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Overview

Balancing Interests in Carve-out Transactions

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A carve-out transaction is a sale of a business line, division or portion of a larger company, usually driven by a strategic decision to divest from non-core assets, raise additional cash or walk away from underperforming divisions. Companies that are facing financial challenges may also be forced to divest certain business lines in order to raise capital. Private equity buyers may also use a carve-out transactions as a turn-around opportunity for a relegated asset that may provide an upside potential under the right management and focus.

These transactions present unique challenges to potential buyers as compared to traditional M&A deals. Seller and buyer will need to ensure that they have put sufficient thought into planning the transaction to maintain and maximize the value of the target business or assets. Because the assets, division or business line are part of a larger business, sellers are usually required to implement an internal reorganization to establish the division as a stand-alone business before the sale can be completed. This often involves the transfer of assets, employees, systems, customer contracts, supplier contracts and licenses — all while the seller is still operating in the ordinary course. These challenges are amplified when the target business operates in multiple jurisdictions, which may require different structures and implementation timeframes. Buyers, meanwhile, disproportionately bear the risks associated with an improperly completed carve-out. Advisor fees and internal headaches can be quite large, anticipated synergies from integration may be lost and transfer of legal title to assets and equity may be significantly delayed.

A well-thought-out reorganization covenant, elements of which are discussed below, is one key method to addressing these layers of complexity. These covenants seek to balance buyers' concerns to ensure that the reorganization will be implemented in a satisfactory manner and the sellers' interests in obtaining flexibility and deal certainty.

The Carve-Out Step Plan

Typically, buyers will ask for a reorganization covenant pursuant to which the seller commits to perform the reorganization in accordance with a previously agreed tax-driven step plan. The buyer will usually require that the proper completion of such reorganization is a condition to closing. The step plan, which is typically appended to the master acquisition agreement as a schedule, will set out in greater detail what the seller is required to do in terms of carving out the target business. Sellers will usually prefer a high-level plan, focused on major milestones and key jurisdictions, and they normally push for flexibility in conducting the reorganization while ensuring that non-material deviations will not prevent closing or create unwanted leverage to the buyer. Buyers may prefer a more detailed approach that will provide visibility and certainty of what is required to be done.

While the parties will attempt to diligence the plan (which will require input from their respective tax and legal advisors) in advance of executing the acquisition agreement, inevitably implementation will uncover unforeseen aspects and require the parties to re-think their initial plan. The acquisition agreement should dictate whether the seller has the right to modify the plan without the buyer's consent and under what circumstances. Possible compromises will reserve the seller's right to amend the plan where changes are not expected to adversely affect the buyer, including to increase the buyer's tax liability. It may also contemplate the buyer's promise to consider in good faith an Balancing Buyers' Concerns and Sellers' Interests in Carve-out Transactions requests from the seller and not to unreasonably withhold its consent.

Diligence Rights

Although the seller is responsible for carrying out the pre-closing reorganization, it is the buyer who is going to inherit the carved-out business. As such, it is in the buyer's best interest to oversee and diligence the material aspects of the implementation of the reorganization. Buyers should want and insist on the right to review, comment and approve reorganization documents prior to execution or filing. On the other hand, sellers desire independence in order to discharge their obligations under the acquisition agreement in an expeditious manner. Reasonable consultation rights, potential materiality parameters, and commitments to accept good-faith comments are common compromises that can be acceptable to both sides depending on the circumstances.

Reorganization Costs

Typical costs associated with a reorganization include: tax benefits and liabilities (including withholding taxes), advisor fees, and third-party and governmental consent fees. Absent reorganizations driven by specific buyer requirements, we are seeing a market practice of seller bearing fees and expenses, with taxes negotiated on a transaction-by-transaction basis. The mechanics of the allocation of reorganization costs vary by acquisition agreement. There are, however, multiple mechanisms for allocating costs. In transactions with a purchase price adjustment, costs of a reorganization may be treated as a transaction expense that is deducted from the consideration paid to seller. In asset transactions, costs associated with a reorganization can be defined as excluded liabilities that are not transferred to buyer. Some acquisition agreements include an indemnity for reorganization costs or a covenant to pay the costs backed by an indemnity for breach of covenants. Regardless of the mechanism chosen, there should be a clear allocation of reorganization costs.

Post-Closing Corrections

The seller is typically less motivated to assist with cleaning up issues post-closing (i.e., after the seller has been paid) than pre-closing, which is why buyers often insist on post-closing covenants, such as "wrong pocket" or further assurance provisions requiring the seller to transfer any assets related to the carved-out business that might remain with the seller after closing, at no additional cost to the buyer. Such covenants are usually supplemented by robust representations and warranties related to sufficiency of assets of the carved-out business.

Ancillary Agreements

Ancillary agreements are an important aspect of carve-out deals. They may include transition services agreements (TSAs), reverse TSAs, supply/sale agreements where the carved-out business will continue to rely on the original business for in/output, consultancy agreements with management personnel retained by the seller, temporary IT support, temporary IP license agreements, and others. Because the target will be invariably new at operating as a stand-alone business, ancillary agreements will ensure that the buyer will have access to the resources it needs to operate the business immediately after closing and prevent unwanted interruptions.

An acquisition agreement that covers all the unique aspects presented in a carve-out transaction will reduce the risks of unpleasant surprises. It will also force both seller and buyer to think about the challenges that are likely to arise before closing can be achieved, increasing the likelihood of a successful closing aligned with the parties' reasonable timing and cost expectations.