

# **A Hard Division: Distributing the Value of a Split Microsoft Among Shareholders Would Be Tricky**

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The decision by the U.S. Supreme Court this September not to take the Microsoft antitrust case on direct appeal will enable a thorough review of the breakup order by the U.S. Court of Appeals for the D.C. Circuit. Such review, we believe, should consider a problematic aspect of the breakup plan that has been thus far completely overlooked. Readers of this paper probably have grown tired of hearing how difficult it will be to divide Microsoft's operations, patents, and people into two separate companies. But at least one aspect of the breakup-dividing the securities of the separated companies among the former Microsoft shareholders-is straightforward, right?

Wrong. Although neither the government nor the court nor commentators seem to have recognized it, such division would be far from straightforward. Finding a way to distribute the securities without imposing significant costs on some shareholders-or producing a substantial transfer of value among shareholders-will be very tough indeed.

The government has argued in its submissions to the trial court that the new securities could be distributed to Microsoft's shareholders using conventional spinoff techniques. The Baby Bills, government experts suggested, can be spun off in much the same way that AT&T spun off the Baby Bells. When AT&T was broken up in the early 1980s, subsidiaries were created for each of the regional phone companies, and AT&T stockholders received a share in each of these subsidiaries for every 10 shares of AT&T stock they held.

A spinoff of this nature won't work for Microsoft, however, because of one critical aspect of U.S. District Judge Thomas Penfield Jackson's breakup order: Any shareholder who now owns more than 5 percent of the total shares is prohibited from owning stock in more than one of the Microsoft offshoots. This restriction applies to Bill Gates, of course, and probably also to Steve Ballmer. Each of them will be allowed to have ties to only one of the two companies-the operating systems company or the applications company.

The government sought this restriction, and the trial court granted it, in order to prevent these "covered shareholders" from wielding influence in both companies. But the restriction makes it impossible to use a standard spinoff technique, since that would result in the covered shareholders holding shares in both offshoots.

## **Sell Now**

Given this restriction, there are two ways to implement the breakup order. First, Microsoft could undertake an AT&T-type spinoff, and then Gates and any other covered shareholders would be required to sell their shares in one of the two offshoots immediately. In this scenario, the covered shareholders would bear large financial penalties. One source of costs would be accelerated taxation. A conventional spinoff

enables shareholders to continue to defer taxes until they elect to sell their holdings. But if the covered shareholders were required to sell their shares in one of the Baby Bills right away, they would be forced to realize substantial gains right away. Given the size and low tax basis of the covered shareholders' positions, they would lose the opportunity to defer billions of dollars in taxes.

In addition to the tax costs, selling such large blocks of stock in a hurry would not be easy. Assuming that Microsoft's operations were divided equally, Gates would own about 15 percent of the stock of each company—that is, two blocks of stock worth about \$ 25 billion each. Normally, a block of this size would carry some premium for control of the company or for the possibility of gaining control. Given the very limited number of buyers for such a large block and the time pressures, Gates would be in a weak bargaining position. He might have to sell the stock diffusely in the market or accept a fire-sale price for the block. In either scenario, he would not achieve full value for his block of shares.

To be sure, some readers might take the view that Gates deserves to be punished if the D.C. Circuit upholds the conclusion that Microsoft, the company he has run, violated the antitrust laws. But substantial penalties should not be imposed on individuals in the absence of a judicial determination that finds such penalties to be warranted. Gates, after all, was not personally charged in the indictment. And the government has taken the position that the breakup will not harm individual Microsoft shareholders except, of course, for the elimination of monopoly profits.

### **Choose One**

A second method of divvying up the securities of Microsoft's offshoots in compliance with the breakup order would be to distribute them in such a way that the covered shareholders wind up with stock in only one of the companies. Since no one would be forced to sell stock, such non-pro-rata distribution would take care of the tax problem and the fire-sale problem. It would, however, introduce other difficulties.

The primary challenge involved in non-pro-rata distribution would be to ensure that it does not produce an unfair division of total value among the shareholders. A great advantage of conventional spinoffs is that there is no need to value the parts; each shareholder simply receives a fraction of the shares of the spun-off company equal to her fraction of the shares of the parent. However, if each of the Microsoft covered shareholders is to receive no shares in one of the resulting companies and more shares in the other, the relative value of the two companies must be estimated to determine the right exchange rate.

To be sure, an expert could be hired to estimate the value of the two companies. Given the unique nature of these companies and the legal and economic uncertainties surrounding their birth, however, estimating their value would be especially speculative. A small error, moreover, could result in a transfer of billions of dollars between the covered shareholders and the other shareholders.

Alternatively, the securities of the two offshoots could be allocated based on market values for the two companies that would be established through an initial public offering or offerings. One problem with this approach is that Gates and Ballmer might have better information than the market regarding the offshoots' prospects. Thus, if either

of them is permitted to choose the company to which his investment will be shifted after the relative values are determined, he could wind up with a disproportionately large fraction of the total value.

Instead, each covered shareholder could be required to choose his company before the market sets the prices. While such an arrangement would reduce the ability of Gates and Ballmer to profit from their informational advantage, it could lead to substantial strategic behavior (since their choices would inevitably influence the market).

Furthermore, whichever way the relative valuation question is handled, it should be recognized that the non-pro-rata scheme of distribution would concentrate Gates' investment into a much smaller company, rendering him less diversified and subject to increased risk-bearing costs.

### **Vote Half**

Thus, the two methods of complying with the breakup order would involve substantial problems. Accordingly, it might be worthwhile to consider another method for splitting up Microsoft that would require amending the order but would be consistent with its spirit and goals.

Under this arrangement, the securities would be distributed pro rata as in a conventional spinoff, and the covered shareholders would be allowed to continue holding shares in both companies, thus avoiding the valuation and fire-sale problems. To prevent the covered shareholders from wielding influence in both companies, however, each covered shareholder would be precluded from using the voting power of his shares in one of the offshoots (he could choose which one). A trustee could be appointed to vote those shares in any corporate election in the same proportion as the votes of other shareholders. Were a covered shareholder to sell his shares, the buyer would acquire normal voting rights.

This method would still impose costs on the covered shareholders, as they would not be able to maintain both the voting power and the tax deferral that they currently enjoy. But overall, it might turn out to be the least costly method for dividing Microsoft's securities.

Our concern, however, is not to determine the least costly method of division, but to highlight significant breakup issues that have been overlooked. A plan of separation that prohibits Gates and other covered shareholders from owning stock in both offshoots would involve major costs and difficulties. If a breakup is to be pursued, the government and the courts should seek to address these problems. Furthermore, these problems should be taken into account in making the basic decision of whether to break up Microsoft at all.

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