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Inventing Tomorrow While Operating Today

HR's Leadership Role in Organizational Spin-offs

Introduction

Organizational spin-offs offer companies the chance to "reinvent" the business while keeping a core of the familiar. Start a new company (NewCo), yet keep the advantages of existing customers, products, operations, and people. Re-focus an existing company (Parent) around a tighter core of business and a new cost/operating model.

It is an exciting time of opportunity and possibility.

Yet the opportunity in a spin-off is balanced by the challenges. These include splitting up the two organizations, refocusing the Parent, and launching NewCo, all the while keeping both organizations operating profitably and serving customers. Furthermore, all of these things must be done in a short time frame to respond to the expectations of shareholders, analysts, customers, and employees. Execution of the spin-off significantly affects cost savings, employee motivation, and speed of mobilization to business performance.

For Human Resources, a spin-off is almost unparalleled in the opportunity it provides for significant impact on the business. HR must contribute and lead in the following areas:

- **Business Strategy:** Define the organizational vision and culture for the Parent and NewCo organizations, focusing on "people" as a business differentiator.
- **HR Strategy:** Align HR programs, services, and costs with business strategy. Choose what to keep and change from the prior organization to increase competitiveness.
- **HR Operations:** Split the HR organization and operations into two distinct businesses while delivering HR services to employees without interruption.
- **Organizational Transition:** Migrate leaders and employees to the right roles in each organization. Maintain morale and build buy-in to the new direction.

Experience and research show that managing people issues is a key driver of spin-off success. An examination of the challenges and lessons learned from previous spin-offs will help senior managers and HR leaders capitalize on this unique opportunity.

To that end, we first provide some background on spin-offs to aid in understanding and planning. Next, we discuss the "Top Ten" issues in a spin-off. Finally, we describe a recommended approach and principles for ensuring business success in the spin.

The Planning Challenge: No Two Spin-offs Are the Same

Although the term "spin-off" always means a separation of one part of the organization from its Parent, spin-offs vary greatly from company to company. They differ in scope, time frame, strategic intent, organization, and many other factors. Success of the spin-off requires an understanding of these factors so that a process can be designed that will produce the desired business results.

Business Rationale

One of the most important factors to consider in preparing for a split is the business rationale. Reasons for spinning off an organization can be grouped into three categories:

Financial	Increase market capitalization, improve market analysis, raise capital, improve debt to equity ratios, reduce liabilities, etc.
Performance	Shed under-performing business units, resolve past issues, increase entrepreneurship and accountability, increase speed and agility, etc.
Strategic	Compete in new markets, acquire new technology or R&D, take a new marketing or distribution approach, focus on narrower strategy, etc.

Most spin-offs are a hybrid of these reasons, but understanding the specific drivers of a particular spin-off is essential to constructing an effective plan.

Size and Scope

"Size and scope" refers to the number and size of the business units to be spun off (e.g., revenue, people, customers, products), as well as the characteristics of those business units. Characteristics include the number of countries in which the businesses operate, the degree to which they share infrastructure with the Parent (e.g., information systems, support services), and/or the extent of overlap of customers and products between the Parent and NewCo.

Size and scope have tremendous impact on the speed, resources, and processes needed to complete the spin-off successfully. Most companies underestimate how significant these differences can be. For example, meeting legal requirements in multiple countries (e.g., financial reporting, labor law) may require double the amount of work in a strictly U.S. transaction. Similarly, a decentralized unit with its own infrastructure may be able to spin off under a much more ambitious timetable.

Spin Structure

Another key factor is the type of divestiture chosen for the NewCo to split from the Parent. Strictly speaking, a *spin-off* occurs when the Parent's stockholders are given new stock representing ownership in what is established as NewCo. A new board of directors and officers are chosen, and NewCo becomes a stand-alone company. Stockholders then own shares in two companies (Parent and NewCo), but no cash is transferred.

By contrast, a *straight divestiture* is the sale of some of the Parent's operating assets, usually an entire business unit, for cash and/or stock of the acquiring firm.

Third, *liquidation* occurs when the assets of a business unit are sold off piecemeal, rather than as an operating entity.

The focus of this discussion is on spin-offs, but there are many similarities in tasks and requirements with all of these different transactions (including a merger or acquisition—the reverse of a spin-off).

Note: Spin-offs can be further segmented into ***pure spin-offs*** *and* ***equity carve-outs****. In an* ***equity carve-out****, the Parent sells an interest of less than 20% in NewCo to the public in an initial public offering (IPO). (An* ***equity carve-out*** *is typically done to raise capital and may be a prelude to a full-fledged spin-off of the remaining interests.)*

Organizational Culture

A final difference across organizations that significantly shapes the spin-off process is organizational culture. Culture is especially important to consider because although its influence is harder to see it has a tremendous effect on results.

For example, while some companies struggle with tough people decisions, such as filling key leadership positions and transitioning employees into new roles, other companies struggle with the level of execution needed to conduct a successful spin-off within timeframes, thereby missing key details or deadlines. Finally, some companies are slow to recognize how centralized their decision-making has been in the past and have difficulty operating as an entrepreneurial NewCo.

A successful spin-off requires that the Parent consider all of these factors in forming a plan tailored to its organization and business goals.

Transition *and* Transformation: Managing Competing Tensions

There are two apt metaphors for the challenges facing HR in dealing simultaneously with both transformation and transition: "changing the tires on the car without slowing down" and "redesigning the airplane without crashing." Achieving these competing objectives is the most difficult—but also the most satisfying—part of a spin-off.

"Transformation" refers to the challenge of refocusing the Parent and/or launching NewCo to function as a more competitive, market-focused organization. HR clearly plays a role in shaping the new organizational vision and culture as one that motivates employees and engages their skills. HR must also transform the HR function itself, which typically must tailor itself to better reflect the business needs and cost model of an updated organization.

"Transition" refers to the challenge of maintaining all necessary HR processes and services during a time of great uncertainty and change. During this period, employees still need to get paid and receive benefits and services. Employees and line managers need more communication as more benefit questions arise, and more help is needed with workforce planning and staffing decisions. This requires creating at least an interim HR function for two organizations from what had been a single HR department.

Operationally, the competing tensions of transformation and transition show up in decisions about time and resource allocation, both for the HR leader's role and for the HR function as a whole. While all of the work needs to get done, there are big differences for HR in terms of prioritizing each task versus defining how it adds value.

For example:

- The HR leader can work with senior management to define the future vision of the Parent or NewCo. This may include the desired culture, values, talent, customer service, and performance. But it can go beyond that to include matters traditionally outside HR, such as cost reduction or restructuring of the sales and distribution strategy.
- The HR leader can focus on ensuring high levels of performance during the transition. This may include playing a key role in shaping employee communications, creating short-term incentives and rewards, or supervising program management for the overall transition effort.
- The HR leader can focus on the HR function itself, ensuring that HR services meet all transition needs and leading the transformation toward the future HR.

These same tradeoffs apply to the HR function as a whole. What resources should be directed toward the exciting opportunities to design the future HR function? Should the "best and brightest" work on transformation, while the "steady and reliable" work on transition? To what extent should HR focus its energies internally on its own operations versus helping line managers and employees deal with change in the business? A clear set of priorities is essential to effectively manage these tradeoffs and promote business success.

What Needs To Be Done: The Top 10 HR Requirements in Spin-offs

A spin-off is much more than just a checklist of tasks, but it is helpful to understand the major categories of work that HR must lead or help facilitate. Below is a "Top Ten" list of HR requirements. Appendix A includes a more detailed listing of each.

This Top Ten list is not arranged in priority order because priorities vary significantly from company to company. Yet each requirement is important in its own right and can produce significant problems if poorly managed.

We also encourage HR staff to work closely with senior management and other support functions (finance, legal, IT, corporate communications, etc.) in a coordinated effort to manage the "Top Ten" requirements. Action will be faster, more effective, and executed with greater buy-in with this type of coordination. Some organizations establish a cross-functional Program Management Office (PMO) to provide this coordination for the Top Ten requirements, as well as overall for the spin-off.

The **Top Ten** requirements are:

1. Communication

Advise internal and external stakeholders of the direction, objectives, and progress of the spin-off. Communicate information on compensation and benefits, job implications, and HR programs and policies to managers and employees so they can stay focused on their core competencies. Use communication strategy and media to address concerns and increase commitment, appropriate to business goals. Enable the needed attitude and behavior shift from transition to genuine transformation and reinvention.

2. Maintaining Productivity

Establish goals, plans, measures, and incentives to keep the business operating effectively and to ensure customers are served during the spin-off. Use celebrations, rewards, visible scorecards, and executive/manager communications to keep employees' "eye on the ball."

3. Organization Structure

Determine which business units to spin off and how they will be organized and structured. Design geographic and organizational roles and reporting relationships. Split each of the Parent support units into two separate teams, one tailored to the Parent and one to NewCo.

4. Leadership and Governance

Establish a governance structure for NewCo and update the governance structure of the Parent, including roles for senior executives and the board. Assess internal and external candidates. Staff executive roles and the board of directors. Launch the new leadership structure to align with the new roles and direction.

5. Retention and Talent

Retain key employees during and after the spin-off. Position both companies as an "employer of choice" to help with the recruitment and retention of top talent. Adjust workforce/leadership staffing levels and skill sets to meet new business needs.

6. Executive Compensation

Benchmark, design, and financially size compensation, equity, and benefit packages for executives, staff, and the board of directors. Communicate the new packages to promote commitment and performance. Model costs and provide input for S-1 filing.

7. Stock/Equity Planning

Address the change in equity ownership resulting from the spin-off. Maintain the intrinsic value of existing option grants. Define new approaches for qualified plans, stock purchase plans, and restricted stock plans. (Equity arrangements are especially complex globally.) Assess the legal, regulatory, and financial impacts. Draft the necessary legal filings and new plan designs.

8. Employee Benefits and Liabilities

Split and/or assign all existing liabilities and tax treatments for pension, deferred compensation, long-term disability, retiree medical, and accrued vacation benefits. Develop a new benefits structure for NewCo. Model costs and liabilities and draft language for filings and plan designs.

9. Compliance Domestic/International

Identify and resolve any HR legal compliance issues. Domestically, these pertain to qualified plans, ERISA, EEOC, COBRA, HIPAA, excess parachute, confidentiality, and employment contracts. Internationally, they pertain to works councils, data protection, severance triggers, and unions.

10. HR Strategy/Service Delivery

Align HR strategy with the Parent's and/or NewCo's business direction. Determine the plan/approach to delivering HR services, both short- and long-term, including cost, infrastructure, and technology. Deliver priority services tied directly to the spin-off (talent, change management, etc.).

These Top Ten requirements together represent a significant amount of work, and it has to be accomplished in a short period of time. HR should lead much of this work, while partnering with senior management and/or other support teams on the rest. See Appendix A for further detail on each of the Top Ten requirements.

Recommended Approach and Principles

Our experience with organizations during spin-offs shows that an overall approach is essential to organize the wide range and complexity of activity required. A framework for orchestrating a spin-off is shown below.

As shown, a spin-off can be thought of as having three distinct phases: Pre-Spin/Deal Closure, Transition Management/Transformation Plan, and Implementation/Optimization. HR's role in Phase 1 is primarily due diligence. HR's major activities begin toward the end of Phase 1 and extend through Phases 2 and 3.

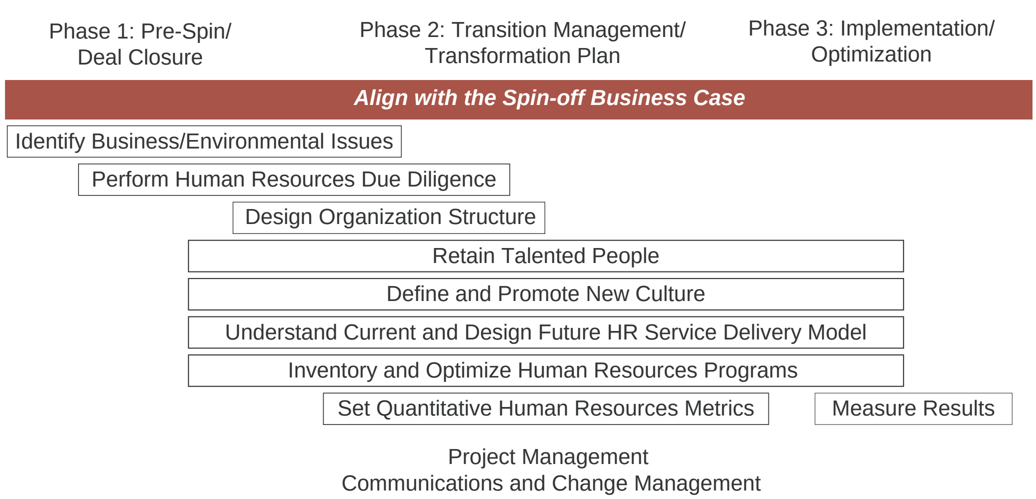
In Phase 1, HR's due diligence activities focus mainly on the financial and certain operational implications of the proposed spin-off. Knowledge of employee benefits and liabilities is particularly important at this stage, to understand the financial burden that will be assumed by the Parent and NewCo following the spin-off. Other key issues include projecting the strength of each company's leadership team and estimating the HR infrastructure cost of each company.

Phase 2 is extremely intense because of the tight schedule and the huge amount of work to be completed. HR must simultaneously perform transition management for today and transformation planning for tomorrow. Transition management affects all aspects of the Top Ten, from communication through talent retention and from stock/equity planning to compliance. Transformation planning in Phase 2 focuses on HR service delivery, talent, and compensation and benefits.

Phase 3 requires careful implementation management and measurement of increased value to the business. This phase is less about vision and design; it's all about execution. Achieving some "quick wins" is essential while building longer-term capabilities.

Program management and communication/change management span all three phases. Program management is responsible for the overall spin-off plan (either for HR alone or as part of an organization-wide PMO) and for ensuring that deadlines and milestones are met. Communication and change management ensure that all stakeholders understand what is occurring and are motivated to participate in and support the effort.

Spin-off Framework for People and Organization Effectiveness



In addition to the spin-off framework, our experience suggests that five principles are particularly important to successful spin-offs. These principles are based on our first-hand experience helping clients to lead people and organizational action during a spin-off. They are crucial to managing such a complex undertaking in a brief time frame.

Principals of Successful Spin-offs

Align with the Business Case for the Spinoff
The business rationale for the spin-off drives all decisions related to the people strategy. Use the business case as the foundation for all people-related initiatives.

Be Quick and Clear About Required Changes
Clarity and speed reduce uncertainty and diversions of key resources; commitment and focus are easier to maintain when goals are clear and in sight.

Involve Employees (where legally possible)
Employees contribute to the success of the spin-off by participating in transition teams, identifying issues and opportunities, and communicating with direct reports, managers, and peers.

Strategically Manage Communications
A communications plan and guiding process facilitates organizational stability, buy-in, and desired employee actions. Upward feedback enables course correction.

Apply an Appropriate Level of Project Management
Create "just enough" governance to oversee the process without creating unnecessary overhead. Plan the work carefully and work the plan aggressively.

Capitalizing on a Unique Opportunity

Human Resources as a profession has worked for years to position itself to have significant impact on the business. Spin-offs represent a rare opportunity to achieve this reality through:

- The ability to participate in new company, culture, and HR strategy/design
- The unusual opportunity to engage senior management, business units, and other support organizations
- The opportunity to achieve tangible business outcomes

in sum, a spin-off can provide Human Resources with a significant showcase for its capabilities, enabling it to build credibility in the organization.

But executing well on this opportunity requires leveraging the lessons from other companies that are documented in this paper. It also requires HR leaders to play a centrally positioned role of influence in a spin-off. By doing so, HR can demonstrate a higher level of performance and thereby help the business deliver significant increases in shareholder value.

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Appendix A

Additional Detail on Addressing Each of the Top Ten

Communication

Advise stakeholders of the direction, objectives, and progress of the spin-off. Use communication strategy and media to address concerns and increase commitment. Focus leadership and workforce on the business while the transaction proceeds.

- Identify stakeholder needs for employee and manager groups within both the Parent and NewCo. Note differences and how to target communications for best impact.
- Develop communication plan focused on a cascading series of key messages. Work backward from the desired end result to show what people need to know, and when.
- Focus early on communicating key compensation and benefit impacts to employees and managers.
- Equip line managers with communication messages and tools so they can serve as an effective vehicle for building understanding and buy-in.

Maintaining Productivity

Establish goals, plans, measures, and incentives to keep the business running effectively and maintaining customer service during the spin-off.

- Identify key business and transition goals to be achieved for both the Parent and NewCo during the spin-off process and time frame. Balance the need to maintain the current business and the need to lay the groundwork for the future.
- Establish measures for progress against these goals. Develop methods to report results and communicate them to key stakeholders.
- Develop rewards to motivate achievement and reduce resistance.
- Develop and communicate an issue resolution process to deal with problems that come up during transition that threaten goal achievement.

Organization Structure

Determine which business and support units to spin off and how they will be organized. Structure geographic and organizational reporting relationships accordingly.

- As part of business strategy development for the Parent and NewCo, review the current organization structure. Analyze staffing, skill sets, and past performance for all business units in light of future organizational requirements.
- Determine which business units will move directly to NewCo, which will remain with the Parent, and which will be subdivided. Identify any new business units to be added to the Parent or NewCo that did not exist previously.
- Determine reporting relationships within the Parent and NewCo, including geographical reporting. Revise previous reporting relationships as needed.
- Use the new business strategy to decide what capabilities are needed for success (e.g., stronger marketing capability). Set targets to develop the capabilities of the Parent and NewCo based on gaps identified.

Leadership and Governance

Staff executive roles and boards of directors. Establish governance structure and responsibilities for NewCo and revise as needed for the Parent.

- Perform analysis to identify gaps between the proposed corporate strategy for the Parent for NewCo and the existing leadership talent. Review gaps by geography and business.
- Develop organization structure and position descriptions for NewCo and revise for the Parent. Develop recruiting and retention tools to build a leadership "bench." Create an employee transfer policy (including "anti-poaching" protocols).
- Staff executive roles and boards of directors, drawing from the Parent company and external recruits.

- Establish governance processes for decision-making, authority, etc. Provide coaching and development to executives and board members, as needed.

Retention and Talent

Retain key employees during and following the spin-off. Position both the Parent and NewCo as “employers of choice” to aid in the recruitment and retention of top talent.

- Review staffing levels for the Parent and NewCo business units in light of organizational needs. Establish an employee transfer policy (including “anti-poaching” protocols). Estimate potential turnover and recruiting needs.
- Develop an “employee deal” concept, explaining why the Parent and NewCo will be good places to work (e.g., culture, pay, opportunity). Develop a communication strategy to build loyalty and “brand recognition” for transferring current employees and for external recruits.
- Develop retention incentives for employees overall and especially for key employees. Decide how to administer these incentives.
- Communicate the “employee deal,” including job opportunities and the employment process for transferring employees and for external recruits. Monitor acceptance rates and recalibrate, as needed.

Executive Compensation

Benchmark, design, and financially size compensation, equity, and benefit packages for executives, staff, and boards of directors.

- Prepare a country-by-country inventory and description of all compensation and benefits practices. For key executives, this inventory should take place on an employee-by-employee basis.
- Assist in choosing a peer group for comparison. Draw from proprietary databases to select: cash compensation, equity (option, ESPP, restricted, etc.), perks (cars, memberships, etc.), level and existence of qualified plan benefits (ESOP, defined benefit, 401(k), profit sharing, etc.), and health and welfare benefits.
- Prepare a country-by-country compensation and benefits strategy and components. Tailor the packages to demographics and align them with corporate strategy.
- Model costs of benchmark; develop pro forma financial statement impacts. Help develop S-1 and employee matters agreement language.

Stock/Equity Planning

Address the changes in equity resulting from the transaction; this likely includes maintaining the intrinsic value of existing option grants, developing a new approach for qualified plans, stock purchase plans, restricted stock plans.

- Perform financial analyses to determine the cost impact on the Parent and NewCo (e.g., FIN 44 analysis, value maintenance and timing of adjustments-conversions, deduction, cash flow, and overhang models).
- Conduct country-by-country due diligence and identify tax, regulatory, securities, withholding, and other roadblocks to the implementation of the equity adjustment.
- Conduct a risk management and chargeback analysis of current equity regulatory and tax compliance issues to minimize costs and avoid legal problems; draft the regulatory filings.
- Resolve administrative and technical issues arising because of changes in stock held inside qualified plans; these likely include dual-employer stock accounts post-spin, net unrealized appreciation rules, and vendor capabilities to administer dividend and x-dividend stock. Prepare the plan documents to accomplish these changes and set out vendor protocols.

Employee Benefits and Liabilities

Split and/or assign existing liabilities and tax treatments for pension, deferred compensation, long-term disability, retiree medical, and accrued vacation. Develop a new benefit structure.

- Conduct a financial review of existing plans and establish a liability-versus-asset scale. Recommend possible splits and conduct actuarial testing for compliance (FAS 106, 112, and 87).
- Suggest methods and experiences in shifting employees (retirees, actives, inactive eligibles, execs, etc.), between the Parent and NewCo. Calculate the actuarial asset splits in each international jurisdiction. Perform demographic analyses of resulting workforces and propose an investment mix for the associated asset bases.
- Calculate the value of deductions and costs to maximize coordination with other liability or debt splitting. Design split or sharing agreements to maximize deductions and equate the financial statement impact.
- Work with auditors and/or other advisors to record splits. Create cost and liability modeling tools. Draft language for S-1, PLR, and Form 10 filings.

Compliance Domestic/International

Identify and resolve compliance issues. Domestically, these pertain to qualified plans, ERISA, EEOC, COBRA, HIPAA, privacy, excess parachute, confidentiality, and employment contracts. Internationally, these likely pertain to works councils, data protection, severance triggers, labor union negotiations, TUPE, and privacy.

- Provide information to help decide whether to "clone and go" or to immediately alter NewCo benefits.
- Negotiate with vendors to keep contracts running through open enrollment. Draft documents for domestic qualified and nonqualified plans (defined benefit, profit sharing, ESOP, 401(k), etc.), and international schemes.
- Review insured costs per employee (at both the Parent and NewCo), including medical, dental, workers' compensation, disability and life and consider pooling or re-bid opportunities.
- Perform financial and legal tests to ensure compliance (self-funded arrangements, IRC and ERISA, EEOC, ADA, ADEA, COBRA, FMLA, STD).

HR Strategy/Service Delivery

Align HR strategy with the Parent's and/or NewCo's business direction. Determine a plan/approach to delivering HR services short-term and long-term.

- Working from the Parent's and/or NewCo's business strategy, identify key HR service needs, resource/budget constraints, and delivery requirements. Compare to original HR infrastructure of the Parent, including costs, services, and staffing.
- Develop key goals and strategy for re-designing the HR function to better fit the Parent and/or NewCo; this will likely include the "employee deal," service delivery model, infrastructure design, technology strategy, etc.
- Develop an implementation plan to meet short-term service needs while building future capabilities and value. Review resources and HR talent to implement plan.
- Monitor implementation of the plan and recalibrate in light of results achieved and changing business needs.