“Reverse Morris Trust” Deal Structures

*Contributed by Christopher S. Harrison, Schulte Roth & Zabel LLP and NYU School of Law*

Procter & Gamble (P&G) announced on April 5, 2011 that it had signed an agreement to merge its Pringles business into Diamond Foods under a so-called “Reverse Morris Trust” structure. P&G has successfully employed this structure in previous deals. These structures are exceptionally complicated, but have unique benefits that have kept them in use.

**Advantages of a Reverse Morris Trust Structure**

A Reverse Morris Trust transaction allows a public company to sell a business “tax free” in circumstances where typical deal structures would be taxable to the seller. The Reverse Morris Trust structure even allows the seller to take cash out of the target business on a tax free basis, by leveraging it up the instant before closing—the seller keeps the cash proceeds and passes the debt along to the buyer. Even in tax-free stock-for-stock deals with mixed cash/stock consideration, at a minimum the cash component is always taxable. Not so in a Reverse Morris Trust deal.

**Transaction Steps**

Reverse Morris Trust deals play out in a sequence of transaction steps, which combine elements of several basic deals structures.

- **Internal Segregation of the Target.** A public company seller transfers its target business into a separate, stand-alone subsidiary, including the IP and related assets that are going with the target in the deal.

- **Levering Up the Target.** The target subsidiary takes on debt, and distributes the cash proceeds up to its parent.

The trick is that the public company seller keeps the cash proceeds, without guaranteeing the debt. The cash stays with the seller, while the obligation to repay the debt travels with the target subsidiary on its path through the next steps of the transaction, and ultimately to the buyer. There are tax-based limits on how much cash can be taken out of the target.
• **Split-off of the Target.** The target company is spun off or split off to the seller’s public shareholders. P&G is contemplating a split-off. In a split-off, the seller makes an offer to its public shareholders to swap out some of their stock in the seller for stock in the target subsidiary (and ultimately the buyer). Since the public company takes back part of its own equity in the process, this structure allows it to retire stock (which boosts earnings per outstanding share, and is perceived as a positive influence on its stock price).

An economic incentive is usually offered to the seller’s shareholders to encourage them to tender into the split-off. The seller may offer its shareholders, for example, an opportunity to exchange $1.00 worth of stock in the seller for $1.10 worth of stock in the target (and ultimately the buyer). Realizing this premium carries relatively little risk, since the buyer’s stock can be immediately sold in the market or shorted in advance of closing. Such premium tenders are usually heavily oversubscribed.

After the split-off, the target business is a stand-alone public company, owned by the public shareholders of the seller who participate in the split-off—but only for an instant.

• **Merger of Target into Buyer.** The target company is merged into the buyer. The buyer assumes the target company’s debt. As part of the merger, the stock in the target is exchanged for publicly-traded stock in the buyer.

All of these steps occur on paper in an instant, at the closing of the deal. As a result, the seller has retained cash proceeds of the target’s debt, and has retired a portion of its equity (equal to a little less than the leveraged equity value of the target business in the deal). The seller’s stockholders who participated in the split-off own at least a majority of the buyer’s outstanding equity. The buyer owns the target business.

*Limitations of a Reverse Morris Trust Structure*

The use of this structure is limited by its complexity and specific tax requirements. The seller’s shareholders need to own a majority of the combined target/buyer business (in order for the distribution of the target stock by the seller to its shareholders to remain tax free). As a result, such transactions can be accomplished only where the buyer is smaller than its target in terms of equity value. Despite that imbalance, the buyer’s senior management team normally continues as the combined company’s senior management.

Although this article refers to the parties as the “buyer” and “seller” for simplicity, from a tax perspective the public company has not actually engaged in a sale (which would be taxable). In formal documentation the designations of the parties are more precise. Click [here](#) to view the P&G transaction agreements.

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