When Spin-Offs Fail aka “Honeywell’s Error”

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Divestments were all the rage in 2019, and prior to the coronavirus-induced market dislocation, they seemed to continue apace with the prior year’s expectations. According to E&Y, 84% of companies surveyed by them planned a divestment within the two years subsequent to their most recent survey in 2019.[1] There are many reasons why such spin-offs could occur – streamlining operations, focusing on a core business or its internal change, financial distress of a parent or an acquisition target, macro-economic and/or geo-political changes, among others. Fundamentally, any one reason is sufficient for a divestment, but having multiple reasons for such a divestment may also mask significant concerns in the underlying division or company being divested. This was no truer than was the case with Honeywell and its divestment of its contingent liability-weighted subsidiary, Garrett Motion.

Honeywell’s (and Garrett’s) recently contentious relationship and problems stem from the legacy of asbestos and its impact on workers, as well as the financial well-being of the companies which used or produced products with asbestos. Honeywell assumed thousands of asbestos liabilities after merging with Allied Signal in 1999. Allied Corporation, later named AlliedSignal, bought Honeywell and shed the Allied Signal name and retained ‘Honeywell’ for its corporate identity. Bendix and Garrett, two of the more well-known names in the Allied Signal portfolio, became Honeywell brands with Bendix’s brake shoes, pads and other parts becoming part of the new Honeywell along with Garrett’s turbochargers. Unfortunately, the contingent liabilities from the Bendix and Garrett brands also transferred to the new Honeywell.

Business lines from Garrett and Bendix were placed inside what became known as Honeywell’s transportation systems division.[2] This bland corporate designation was not conducive to marketing, and alongside the need to structurally silo the companies, Honeywell eventually rebranded the division "Garrett - Advancing Motion" in the summer of 2018.[3] The name harkened back to the days of the firm’s 1950s engineer, Cliff Garrett, who made his name synonymous with turbochargers and engine performance. While the name may have been a great marketing choice for the Honeywell division, the legacy associated with the division, thousands of asbestos-related suits and claims, remained.

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[1] https://www.ey.com/en_us/divestment-study/2019/why-so-many-companies-are-divesting

[2] Honeywell divested Bendix in 2014 but retained responsibility for the firm’s asbestos claims. Remaining bits of the Bendix business, including its trademark, were transferred to Garrett as part of the spinoff. Garrett thinks the associated asbestos liabilities are unrelated to it; Honeywell points out that both Bendix and Garrett turbochargers were part of its transportation systems division before the divestiture.

[3] https://www.prnewswire.com/news-releases/honeywell-announces-garrett-as-company-name-for-transportation-systems-business-after-spin-off-300666050.html

Shortly after the name change, Honeywell divested itself of Garrett, so that it could focus on its core businesses such as aerospace, construction, and industrial software. As would be seen, corporate divestments are fraught with pitfalls, and contingent liabilities only exacerbate the danger of missteps; Honeywell's divestment of Garrett was no exception.

So, one must ask, "What went wrong?" Firstly, once the decision is made to spin off a subsidiary or division, the primary consideration is whether the financial structure would impair the separate business to the point of insolvency. In this case, the new financial structure didn't; even though Garrett was to take out $1.66 billion in debt, and dividend most of that amount ($1.63 billion) to Honeywell, its debt ratios were high, but not unreasonable. However, the contingent liabilities associated with the firm's asbestos claims have and continue to weigh on the now struggling, but legally independent company. As part of the divestment, Garrett makes quarterly payments to Honeywell to cover Honeywell's ongoing asbestos liabilities. This liability was $1.32 billion and represented 90% of Honeywell's asbestos payment obligations. While Garrett is footing much of the bill, the legal liability remains with Honeywell and Garrett remains on the hook for payments up to $175 million per year over 30 years.[4] The present value of these payments is a multiple of Garrett's market capitalization, but a fraction of Honeywell's.

Legally, the separation from Honeywell seemed just as inauspicious for Garrett as the financials. Subsequent to the spinoff, Garrett claimed that "the indemnity agreement it signed [with Honeywell] was imposed upon it without proper arms-length negotiations and includes covenants that give Honeywell too much control over its corporate decisions."[5] Moreover, Garret believes that it was not provided enough information concerning the liability and its right to indemnity. To compound the complexity in the deal, the Securities and Exchange Commission opened an investigation into Honeywell 's accounting for asbestos-related liabilities and the firm had to revise upward by $1.09 billion its prior estimate of ~$1.52 billion (end-2017).[6] These facts, coupled with Garrett's requirement to compensate Honeywell for punitive damages associated with the contingent liabilities, also put the divestment of Garrett in a litigious light.

Fundamentally, then, what could have been done differently? For starters, Honeywell didn't properly isolate the contingent liabilities from its new progeny or itself. Contractually, Honeywell remained obligated to pay for these liabilities, even though it foisted responsibility for payment primarily upon Garrett.

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[4] Royal, Jim, "3 Things Investors Need to Know About Honeywell's Spinoff", *The Motley Fool*, September 20, 2018. https://finance.yahoo.com/news/3-things-investors-know-honeywell-124600241.html

[5] https://www.bloomberg.com/opinion/articles/2019-12-06/industrial-spinoffs-test-the-limits-of-breakup-logic#footnote-1

[6] The liabilities are related to Bendix Friction Materials, which made automotive brake linings containing asbestos and which Honeywell sold in 2014.
https://www.sec.gov/Archives/edgar/data/773840/000093041318003111/c92183_10q.htm

Secondly, the indemnification and accounting for the liabilities came into question to the point where such claims were dramatically revised, and perhaps could be challenged. Proper actuarial assessment could, and should be done, at least to the point where an independent third party would concur with a range of amounts due over the existing 30-year accounting =-related requirement for reserves.

The self-insurance mechanism which Honeywell effectively put into place also remains contingent upon the continued success of Garrett. While Garrett and its management may have the wherewithal to weather the ups and downs of the cyclical market in which they operate, it remains unclear whether they will be able to do so while making payments to Honeywell.

A better solution for the company (divestment aside), would have been to engage in a true sale of the legacy subsidiary that created the asbestos-related contingent liabilities on its books to a third party. Managing such a large liability creates a cost center all its own, and in Garrett's case, not even tax benefits accrued to the company in making its liability-related payments to Honeywell. A third-party investor and manager of contingent liabilities is often a better solution for any company, especially one with such a large amount of contingent liabilities. The selling company is relieved of its burdens, and any insurance and reserves and the transference of the liabilities are calculated in a fashion to preclude follow on litigation at the corporate level, as the transaction is negotiated at arms-length with a truly independent owner. Moreover, in the case of Garrett and Honeywell, their respective balance sheets would be relieved of liabilities which could otherwise burden M&A and capital markets opportunities, as well as provide the prospect of improved cost of funds. While not for every situation, a sale of contingent liabilities is one that can bring immediate financial relief as well as qualitative measures appreciated by investors, financiers, shareholders and partners alike.