<u>American Express Co and DLJ</u>

Duty of Care

In 1972, American Express Company (Amex) bought Donaldson, Lufken and Jenrette, Inc. (DLJ), an investment bank, for $30 million. Only three years later, DLJ was widely thought to be worth only $4 million. The directors of Amex decided it was time to divest itself of ownership in DLJ – they decided to sell or get rid of DLJ.

The board thought about two ways to separate DLJ from Amex. First, they could sell the DLJ shares on the market (in an IPO) and raise $4 million. DLJ would then be owned by its new owners (whoever bought those shares) and Amex would have the money from selling the shares. One advantage of this method was that selling the shares would mean that Amex would realize a net capital loss of $26 million on the deal. This loss could be used to reduce the taxes they would otherwise owe and create an estimated tax savings of approximately $8 million. The $26 million loss on their investment would be disclosed in the income statement and reduce American Express' net income.

Alternatively, instead of selling the DLJ stock, the board could "spin-off" the investment bank. In a spin-off, the parent firm distributes shares in subsidiary as an "in kind" dividend to its shareholders. It effectively takes all the shares of the subsidiary and mails them to its own shareholders. If you owned 1 Amex share before the spinoff, after the spinoff you'd own 1 Amex share and 1 share of DLJ (a diagram is below). A spinoff would achieve the same basic goal as an IPO: DLJ would be a separate entity owned by public shareholders, with its own management, but it would have different cash and accounting consequences for Amex and its shareholders.

First, a spinoff would not reduce net income like the IPO would, because the loss in DLJ's value would be charged against accounting surplus, not against earnings. (You don't need to understand the details of this; think of it simply as the sale showing up in the balance sheet instead of the income statement). Second, a spinoff would forfeit the tax advantages of the IPO. That is, the company could have higher net income, but would forfeit the $8 million in real tax savings.

In short, both the IPO and spinoff achieved the same operational outcome. An IPO would mean that Amex recorded the loss in net income and have $8 <u>more</u> in cash at the end of the day. A spinoff would mean that Amex would record the loss in its balance sheet, and have $8 <u>less</u> in cash at the end of the day.

The costs and benefits of these two strategies were discussed by the board members at a 2 hour-long special meeting called specifically to determine the divestment strategy. The board heard advice from lawyers and investment bankers and read memos prepared on the topic. Some directors worried that, in the event of an IPO, investors would look at the decline in Amex's net earnings and that Amex's stock price would fall as a result (investors would see the earnings decline and might think the firm is doing worse). They favored the spinoff instead. Others opposed the spinoff on the grounds that it destroyed value (wasting $8 million in potential tax savings). Available empirical evidence indicated that shareholders would not care much about where the disclosures were made – investors were smart enough to focus on how much cash the firm produced and the drop in DLJ value was already well known.

Amex’s legal advisors told the directors (accurately) that they owe a duty to shareholders to act in firm’s best interest and be careful, prudent, informed, and hard working when managing the firm’s money. Directors and officers are required to act with “the care of an ordinarily prudent person in the same or

What is a spin-off?