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CONSIDERATIONS IN CARVE-OUT TRANSACTIONS

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A notable feature of the 2019 deal-making environment is the significant number of carve-out transactions that have been executed. These transactions have involved many different structures, from divestitures of entire business segments to sales of single brands. The unifying theme of these diverse structures is, of course, that they involve the "carve-out" of a business from a larger going concern. This article focuses on the unique, multifaceted and often intertwined issues that arise in planning and executing carve-out transactions.

General Considerations

Why a Carve-Out?

Broadly speaking, carve-out transactions fall into one of two buckets. The first group could be termed "regulatory divestitures." In this context parties to a pending business combination agree, either proactively or reactively, to divest assets in order to assuage regulatory concerns about the effects of the pending business combination on competition. In antitrust parlance these carve-outs are referred to as "structural remedies" for addressing competition concerns. The second group, which is the primary focus of this article, could be termed "commercial divestitures." Commercial considerations, whether strategic or financial, are the primary motive for these carve-outs. For instance, in the course of reviewing its portfolio of businesses, a company might identify business lines or products that are "non-core" to strategy, under-resourced, or less competitive than its other offerings. One alternative for these assets is to divest them and put the sale proceeds to better use, whether through new investment in "core" assets, R&D, deleveraging, or returning capital to stockholders. Commercial divestitures were, for example, a key strategy of General Electric Co. under the leadership of Jack Welch. Mr. Welch famously employed the slogan that if a GE business was not first or second in its market, then GE would either have to "fix it, close it or sell it." And sell it they did: GE sold 71 businesses during Mr. Welch's first two years at the helm alone.[1] Another alternative for such assets is to spin them off. We will touch briefly on this alternative later in this article as well.

Notably, a commercial divestiture is not always the brain-child of a corporate decision-maker. The call that a public company divest a

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business line or break-up entirely, whether through one or more sales or spin-offs, is a familiar refrain of the stockholder activist. In fact a break-up or divestiture was the activist's thesis in 28% of M&A-driven activist campaigns launched in 2018.[2]

Defining the Business To Be Carved Out

Unlike the sale of a whole company, in which the buyer acquires each and every asset (and liability) of a going concern, the asset and liability perimeter of a carve-out transaction needs to be defined with particularity. In a commercial divestiture of any meaningful scale, however, it would be virtually impossible to list every single asset to be transferred and liability to be assumed. Accordingly, the first step in any carve-out is to craft a workable definition of the business to be sold. This step is critical from both a commercial perspective and a legal one. From a commercial standpoint a clear understanding of the business to be sold avoids any ambiguity in planning and allows clear and coherent analysis and messaging of the transaction. From a legal perspective a clear definition of the business being sold is vital to ensuring the envisaged transaction is documented accurately and efficiently.

At a more granular level, the definition of the business shapes the perimeter of the carve-out by providing the reference point for identifying those assets that are to be included in the divestiture. A seller, wishing to retain all assets used in its other businesses, will typically propose to limit the assets being transferred in the carve-out to those "exclusively" related to the carved-out business. A buyer, by contrast, will be motivated by the opposite concern and want to acquire all assets of the seller "related" to the carved-out business. A common middle-ground is to agree upon a "primarily" related standard for defining the universe of carved-out assets and negotiating tailored treatments for asset categories for which this general standard is not appropriate. Given these competing interests, one can see why a shorthand or vague definition of the business to be sold can be a rich source for future disputes between principals over which assets are "in" or "out" of the transaction. Accordingly, close and careful coordination between businesspeople and counsel is integral to aligning on an appropriately detailed and comprehensive definition of the business to be sold.

On the liability side, a typical seller will want the buyer to assume all historic liabilities of the defined business. On this view the transfer of ownership of the business means that the seller should have a "clean break" from such historic liabilities. A buyer, by contrast, will often take the position that the seller should retain all historic liabilities on the basis that they arose

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under the seller's "watch." This negotiation should be considered in the context of the legal structure of the transaction. When a buyer acquires a legal entity as part of the carve-out, all liabilities of that legal entity travel with it as a matter of law, regardless of the nature of those liabilities. Accordingly, careful due diligence is required whenever "mixed-use" entities are acquired to ensure that any legacy liabilities associated with historic operations are not of concern or are appropriately insured or indemnified. If the seller agrees to remain on the hook for any historic liabilities of a transferred entity, the seller will need to indemnify the buyer as and when such liabilities become due. The value of any such indemnity will depend on the creditworthiness of the indemnitor. When, by contrast, the carve-out is structured as a sale of assets, the buyer does not assume any liabilities that it does not contractually agree to take on (subject to the state law doctrine of successor liability). In either scenario, the ability to allocate historic liabilities in deal documents provides room for creativity and can be a key value point, particularly in view of the information asymmetries between buyers and sellers.

Financial Statements

The process for preparing carve-out financial statements goes hand-in-hand with defining the business to be sold. Sellers should be mindful that the preparation of these financials can be a significant undertaking. Difficult judgments may be needed on the right approach to allocating liabilities or shared assets and how to appropriately present the revenues and costs of doing business on a carve-out basis. A buyer's ability to review carve-out financials is an important component of a fulsome and complete buyer due diligence process. For example, liabilities that are not recorded in the ultimate parent company's consolidated balance sheet because of GAAP materiality determinations may need to be recorded in the carve-out balance sheet.

For a public company considering a carve-out sale, the company's existing independent auditor is a natural candidate to support preparation of the carve-out financials. But the carve-out financials do not necessarily need to be audited. In fact, a seller may prefer to avoid the time and expense involved in an audit process. Many smaller carve-out deals are executed on the basis of unaudited carve-out financials. Purely as a due diligence matter buyers will prefer receiving audited financials in view of the comfort added by the audit process. In addition, when a buyer plans to rely on third party debt financing to fund the planned acquisition—whether bank or bond—audited carve-out financials may be necessary. Moreover, in the case of a U.S. public company buyer, Rule 3-05 of Regulation S-X generally requires such a buyer to provide separate audited annual and unaudited interim pre-acquisition financial statements of the business being acquired where the carved-out business meets specified acquisition significance thresholds. The number of years of historic financial information that must be provided depends on the relative significance of the acquired business to the buyer.[3]

Another topic of negotiation is the level of cooperation that the seller is to provide in the preparation of additional financial statements between signing and closing; this negotiation is often framed by the financial information that is needed for buyer's debt financing. The buyer may also seek a commitment from the seller to make the appropriate seller personnel available for due diligence sessions, lender presentations, road shows, and other miscellaneous calls and meetings in connection with the arrangement of buyer's debt financing for the carve-out.

Sellers are also expected to provide various representations and warranties about the carve-out financial statements in the definitive sale agreement. These representations and warranties will address matters such as confirmation the financials were prepared in accordance with seller's books and records, accurately present the financial condition and operating results of the carved-out business, and reflect or adequately reserve for material liabilities. Traditionally a seller would agree to indemnify the buyer for any losses arising from an inaccuracy in these representations and warranties (subject to agreed-upon baskets and caps). But in the

current market, buyers in carve-out deals are expected to rely on a representations and warranties insurance policy as their sole recourse for losses arising from all but the most fundamental representations and warranties.

Legal Structure

Another consideration is the legal structure by which the carved-out business will be conveyed to the buyer. Common structures include a direct asset sale, a sale of the entities that own transferred assets, or a mix of the two. More exotic structures, such as a reverse Morris Trust, are sometimes utilized when specific tax objectives are sought.

In carve-outs structured as a straight equity sale, all contracts of the transferred entity or entities will travel with them as a matter of law when they are sold to the buyer. Accordingly, the contracts to which these transferred entities are party will need to be reviewed to confirm whether they include a provision that affords certain rights to the counter-party upon a change of control. Common examples of such rights include a right to be provided with advance notice of the change of control and, sometimes, a right to terminate the contract at the counterparty's option. In a direct asset sale structure, whenever the consent of a contractual counterparty is required before the contract can be assigned, the contract cannot be conveyed to the buyer at all until such consent is obtained. Appropriate contractual due diligence is therefore necessary to understand the interplay between the structure of the carve-out and existing commercial agreements.

Purchase Price Elements

Carve-out transactions are typically priced on a cash-free and debt-free basis. In theory, this means that any cash or cash equivalents delivered with the carved-out business will result in an upward adjustment to the purchase price. Conversely, any debt assumed with the carved-out business will result in a downward adjustment to the purchase price. Practice is more complicated, however, as parties often seek to negotiate over which "cash-like" and "debt-like" items should appropriately result in purchase price adjustments.

Another purchase price element in carve-out transactions is working capital. In a carve-out, sellers typically agree to deliver the business with a "normalized" level of working capital. Any shortfall or surplus relative to this normalized peg results in a purchase price adjustment. Because a carved-out business lacks a standalone operating history, however, triangulating a normalized level of working capital can be challenging in practice. The parties should also align on the accounting principles to be used in calculating any working capital surplus or shortfall.

Separation Planning Considerations

Separation Framework

The carve-out of a business from a going concern presents meaningful separation complexities. Ideally, from a separation planning standpoint, the carved-out business would already be operating structurally and commercially on a standalone basis, with its own IT architecture, real estate footprint and allocated personnel. In practice, however, this is rarely the case; IT architecture is often comingled, shared sites are common, and employees often split their time among the seller's various businesses. It is particularly common for vendors to be under contract to provide goods or services to both the carved-out business and the seller's other remaining businesses. In order to thoughtfully carve-out these arrangements the seller's contract management team must, as an initial step, identify these shared agreements. Once the shared contracts are mapped, proposed transfer strategies (such as splitting or subcontracting) need to be assigned by commercial personnel with appropriate functional expertise. At this point counsel will then need to assess whether the counter-party has a consent right over the proposed transfer. When consent is required in this context vendors often seek to negotiate significant concessions. Such transaction costs need to be taken into account by the buyer and its financial advisors for modeling purposes. For this reason buyers regularly insist on full

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visibility into the seller's separation plan prior to signing. The inability of a seller to efficiently and confidently provide this visibility will raise questions about feasibility and cost of execution. A sensible transaction timeline should, therefore, build in an appropriate buffer for thorough separation planning.

In order to obtain additional comfort on the seller's separation plan, a buyer will often require the seller to represent that the assets being sold are "sufficient" for the buyer to continue operating the carved-out business in the ordinary course on a standalone basis. This representation is typically tested against a negotiated benchmark, such as the manner the carved-out business was operated by the seller the moment before the carve-out was completed or in the year leading to completion. Before agreeing to provide a "sufficiency" representation a seller is well-advised to engage in granular separation planning to identify in detail how the carved-out business is to be unwound from the seller's existing operations.

At a more general level, the process of splitting and migrating assets in a carve-out is sometimes memorialized in a formal reorganization plan. Such a plan is designed to neatly package the carved-out business for sale. The terms of such a plan will vary based on the circumstances, but it will often include maps for migrating retained assets out of entities to be sold (so-called "reverse carve-outs") and vice versa. The reorganization documents should track the terms of the definitive sale agreement to ensure that the carved-out business is indeed being properly migrated. The reorganization should also be appropriately documented from a corporate approvals perspective; it is not unusual for an omnibus form of written consent to the reorganization be adopted by the governing bodies of each of the seller-affiliated entities involved.

Intercompany Arrangements

The process of identifying shared third-party dependencies is only one side of the separation planning coin. The other side is mapping any intercompany arrangements in place between the seller and the carved-out business. As one example, the seller may operate a factory that produces an input used in multiple seller business lines, including the carved-out business. Such intercompany arrangements are typical and, for this reason, one or more commercial agreements between the seller and carved-out business will often be put in place at transaction closing. Another frequent interdependency is credit support. Often a seller, as the most credit-worthy entity in a broader organization, provides payment and performance guaranties or deposits on behalf of the carved-out business. These support arrangements will need to be identified and replaced by the buyer in the carve-out. When a buyer is unable to replace the credit support arrangements a seller typically requires special indemnity as recourse in the event such support arrangements are utilized post-closing.

Transition Services Agreements

As outlined above, a carved-out business is often deeply engrained in a seller's corporate infrastructure. For this reason it will typically be impossible for a carved-out business to be ready to function as a truly standalone unit as soon as the transaction is completed. This is especially likely when the buyer is a financial sponsor that lacks an existing platform to integrate the carved-out business into. While a seller may prefer to achieve a "clean-break" with the carved out business, a seller's commitment to provide "transition services" to give the buyer time to build-out or source missing infrastructure is often key to the buyer's underwriting process and a critical element of a complete separation framework.

Careful commercial due diligence is needed to identify which transition services are required and the duration over which they should be provided. Often the individuals needed to identify and define the transition services will be the personnel involved in, and transferred with, the carved-out business. Sellers should be mindful of this fact, since such employees may naturally have goals or loyalties that diverge from the seller. The buyer and seller should also plan for the contingency of identifying additional services that are needed on a

transitional basis that were overlooked during initial separation planning. One approach to addressing these oversights is to align on a framework for negotiating transition arrangements for the omitted services. Another approach is for the buyer to make an indemnity claim under the "sufficiency" representation, which we described above, and use the proceeds of the claim to obtain replacement services.

As with any commercial agreement, the buyer and the seller will need to align on fundamental topics such as the level of care and quality with which the transition services will be provided and the remedies that will be available if these commitments are not met. Sellers will often seek to cap damages at the amount of fees paid by the buyer for the transition services (or some multiple thereof) and exclude any recovery for consequential damages.

Pricing transition services is another matter for negotiation. In the commercial divestiture context, in order to ensure the buyer has an appropriate economic incentive to implement alternatives to the transition services, pricing for transition services often escalates if the buyer wishes to extend the transition services beyond the initial agreed term. A concerned seller can also implement other measures to help ensure the buyer ceases using the transition services in a timely fashion, including requiring the buyer to develop and implement an appropriately detailed transition plan.

The form of agreement governing the provision of transition services is typically fully negotiated at signing and appended to the definitive sale agreement. When this is not possible due to timing or other considerations, the buyer and seller can align on a term-sheet at the time of transaction announcement and finalize a complete transition services agreement between signing and closing of the carve-out. This approach is, however, a distinctly second-best alternative to having a fully negotiated transition services agreement in hand at signing as it may gloss over unrecognized and important points of difference between the buyer and seller.

Employee Matters

In any carve-out the buyer and seller must determine which employees will remain with the seller and which will be transferred with the carved-out business. At bottom, a buyer will want comfort that it is getting the employees needed to run and support the business on "day one." This can be difficult to assess. In large organizations, for example, it is common for a significant employee population to be only partly dedicated to the carved-out business. The challenge of ensuring the right employee population will be transferring is magnified for a buyer, such as a financial sponsor, that lacks an existing employee base. The opposite is often true for large strategic acquirers; these buyers will have a well-established personnel base and may not wish to take the full employee population the seller envisions transferring. If the transaction will result in significant redundancies then obligations arising under labor laws should be front of mind. In addition to agreeing on the universe of transferred employees the buyer and seller will also need to allocate responsibility for any obligations, such as severance payments, arising in connection with employee transfers in the transaction.

It is often difficult to predict how employees affected by a carve-out will react to the deal announcement. For this reason the retention of employees is something that buyers and sellers are wise to consider prior to signing a definitive sale agreement. The parties can work together to develop appropriate retention packages, such as a stay bonus program, to incentivize key employees to remain with the carved-out business until transaction closing. As additional protection against attrition, the seller will often require the buyer to commit to maintain the salary, benefits and bonus opportunity of the affected employee population for some period post-closing. The duration of this commitment and its precise terms are often the subject of extensive negotiation. In our experience, the best outcomes are achieved when in-house HR and benefits experts work closely with external counsel in negotiating an appropriate package.

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Real Estate Matters

Another separation issue in carve-out transactions is addressing the physical space that the carved-out business operates in. Because carved-out businesses generally do not operate on a structurally standalone basis, there is often not a clear division of real property as between the carved-out business and the seller's other business units. Multiple segments may use different production lines in a seller-owned factory or share office space, for instance. While the most straightforward solution from the seller's standpoint may be to simply require the buyer to take full responsibility for addressing the space needs of the carved-out business, this approach can be a major source of business disruption and could create valuation issues. Accordingly, buyers and sellers often try to devise more cooperative solutions. When the carved-out business shares space with retained seller operations under a common lease, for example, the parties may align on a commercial subleasing arrangement. If the carved-out business operates on land owned by the seller, lease arrangements or partial title transfers could be considered. Each solution poses its own complexities, from day-to-day issues like ensuring appropriate information barriers are in place at shared sites, to liability allocation issues if a site with environmental liabilities is being divided.

Additional Considerations

Post-Closing Covenants

Buyers in carve-out transactions often try to bind sellers to various restrictive covenants that apply after the deal has closed to help ensure they receive the benefit of their bargain. One such commitment is the non-compete covenant, which requires a seller not to compete with the carved-out business for a specified period of time. This covenant is meant to protect the buyer from acquiring a so-called "pig-in-a-poke"; the theory is that the value of what the buyer is purchasing would be diminished or even destroyed if the seller could immediately use its resources, know-how and relationships to replicate the carved-out business right after it has been sold. Defining which competitive activities will be prohibited is often the subject of involved negotiation, particularly in respect of actions that are not overtly competitive.

Another post-closing commitment commonly sought by buyers is a "no-poach" or "non-solicitation" covenant. This covenant restricts the seller from soliciting or rehiring employees that are transferred with the carved-out business. In this context, buyers take the view that the talent of the carved-out business employee base is a key asset being acquired. As a compromise, sellers often seek exceptions to a no-poach covenant, such as the ability to re-hire employees of the carved-out business who respond to general (non-targeted) employment solicitations or who are made redundant by the buyer.

It is important that antitrust counsel review both the scope and duration of any non-compete or no-poach covenants being agreed to so as to ensure they would not be viewed by enforcement authorities as impermissible restraints on trade.

Carve-Outs in Heavily Regulated Industries

In heavily regulated industries, such as the financial services sector, a key asset of the carved-out business will be the licenses and permits it possesses. When the carve-out will not simply be a bolt-on for a buyer that already operates with all required licenses, the buyer will often prefer to acquire licensed entities when possible. This is because a licensing change-of-control proceeding is often less onerous and time-consuming than applying for a license from scratch. The licensed entity will be already familiar with the regulatory authority whereas the buyer could be a relative unknown. When change-of-control proceedings or new licenses are required in connection with a carve-out, counsel with appropriate expertise can be a valuable aid in navigating the regulatory process. If the transaction involves a significant number of such proceedings and licenses, it may be prudent for the buyer and seller to prepare a regulatory transition plan. Such a plan typically sets out, on a license-by-license basis, key mile-

stones and protocols for completing the regulatory process.

Cross-Border Issues

The global carve-out is perhaps the most complex form of divestiture to execute. From a legal standpoint, each jurisdiction within the transaction perimeter can introduce its own particularities. These could take the form of additional regulatory frameworks to be complied with, requirements to inform or consult with local employee representatives, or technical legal requirements to be observed in order to properly transfer entities or assets. Close coordination among country counsel is essential to achieving seamless legal execution of a global carve-out.

Where local legal requirements are such that closing in one jurisdiction is not feasible (or legally permissible) until a meaningfully later date than the other jurisdictions within the transaction perimeter, parties sometimes agree to complete a "staggered closing." In a staggered closing, the carve-out of the business in some countries is completed in advance of the transaction closing in other countries. This permits the earlier realization of a portion of the deal synergies (in the case of the buyer) and the transaction proceeds (in the case of the seller). A staggered closing requires meticulous planning from both a commercial and legal perspective. When a staggered closing is seen as a meaningful possibility, the mechanics for completion should be detailed in the definitive sale agreement. The mechanics should address various contingencies, including a situation in which the delayed closing jurisdictions fail to ever close because required local approvals are ultimately not obtained.

The Spin-Off Alternative

As an alternative to selling a business to a third-party in a commercial divestiture, a company can also unlock value for stockholders by separating the business via a spin-off. At the most basic level, a spin-off involves a company—often termed the "DistributingCo"—packaging a business into a subsidiary—a so-called "SpinCo"—and then distributing the shares of SpinCo to stockholders pro rata in accordance with their stock ownership. Spin-offs can be attractive for a number of reasons. For instance, the equity markets might value SpinCo's assets more attractively as a "pure play" investment opportunity. SpinCo's management might also benefit from the opportunity to define SpinCo's focus and strategy independently from the competing priorities and resource demands of operating in a larger organization with multiple businesses.

A spin-off presents many of the same complexities we have outlined in the context of commercial divestitures, from defining the business to be spun-off to the nuts-and-bolts process of separating that business from a broader enterprise. But spin-offs also present their own special considerations. For one thing, highly involved rules and regulations govern the tax treatment of spin-offs. In order to ensure a spin-off can be structured an executed in a manner that is "tax free" to both the entities involved and stockholders, tax counsel should be consulted early in the planning process. On the securities side, a Form 10 registration statement will need to be prepared and disseminated to stockholders in conjunction with the spin-off. Lastly, multiple ancillary agreements will need to be put in place between DistributingCo and SpinCo to memorialize terms that would be addressed in the definitive sale agreement in a commercial divestiture context, such as allocating responsibility for historic liabilities of SpinCo.

Conclusion

While the issues we have discussed in this article are what make carve-outs uniquely challenging, they are also what make them one of the most rewarding transaction types to complete. Thoughtful and careful planning by dealmakers in anticipating and addressing these matters can help achieve smooth deal execution for all involved.

ENDNOTES:

[1]*See* Joe Nocera, *Was Jack Welch Really That*

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Good? BUSINESS WEEK (Jun. 14, 2019).

[2]*See* Lazard Shareholder Advisory Group 2018 REVIEW OF SHAREHOLDER ACTIVISM (Jan. 2019) *available at* https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf.

[3]*See generally* Sullivan & Cromwell LLP, FINANCIAL DISCLOSURES ABOUT ACQUIRED AND DISPOSED BUSINESSES (May 8, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Financial-Disclosures-About-Acquired-and-Disposed-Businesses.pdf.