

Special Issues in Carve-out transactions

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Overview of Carve-Outs

- Acquisition or disposition of a division, subsidiary, or business unit of a larger enterprise
- Complex transactions, with many opportunities for creative lawyering

Structuring your carve-out



Deal Structure Generally

HOW BEST TO STRUCTURE A TRANSACTION FROM AN EXECUTION AND TAX PERSPECTIVE

- Depending on how the Business and related assets have been held and run and related tax considerations, transaction may end up as an asset sale, a stock sale or a mixed asset and stock sale
- Buyers often prefer asset sales, but they are generally more complex
 - Issues such as third party consents and the transfer of employee benefits are more prominent in an asset sale
 - Depending on how the Business is structured, a mixed stock and asset sale may be necessary
- Tax structuring issues and alternatives include:
 - Stock sale with Section 338(h)(10) election
 - Reverse Morris Trust election
 - Seller's receipt of equity and/or cash consideration in the sale
- If a stock sale is both preferred and possible, need to confirm whether there are any assets or liabilities (i) primarily related to the Business that are held outside of the companies to be sold or (ii) primarily related to retained businesses that are located within the companies to be sold
 - If there are, then some restructurings or a mixed stock/asset sale structure for the sale will be required

Deal Structure Generally

TACTICAL PLANNING

Tip for Seller in an auction process:

- As soon as possible (preferably in Phase I of the process), give bidders an overview of Seller's proposed transaction structure
 - Designed to give Seller greater control over the sale process by corralling all bidders into Seller's preferred transaction structure – *i.e.*, less likely “rogue” bidder will suggest alternative structure
 - Allows Seller to more easily compare bids
 - Particularly advantageous where Seller can use the structure of transaction to obtain a preferred outcome
 - For example, structuring a carve-out as a pure stock deal with a pre-closing restructuring vs. a partial stock and asset deal may avoid possibility of buyer introducing a “your watch-our watch” construct

Defining the Business



Defining the Business

- Define the Business
 - Analyze the Business both from a functional perspective and with respect to corporate structure
- What assets are needed to conduct the Business? What liabilities should be borne by the Business?
 - Particular consideration should be given to shared assets and liabilities, such as:
 - Corporate assets that are used in more than one business (e.g., real property, office equipment, software, books and records)
 - Blended contracts
 - Patents and other IP assets
 - Corporate level debt of Seller that is also attributable to the Business
 - Tax liabilities and benefits
 - Litigation matters and contingent liabilities
 - Exposure as defendant or indemnitor
 - Claims held as plaintiff or indemnitee
 - Which employees should go with the Business versus remain with Seller?
- A similar analysis should be undertaken with respect to Seller's retained businesses

Allocating Assets & Liabilities

- Once the assets and liabilities that belong with the Business are identified, determine where those assets and liabilities reside as a legal matter
 - How can “misplaced” or joint assets and liabilities can be transferred or shared?
 - Transfers or assignments of specific assets or liabilities may raise issues, including:
 - Are third-party or governmental consents required?
 - Are any other third-party rights triggered? (E.g., ROFR; tag-along; put right under debt securities)
 - What are the tax and accounting consequences of transfer?
 - Does the carve-out constitute a change in control under employee benefit plans and other employment arrangements?
 - Seller and Buyer may enter into agreements to share services, rights or liabilities after the carve-out occurs
 - For instance, transition services agreements; tax sharing agreements; real property leases; IP licenses
 - If assets or liabilities cannot be legally transferred before closing:
 - One party may operate an asset for the other’s benefit until transfer is feasible
 - Consider how indemnification, reimbursement or other contractual arrangements can address assets and liabilities that cannot be transferred to achieve equivalent economic results
 - Intellectual Property assets can raise particularly thorny issues

Case Study

SHARING OF KEY BRAND ACROSS MULTIPLE JURISDICTIONS

- Background
 - Issues often arise where a seller insists on retaining ownership of worldwide rights in key brand even though the business it was selling was wholly or heavily reliant on the key brand in the marketplace
 - Buyer often prices its bid on the basis that it will receive ownership or exclusive rights to the key brand for the territory or business segment it is purchasing with freedom/flexibility to modify and improve the brand as it sees fit
 - Where the seller refuses to enter into any type of joint-ownership or co-existence arrangement, a trademark license can be negotiated to address these issues in various ways

Case Study

SHARING OF KEY BRAND ACROSS MULTIPLE JURISDICTIONS

- Possible solutions

- Buyer-friendly outcome

- A perpetual and exclusive license to key brand in the U.S. on any products with very limited exceptions
 - Limited quality control provisions and freedom/flexibility for buyer to create new marks and new products utilizing the key brand without seller's prior approval
 - Seller retained ownership of the key brand and new marks that utilize the key brand with freedom to use new brands outside of the U.S.

- Seller-friendly outcome

- A long-term (but not perpetual) exclusive license to key brand for certain business segment
 - Fairly limited quality control and freedom/flexibility for buyer to combine key brand with new/existing marks to help transition in the marketplace
 - Seller retained the ability to terminate buyer's exclusivity early after a certain minimum term by paying buyer a pre-negotiated amount based on the number of years left in the exclusivity
 - Buyer would retain a non-exclusive license to continue use of the key brand for the remainder of the term

Non-assignable Contracts



Anti-assignment Clauses

HOW TO TRANSFER THE CONTRACTS OF THE BUSINESS TO THE BUYER

- In some cases, assets and/or liabilities that would ideally be transferred are not transferrable for legal or practical reasons
 - Anti-assignment or change of control clauses could be triggered by the carve-out sale itself, or by an internal restructuring prior to the sale
- Partial assignment of shared contracts
 - Parties may need to transfer a contract in part, and retain it in part
 - Which party will have primary responsibility for the contract (e.g. invoicing, receipt of notices, exercise of renewal/termination rights, etc.)
 - Seller may not wish Buyer to receive an unredacted copy of the shared contract
- Contracts and assets that cannot be assigned or transferred
 - In some cases, contracts cannot be transferred immediately due to lag in receiving a license or permit, or customer consent

Non-assignable Customer Contracts

- Structure
 - Many commercial agreements do not permit an assignment, except for an assignment to an affiliate. And they are often silent as to a change of control.
 - Is it permissible to assign the contracts to a newly formed subsidiary of the Seller, and sell the equity of the subsidiary to the Buyer?
- Anticipate potential customer reaction
 - Consider specifying how Buyer and Seller will conduct interim period outreach to affected customers
 - Assess customers' willingness to accept the transition

Non-assignable Customer Contracts: Shared Contracts

- “Constructive trust” constructs should be carefully drafted
 - Seller may agree to continue to hold the contract in constructive trust for the Buyer, and pass through revenue and expenses
 - Buyer may need a consent rights over terminations and amendments
 - Will Buyer have the essential employees and assets to perform its portion of the contract at the closing, or will it also rely on Seller to meet any service-level commitments?
 - Parties covenant to use efforts to amend and separate the contract
 - Further assurances to make conveyances of the contract Third Bullet: 14 pt. font
 - Assurances should be cabined by an end date
 - Does Buyer bear the risk if the contracts cannot be assigned or otherwise conveyed before the end date?

Benefits/Employee Issues



Benefits/Employee Issues

- First step is to identify which employees will remain with Seller and which will go with the divested Business
 - Operational or “line” employees associated with the divested Businesses typically (but not always) remain with the divested Businesses
 - Are there any shared employees, and what will the plans be in that respect?
 - Does Seller wish to retain any Business employees and, if so, whom and should you provide for a non-solicit/non-hire in the purchase agreement?
 - More difficult question is whether any corporate, administrative or support personnel will be transferred
 - Buyer will be concerned that it is getting all of the employees it needs to run the Business and that it has sufficient support and back-office personnel to support the Business
- Need to understand the benefits that the transferred Business employees enjoy, which Seller entity(ies) employs these employees, the structure of any sale incentive package and whether any benefits obligations will be transferred to Buyer in the sale
 - Also need to understand whether Buyer intends to fold Business employees into existing plans or create new plans (virtual certainty in the case of PE firms)

Benefits/Employee Issues *(cont.)*

- Need to diligence whether there are any pension funding requirements in specific countries that can give rise to questions as to whether a Seller has adequately funded any required plans in a specific country
- Does divestiture trigger any termination or severance payments or other concessions under existing employment arrangements?
- To what extent will employees going with the divested Business receive credit for prior employment with Seller for purposes of determining eligibility for, and vesting under, benefit plans offered by the divested businesses/operations?
- Will any adjustments be made to existing stock options held by the employees going with the divested Business?

Issues in Carve-Out Financial Statements



Status/Quality of Financials for the Business Being Sold

- Do financial statements for the Business being sold exist?
 - If so:
 - Have the statements been separately audited or only audited as part of the Seller audit? If the latter, how material is the business to be sold relative to the entire Seller business?
 - Have any accounting policies been adopted that can materially affect the P&L?
 - If not, care must be taken to ensure that financial statements are completed in time to avoid transaction delays and/or closing risk
 - Carve-out financials often take significant time to prepare due, in part, to the nature of carve-out accounting and cost allocation issues
- If Buyer or Seller is a US public company and the acquisition is material (under SEC rules) to Buyer or Seller, then audited financials to be sold may be required
- For these reasons, Buyer may insist that the delivery of financials (or audited financials) for the Business is a condition to Buyer's obligation to close
 - A condition that financials must be “satisfactory to Buyer” may give Buyer sufficient latitude to walk in the face of adverse developments
 - While a condition that the audited financials will not deviate from unaudited financials in any material respect is more objective, it nevertheless creates meaningful closing risk
 - Consider trying to give an indemnity for any material differences, but not bearing any incremental closing risk

Purchase Price Adjustment Issues

- Should the sale agreement contemplate a purchase price adjustment (relatively customary)?
 - If so, based on what metric (working capital, net tangible assets, etc.)?
- Should there be any specific carve-outs from, or adjustments to, the base metric definition (e.g., any assets removed or added in a restructuring)?
- Is there any seasonality to the Business (or intra-month movements to the working capital levels) that need to be taken into account in setting the base working capital or other figure?
 - Buyers often retain accountants who specialize in M&A transactions generally and adjustment disputes more particularly when looking at a business
 - Seller might consider having its own M&A accountant specialist to represent it on the transaction in order to be better prepared for those negotiations
- Consider need to close at month-end to deal with any intra-month movements in working capital or to simplify accounting treatment related to the Business being acquired.
 - Needs to be weighed against incremental closing risk of delaying completion

Shared Services between seller and divested business



Shared Services Between Seller and Divested Business

Background

- Numerous corporate services (such as payroll, employee benefits administration, tax preparation and information systems) may be jointly used by both the divested and retained businesses/operations
- Typical to have certain of these services provided from either the divested or retained businesses/operations to the other on a “transitional basis” in order to ease the separation process
- Where common facilities are shared, appropriate solutions can be found through joint usage, subcontracting/subletting or other contractual arrangements

Post-Separation Arrangements

TRANSITION SERVICES AGREEMENTS

- Typically, Seller and the divested business (and/or the Buyer) agree to a post-separation Transition Services Agreement
 - Specifies the services that Seller will provide to the Business for a limited period post-closing.
 - How will the services be priced? Will they be subject to adjustment?
 - May Buyer request additional services post-closing, or does Buyer need to anticipate in advance each service that it will need to run the business?
 - What is the term of these obligations? Under what circumstances can the agreement be terminated? What are the performance standards?
 - Will Seller need to negotiate additional licenses or third-party consents from applicable enterprise software providers in order to provide the services post-closing? Will TSA require Seller employees to access Buyer data?

Obligations to “Stand Up” Divested Business

Background

- Buyers (especially PE buyers) are more often requiring that Seller “stand up” the divested business pre-closing with respect to IT, disaster recovery, HR processing, treasury systems, facilities, etc.
- Buyers are unwilling to rely solely on transition services
 - Concern especially high where information security is an issue and Buyer concerned about data security breaches
- Sellers also sometimes concerned with providing transition services, particularly where that will require access to a Seller’s IT systems (especially in industries that collect sensitive data)
- Two Key Issues
 - Closing risk – tension between Buyer wanting a closing condition that the company can operate independently and seller wanting certainty of closing
 - Who pays the cost?

Obligations to “Stand Up” Divested Business

Possible solution

- No closing condition, but:
 - Closing could not occur for 3 months to allow time to put systems in place
 - Seller obligated to use commercially reasonable efforts to establish systems using nationally recognized service providers
 - TSA back-stop if service not operational at closing
- Buyer’s consent (not to be unreasonably withheld) required before entering into service provider arrangements
 - Buyer concerned, for example, with seller back-loading costs that would be borne by company post-closing
- Responsibility for costs allocated between Buyer and Seller – Seller not obligated to pay in excess of scheduled costs

Deferred or Staggered Closings



Deferred or Staggered Closings

- When divested businesses span multiple jurisdictions, it is not atypical for legal requirements in certain jurisdictions to extend well beyond the time required to close the transaction in the primary jurisdictions
 - Typically, a seller does not want to delay the closing until all these legal requirements are met since a seller is typically concerned with (i) minimizing closing risk and obtaining the transaction consideration as soon as possible
 - In addition, a buyer is often anxious to obtain control of the business
- Typically addressed by providing for “delayed closings” – i.e., the transaction closes in most jurisdictions on a first closing date, and once the applicable legal requirements are met in other jurisdictions, subsequent “delayed closings” occur
 - Not an effective solution where a material portion of the business would be “left behind” and there is meaningful risk that a required legal approval would not be granted

Key Negotiated Issues Associated with Deferred Closings

- Purchase Price
 - Purchase price for any deferred businesses must be separately determined
 - Often paid into escrow at the first closing and released once delayed closing occurs
 - Sometime if a deferred closing is delayed beyond an agreed date, purchase price increases – aka a “ticking fee”
- Control/Governance
 - Buyer will seek control over management and operation of the deferred business
 - However, any such control must comply with applicable legal requirements
 - At a minimum, seller prohibited from taking actions over deferred business that would have been prohibited by the interim operating covenants between signing and closing
- IP Rights
 - Buyer will often seek to ensure that any IP conceived or created by the deferred business after the main closing and prior to the relevant deferred closing will become buyer’s property

Key Negotiated Issues Associated with Deferred Closings

- Net Economic Benefit
 - Parties typically desire for the net economic benefit (cash received in excess of expenses) from the deferred business to accrue to buyer
 - Monthly true-up payments often made between the parties, with monthly reporting of “cash surpluses” and “cash deficits”
 - Sometimes parties contemplate post-deferred closing adjustments to account for any difference between estimated and final calculations
- Seller Liability
 - Seller will often seek to limit its liability with respect to the deferred business during the deferral period – akin to a service provider under a transition services arrangement
 - Typical exceptions include:
 - Seller taking action in contravention of buyer’s instructions
 - Seller’s gross negligence (or sometimes breach of limited covenants)

Post-Closing Non-Competes



Post-Separation Arrangements

NON-COMPETE AGREEMENTS

- Buyers frequently insist on a non-compete from Seller with respect to the divested business
 - Frequently-negotiated points:
 - Duration
 - Geographic area
 - Definition of “competing business”
 - Permitted exceptions (e.g. for Seller’s retained businesses, or for Seller’s acquisition of entities where a “competing business” represents less than X% of revenues)
- Reciprocal non-solicit/non-hire covenants are also common

Striking an Appropriate Non-Compete Balance

- Situations where “challenging” complexities arise:
 - Seller is a supplier or service provider to or customer of the divested business
- Possible solutions
 - In a supplier/service provider situation, consider a tiered non-compete:
 - A “core” tier where seller is completely prohibited from competing in certain fundamental (but narrowly defined) areas
 - A middle tier where seller could continue to operate, but effectively prohibited from growing/expanding the business
 - For example, seller could not exceed historical volumes, and sales could only be made to existing customers for existing products in existing geographies
 - A lowest tier where seller could operate a business if it was meaningfully engaged in that business prior to signing, and with no limitation on growing/expanding that business

Speaker Biographies



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