Carve-Out Transactions

Practical Tips for Successfully Navigating the Key Pitfalls

November 8, 2018

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Agenda

- Section 1 – Introduction
- Section 2 – Preparing for Sale
- Section 3 – Scope of Due Diligence
- Section 4 – Allocation of Assets & Liabilities
- Section 5 – Transition
- Section 6 – Key Transaction Documents

Section 1 – Introduction

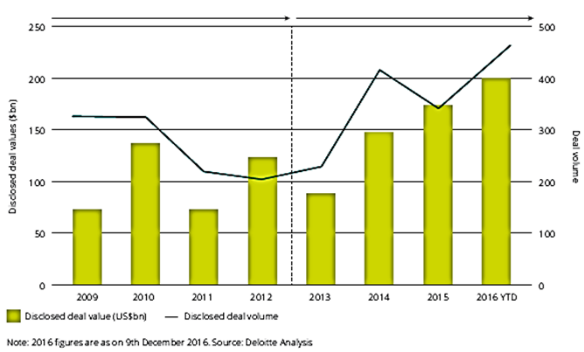
Overview – What is a Carve-Out?

- A sale of a business or division
- Why carve-out a business or division?
- Preparation is key
  - Unique, complex issues that need to be addressed

Practice Point: Carve-outs are typically closed within six to 12 months of initiation of the sale process.

Market Data

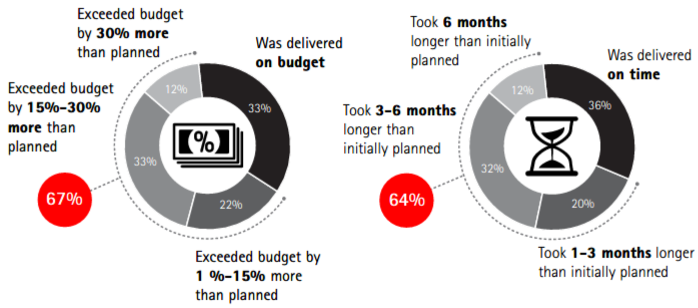
- Carve-Outs by Year and by Deal Value:



Source: Deloitte M&A Index 2017: CREATING SHAREHOLDER VALUE THROUGH DIVESTMENTS

Section 1 – **Introduction** (continued)

- Ability to Meet Expected Timeline & Budget for Carve-Outs:

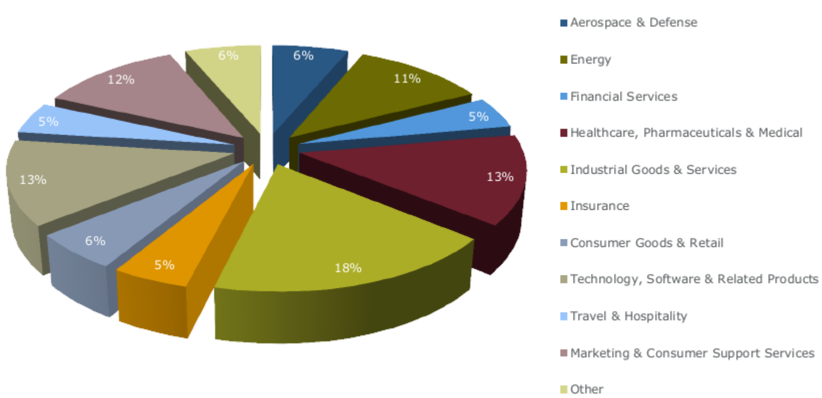


Source: Accenture's 2015 Strategy Carve-out Survey

Practice Point: Setting realistic expectations is key—carve-outs frequently run over budget and past internal deadlines.

Section 2 – Preparing for Sale

- Carve-out Transactions by Industry:



Source: ABA Mergers and Acquisitions Committee's M&A Carveout Transactions Deal Points Study (surveying 126 transactions from 2015-2016)

Determining a Transaction Perimeter

- A seller should clearly delineate what parts of its business are "in scope" and being sold versus "out of scope" and being retained
- Where is the target business operated?
  - Where are assets, sales, and employees located?
  - How is non-U.S. business held?
  - Create jurisdiction summary charts
- Are there sites where sold and retained businesses will be co-located?

Practice Point: Consider the touch points between the target business, on the one hand, and the retained business, on the other hand.

Building a Carve-Out Team

- Creating a strong internal and external team is key
  - Responsible for sell-side diligence
  - Develop a carve-out plan
  - Failing to prepare is preparing to fail
- Sellers should carefully determine which employees to bring "under the tent" to assist with the transaction
  - Devising a communication strategy or policy with respect to employees who are outside of the tent is recommended
  - Employee loyalty may shift as deal progresses

Practice Point: Engage appropriate professional services firms early on to assist with planning, negotiation, and execution.

Deal structure

- An in-depth tax analysis should be conducted to determine viability and preferred transaction structure
  - Develop a steps plan
- Key considerations include:
  - Number of entities sold and location of entities' assets
  - Tax classification of seller
  - Available tax attributes of seller
  - Historical tax liabilities

Preparation of stand-alone financials

- Preparing separate financial statements to the satisfaction of the buyer and its lenders is a common long lead time item
  - International Financial Reporting Standards may be required for prospective non-U.S. buyers

Practice Point: Having financials available can be value additive and ease the sale process.

- Consider the expected buyer and financing structure
  - Public M&A

Section 3 – Scope of Due Diligence

- Contracts & Licenses
  - Change of control, assignment, and other consent rights
  - Acceleration of payments or vesting
  - Shared contracts
  - Related party agreements
- Assets
  - Real estate & other tangible property
  - Intellectual property & intangibles
  - Permits, licenses and registrations
- Collateral to be replaced
  - Letters of credit
  - Guarantees
  - Bonding arrangements
- Buyer should engage diligence team early on

Practice Point: Establishing a clearly defined materiality threshold can streamline the due diligence process.

Section 4 – Allocation of Assets & Liabilities

Allocation of Assets

- Stock sale vs. asset sale vs. combination
- Important to clearly define what constitutes the business being acquired
  - Sufficiency of assets representation in the purchase agreement
- Are assets limited to those “exclusively” used by the acquired business or is a different standard more appropriate?
  - Key diligence focus for the buyer
- What happens when acquired assets don’t transfer?
  - Wrong pockets provisions
  - “Back-to-back” arrangements

Allocation of Liabilities

- Stock sale vs. asset sale vs. combination
  - Use of indemnification to change structure
  - Consider whether to allocate liabilities relating to businesses or assets no longer owned or operated by the Business
- "Your watch" vs. "our watch"
  - Depends on leverage
  - Buyers want a clearly defined set of liabilities

Allocation of Liabilities

- Liabilities that may transfer as a matter of law:
  - Environmental (owner/operator liability)
  - Products liability
  - Employee matters
- How to protect against liabilities in the purchase agreement:
  - Diligence
  - Indemnity
  - "Excluded" liabilities
  - Cooperation & privilege

Section 5 – Transition

Shared Business Functions & Services

- Certain critical services may be intertwined between the target business and the retained business:
  - IT
  - Accounting
  - Payroll & HR
  - Benefit plans
  - Insurance
  - Counsel and litigation support
  - Local
- Shared contracts
  - Splitting contracts / timing
  - Address consent fees
- Integration is key
- Focus on the details and cost analysis of any transition services

Practice Point: Failing to ensure business continuity for shared services on day one post-close is the #1 item of value leakage for a buyer.

Employees & Benefits

- Understanding the employees involved, along with their prior and future job functions, is crucial to a successful carve-out
  - Seller should initially plan who they intend to transfer vs. who they intend to retain
  - Buyer can condition transaction on the retention of key employees identified prior to signing
  - Mapping employees to new organization – Pre- or post-closing layoffs?
- Seller may incentivize loyalty through retention and/or performance bonuses

Practice Point: It is important to minimize disruption of employees' day-to-day operations during the negotiation and consummation of the transaction.

Employees & Benefits

- Transfer of Employees
  - Depending on structure, some employees may transfer to the buyer automatically while others may require a formal offer and acceptance
  - The parties may allocate the severance costs of any non-transferred employees, as well as other employee-related liabilities
  - Required notifications and/or consents may affect timing
    - Unions
    - WARN Act
- Post-Closing Integration
  - Strategic buyers should plan for how to fold acquired employees into their existing compensation structure and benefit plans
  - The purchase agreement may provide for a continuation of a certain level of benefits for transferred employees
  - Benefit plan transfer/integration

Transfer of Union Employees

- A buyer's obligations regarding unions and collective bargaining agreements depend on the form of transaction
  - Stock sale – No change in employing entity, so CBAs and bargaining obligations are unaffected
  - Asset sale
    - CBAs can be expressly assumed
    - Successorship principles will typically require recognition and bargaining with unions even if agreements are not assumed
- Effects bargaining
  - A seller in an asset sale must bargain with unions representing employees concerning the "effects" of the sale. Typical subjects include severance, transfers within seller's organization, pension and retiree benefits
  - Notice and opportunity to bargain are required in advance of closing
  - Seller is only required to bargain in good faith, not to agree to any specific terms
- Multiemployer pension plans
  - An asset sale can trigger a seller's withdrawal from union multiemployer pension plans, resulting in substantial liability
  - ERISA § 4202 allows for avoidance of withdrawal liability if certain conditions are met

Intellectual Property & Information Technology

- Legal ownership of IP used by the acquired business may be difficult to disentangle:
  - Software used by the acquired business' employees often licensed at the seller-entity level and will need to be renegotiated separately
  - Buyer may want to enter into licensing or joint ownership arrangements with the seller to permit the acquired business to continue using seller IP
- Carved-out business might have limited or no backoffice IT, so planning for replacement is a key workstream
- Plan for the use of trade names after closing and whether the seller or buyer will have to rebrand

Environmental

- Due Diligence
  - Sell-side Phase I's and Limited Environmental Compliance Reviews can streamline due diligence process and minimize disruption of multiple bidder site visits
  - For regulated industry sectors, high level review of permit transfer/reissuance process and timing should be part of preliminary due diligence
    - Sellers should expect that sell-side employees will need to prepare technical permit transfer/reissuance applications
  - Environmental transfer acts, like NJ ISRA or CT Transfer Act, can be gating issues
  - Buyers should consider whether financial assurance obligations will be triggered or need to be maintained post-closing

Environmental

- Managing Post-Closing Environmental Liabilities
  - Consider whether existing environmental insurance, third party indemnity or guarantees will be available to buyer post-closing
    - Unusual for seller's environmental insurance to be assignable to buyer
  - Splitting shared facilities post-closing can be challenging environmentally
    - Consider cost, timing and who controls
- Post-Closing Integration
  - Will key EHS personnel remain with seller?
    - If so, consider how to replace the functions, maintain institutional knowledge
  - Will the acquired business change the buyer's environmental/regulatory profile?

Section 6 – Key Transaction Documents

- Purchase agreement
- Transition services agreement
- Escrow agreement
- Assignment agreements
- Arrangements for licensing or joint ownership of IP
- Subleases of leased real property
- Consents
  - Regulatory
  - Contractual
  - Stockholder approval (public M&A)

Conclusion & Questions

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