earnings-per-Share (EPS)?*, ("Executives chase EPS because they are paid to do so.")

[59] Which can be rewritten as: $E_X - nE_X < E_X - E_y$. From this follows that $E_y < nE_x$.

[60] This is because the denominator of the earnings per share is decreased by more than the decrease in the nominator of the earnings per share.

V. Mitigating Strategies – Contingent Automatic Tender Rule

In the previous Sections I showed that RMT transactions may not be optimal or even efficient and that unsophisticated shareholders may be adversely affected by them. In this Section I consider a few courses of action aimed at mitigating the potential harmful effect of the misalignment of interests between management, sophisticated investors, and retail investors. I conclude by proposing an amendment to the tender offer rules that will help the unsophisticated shareholders and recruit the sophisticated shareholders for the aid of the entire shareholders as a single group.

General common strategies that seek to protect shareholders and to foster efficiency are likely to fail in the case of RMTs. For example, attempting to align the interests of the managers with those of the shareholders through equity compensation is not likely to succeed. First, if the managers are given a substantial equity stake in the company then, as shareholders, they will simply be in the position of the sophisticated shareholders, and will strive to benefit from the exchange offer at the expense of the non-participating shareholders.[61][62] On top of this, management will continue to be influenced by the prospects of their future compensation, which is tied to earnings per share of the company. Nonetheless, if the managers own a significant equity stake in the parent company and a spinoff, rather than a split-off is used to distribute the shares to the parent company's shareholders pro-rata, treating all shareholders equally, including the insiders, then managers' equity may incentivize them to refrain from harming shareholder aggregate value.

Giving the Parent's officers and directors positions in Company A[63] is likewise not going to solve the problem of misaligned incentives. In fact, should the members of management hold positions in both companies it might defeat the purpose of the divestiture, rather than enhancing management focus on P's core business it is likely to distract the management. Conversely, the prospect of the new added position might incentivize the management to pursue the RMT transaction for self-interested reasons rather than the company's best interests.[64] It may, however, give P's management an incentive to assure the future prospects of the merged company, and not merely the closing of the deal, which is an

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[61] [For the failure of managerial pay to motivate management efficiently see generally Bebchuk & Fried, Pay without Performance. For the risk of managers using insider information and equity to benefit at the expense of the shareholders see, e.g., Fried & Spamann.]

[62] Cf. Kraft no action request letter ("Participation in the Exchange Offer is voluntary, and Kraft has not and will not make any recommendation about whether anyone should participate. Directors and officers of Kraft may participate in the Exchange Offer, but the terms of the offer do not provide them with any advantage relative to other Kraft shareholders.").

[63] See, e.g., Business Wire, *IFF Shareholders Approve Merger with DuPont's Nutrition & Biosciences Business*, (Aug. 27, 2020) ("Ed Breen, DuPont Executive Chairman and Chief Executive Officer. … will join the board of the combined company following the close of the [RMT] transaction and will serve as Lead Independent Director")

[64] Cf. Mira Ganor, *Salvaged Directors or Perpetual Thrones?* (analyzing the practice of bidders undertaking to nominate a few target company directors to their board in merger agreements).

advantage. Yet, this strategy does not incentivize management to increase the slice of the merged company that the parent's shareholders will receive.

Similarly, requiring P's shareholders to vote on the RMT, will increase the cost of the transaction as it will require proxy solicitation, but may not assure the desirability of the transaction. The sophisticated investors have an incentive to approve the transaction even if it is not optimal, since they stand to benefit from it at the expense of the unsophisticated nonparticipating investors.[65] If the vote requires the approval of the majority of the outstanding shares, rather than a simple majority of the vote cast, a high threshold used for fundamental transaction such as amendment of the charter and merger transactions, then it is likely that those shareholders who were convinced to approve the transaction will also opt to participate in the exchange. This will lower the number of non-participating shareholders in the exchange offer, and thus may lower the benefit for the sophisticated investors but may not eliminate it completely as there are still likely to be non-participating shareholders.

However, the unsophisticated shareholders can be protected by the informed sophisticated shareholders if they participate in the exchange offer whenever the sophisticated shareholders do. If the unsophisticated shareholders participated along with the informed investors, they would benefit from not losing when the participating shareholders benefit from the discounted exchange rate at their expense. They will also benefit because the sophisticated investors will no longer stand to gain from the discounted exchange rate even when the deal itself is suboptimal, and instead the sophisticated investors will benefit only when the RMT transaction will benefit the whole shareholder base. If sophisticated investors were to benefit only when the whole shareholder base benefits, management is likely to be deterred from destroying shareholder value in fear of informed investors' opposition and reprisal.

Thus, I propose amending the tender offer rules by adopting a default rule that will cause shares to be tendered into the exchange offer automatically whenever a significant percentage of shares are tendered.[66] The proposed automatic tender rule is contingent on a significant percentage of shares being tendered and is consequently designed to protect the unsophisticated shareholders. Passive investors and unsophisticated investors will be protected by being automatically linked to the large group of sophisticated investors. Yet, shareholders will be able to opt out of the contingent automatic tender and choose not to tender their shares, even though a high number of shareholders choose to participate in the exchange offer. The opt-out option will serve sophisticated informed investors with divergent views of the RMT transaction.

Sophisticated shareholders may try to act strategically and attempt not to trigger the proposed default tender rule so that they will extract value from non-participating shareholders. The proposed rule is contingent on a high percentage of shares being tendered, and the sophisticated shareholders may

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[65] [Cf. the case of SPACs and redemption rights, Mira Ganor, *The Case for Non-binary, Contingent Shareholder Action* (questioning the ability of shareholders to vote for the de-SPAC transaction and nonetheless redeem their shares)].

[66] [Cf. Id., in the contingent shareholder action proposed in T*he Case for Non-binary, Contingent Shareholder Action,* I advocate for allowing the shareholders to follow the actions of those who act decisively. This proposal recognizes that uninformed shareholders are disadvantaged for lacking the relevant information, yet it requires a level of sophistication that many shareholders may similarly lack. Thus, I the case at hand I propose a default rule that will automatically tie the unsophisticated shareholders to the informed investors, eliminating the need to understand the required action.

restrict the number of shares they tender to avoid triggering the rule. However, such a strategy is precarious as the sophisticated shareholders will need to know how many shares are tendered by other investors to try to manipulate and keep the percentage below the rule's threshold. And as they decrease the number of shares that they tender they decrease their participation in the exchange offer and, as a result, they also decrease their gain from the discounted exchange rate.[67]

VI. Conclusion

[Given the special case of the RMT transactions, empirical study of RMT transactions may reveal further insights about managerial behavior and their motivations. Such study could also help with setting the size of the significant percentage of shares that will trigger the proposed default tender offer rule.]

[TBD]

[67] [Cf. Mira Ganor, *Manipulative Behavior in Auction IPOs*, (analyzing the strategy of decreasing the level of participation in auction IPOs in order to maximize investors' gain).]