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Navigating Complex Challenges in Carveout Transactions

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MCLE Certificate Information

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Today's Panelists

Stephen Glover
Washington, D.C.
siglover@gibsondunn.com

Pamela Lawrence Endreny
New York
pendreny@gibsondunn.com

Sean Feller
Century City
sfeller@gibsondunn.com

James Cox
London
jcox@gibsondunn.com

Evan D'Amico
Washington, D.C.
edamico@gibsondunn.com

Candace Choh
Century City
cchoh@gibsondunn.com

David Kennedy
Palo Alto
dkennedy@gibsondunn.com

Agenda for Today's Webinar

I.	Overview of Carve-Out Transactions
II.	Key Corporate Law Issues
III.	Key Tax Issues
IV.	Key Employee-Related Issues
V.	Key Intellectual Property Issues

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Overview of Carve-Out Transactions

Overview of Carve-Out Transactions

What is a carve-out transaction?

- Sale of a subsidiary, division or other smaller part of a larger business enterprise

Why do companies do carve-out transactions?

- To resolve antitrust concerns about a pending business combination or other regulatory concerns
- To streamline operations and allow management to focus time and resources on core operations
- To divest an underperforming division and improve remaining company's financial results
- To generate cash that can be put to better immediate use (e.g., investment in core assets or returning capital to stockholders) or to provide liquidity
- To maximize value if a sale to a strategic third party would produce more value than the company continuing to operate the business
- Sometimes done in response to pressure from activist investors

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Key Corporate Law Issues

Key Issue: Transaction Perimeter

Define the scope of the business to be carved-out (the "Business")

- Affects the buyer's pricing
- Enables parties to define assets and liabilities being transferred
- Basis for preparing financial statements

What assets are required to conduct the Business?

- Are there any assets utilized in both the Business and retained businesses (shared assets)?
  - Enterprise-wide contracts / parent guarantees / financing arrangements
  - Intellectual property / brand names
  - Shared real property / insurance coverage
  - Management / corporate functions (*i.e.*, HR, IT, legal, accounting, procurement, etc.)

Which liabilities should be transferred?

- Should historical liabilities be transferred? *Seller favorable*
- Should only future liabilities be transferred (*i.e.*, "our watch your watch")? *Buyer favorable*
- How should shared liabilities be handled?
- Should any liabilities be subject to special indemnification arrangements?

Which employees should be transferred?

- Are there any impediments to transferring employees (*e.g.*, works council consultation requirements, employee consent rights)?

Key Issue: Intercompany Arrangements

- Seller may prefer a clean break, but putting in place short or long-term agreements with a buyer may make carve-out Business more desirable for buyers or may be necessary to support the Seller's retained business
- Goal should be for the Business to effect full and smooth transition from retained business
- Agreements may run in either direction – *i.e.,* reverse agreements giving seller use of shared assets being sold with the carve-out Business
  - *Example: Consider whether any enterprise-wide contracts or functions should be included in sale, but will require company to obtain reverse transition services following closing until it can replace such arrangements*
- When pass-through arrangements are not possible or desirable, may need carved-out Business to enter into new agreements with third parties

Transition Services Agreements (TSA)	▪ Buyer will likely require a transition services agreement to provide certain shared services / corporate functions for a period (typically between 3 and 12 months) after closing, until it can institute its own systems ▪ May be challenging to identify true costs of providing these services ▪ In the event of a strategic (instead of financial) buyer, transition services may be very limited in scope or duration if buyer can quickly integrate business into its existing platforms
Real Estate	▪ If the Business is co-located with retained businesses, consider whether short or long term sublease arrangement will need to be entered into
Supply Agreements	▪ If the Business acts as a customer or vendor for retained businesses, will likely be necessary to negotiate arm's-length agreements between sold and retained businesses
Other Agreements	▪ Other possible agreements include **long-term services agreements** and **IP licenses** ▪ Parties should identify and evaluate any existing arrangements between the sold and retained businesses (*e.g.*, guarantees, credit support agreements) to determine if they should survive sale transaction (and, if so, if they must be modified to be arm's length) or should be terminated and, if needed, replaced by buyer

Key Issue: Transaction Structure

Possible Structures

- Consider whether to:
  - Sell only assets;
  - Sell a mix of assets and entities; or
  - Reorganize so everything is housed in one or more entities to be sold

General Considerations

- Timing. *A pre-closing reorganization may add time and complexity*
- Required third-party consents and approvals
  - *Assignment of specific assets / contracts may trigger third-party consents*
  - *Sale of entities might trigger change-of-control provisions*
- Does company want the Business segregated into separate entities even if the sale process is unsuccessful?
- Tax consequences
- Does Business already exist primarily in a standalone entity?
- If selling entities, do any assets or employees need to be moved out of the entities before they are sold?

Regulated Industries

- In heavily regulated industries, a key asset of the carved-out Business is often its licenses and permits
  - May be easier to deal with change-of-control issues for permits than applying for new permits from scratch
  - Therefore, if buyer does not already have the needed permits, it will may prefer to acquire licensed entities

Cross-Border Issues

- Additional regulatory requirements to be complied with
- Requirements to inform or consult with local employee representatives
- Technical legal requirements to transfer entities or assets and liabilities may differ by jurisdiction
- Consider staggered closings if completing requirements in some countries will take longer than others

Key Issue: Financial Statements

- Standalone historical financial statements may be needed for:
  - Buyer's due diligence
  - Buyer's pricing
  - For buyer to obtain bank or public debt financing
  - Compliance with SEC reporting requirements by buyer and / or seller

Potential Considerations

- **Audited vs unaudited**
  - Consider extent to which the Business has been separately reported / audited historically
  - Audited financials may be required if buyer plans on third-party financing or if buyer is a public company and acquisition meets certain materiality thresholds
- **Adjustments / costs to be incorporated into financial statements to reflect the Business as standalone**
  - Challenge of allocating entity-wide assets, operational expenses and revenues to standalone business
  - Liabilities not recorded in parent company's consolidated balance sheet because of GAAP materiality determinations may need to be recorded in the carve-out balance sheet
  - Required adjustments to historical financials to reflect standalone costs / dis-synergies
- **Time periods to cover.** May be dictated by SEC reporting requirements
- **Closing condition.** Is delivery of carve-out financial statements a condition to buyer's obligation to close?
  - Preparation of financial statements as a closing condition essentially gives the buyer the opportunity to engage in further due diligence, which may reveal a breach of the seller's representations and warranties

Seller's Financial Reporting*

- Impact of sale transaction on seller's financial reporting will depend on significance of business transferred, as compared to seller's business as a whole prior to the carveout
- Typically, seller would be required to report disposed business as discontinued operations upon consummation of sale and reflect disposed business as discontinued operations in going-forward reporting
  - Pro formas may be required upon completion of the carveout, depending on its significance

***Assuming seller is SEC reporting company.**

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Key Drafting / Negotiating Points

Key Drafting / Negotiating Points

Defining assets & liabilities to be transferred	▪ "Exclusively" related to the Business (generally most seller-favorable position) ▪ "Primarily" related to the Business (compromise position) ▪ "Related" to the Business (generally most buyer-favorable position) ○ Can chose different standards for different asset / liability categories ○ For liabilities, need to determine the treatment of historical liabilities
Will seller commit to a separation plan?	▪ Sellers usually want any plan to be high-level to retain flexibility and not give buyer leverage to not close because of minor deviations from a detailed plan ▪ Buyers usually want sellers to agree to complete a very specific plan to be attached to the transaction agreement to ensure it will get everything it needs and won't encounter unexpected costs ○ Buyer usually will want completion of restructuring activities to be a closing condition ▪ Parties will need to negotiate under what circumstances any agreed-to plan can be modified
Reorganization process	▪ What rights does buyer have to review, comment or approve of reorganization documents prior to execution or filing? ▪ How do the parties allocate the costs of any reorganization?
Calculation of purchase price	▪ Typically priced on cash-free, debt-free basis ▪ Significant negotiation over treatment of cash-like and debt-like items ▪ If Business has never operated on a standalone basis, could be difficult to agree on target working capital level ▪ Parties need to agree on what accounting principles to be used when determining any true-up ▪ What will be the procedures for any post-closing purchase price adjustments?

Key Drafting / Negotiating Points (continued)

Post-signing cooperation related to arrangement of buyer’s debt financing	▪ Availability of seller personnel to buyer for due diligence sessions, lender presentations, road shows, etc. ▪ Level of assistance by seller in preparation of additional financial statements ▪ If carve-out financial statements are used by buyer to raise public debt and need to be revised due to comments from the SEC, who will perform the revisions and who will bear the cost?
Indemnification	▪ Will buyer get representation and warranty insurance or will seller provide indemnification for breaches of representations? ▪ Indemnification for seller-retained liabilities ○ Especially a concern in entity sales with “our-watch, your watch” construct since all historical liabilities go with the entity by operation of law ○ Generally less of a concern in asset sale structure where buyer assumes only specified liabilities (subject to the state law doctrine of successor liability) ▪ Indemnification by buyer for buyer-assumed liabilities ○ Especially a concern in asset sale structure where buyer has agreed to assume historical liabilities ▪ Indemnification for any special liability allocations (*e.g.*, historical environmental or product liabilities)
Key representations and warranties	▪ Sufficiency of assets ▪ Financial statements

Key Drafting / Negotiating Points (continued)

Other post-closing covenants

- Terms of any covenant not to compete
- Terms of any covenant not to solicit employees
- Post-closing cooperation
- Wrong pocket and further assurances provisions

Employee issues

- Particular sensitivity in carveouts in that employee support is required; potential for shifting loyalties between retained company and Business to be carved-out; partitioning of employee base
- What commitments will buyer make regarding future salary, benefits?
- Who will assume responsibility for pre-closing employee liabilities?
- Will there be a retention program and, if so, who will pay for it?
- Will there be redundancies / layoffs? If so, who will be responsible for severance payments?
- Works council and similar issues are especially critical in cross-border transactions

Transition Services Agreement

- Will seller agree to provide additional required transition services that were not identified prior to closing?
  - If so, under what terms will these omitted services be provided?

Indicative Timeline for Carveout Sale

~8-16 weeks

Preliminary Processes

- Identify and segregate assets to be sold (create new legal entities as needed)
- Prepare standalone financials. Process will likely be longer if audited financials need to be prepared
- Prepare virtual data room
- Sign confidentiality agreements
- Conduct auction process (potentially several rounds of bids)

~3-6 weeks

Negotiations and Diligence

- Negotiate acquisition agreement
- Negotiate ancillary agreements, including any transition services, real estate, key employment and / or other commercial arrangements
- Assist buyers in completion of due diligence

Signing

- Sign acquisition agreement
- Announce agreement

~4 weeks

Approvals and Consents

- Obtain other third-party consents and regulatory approvals, as applicable
- Buyer arranges financing, if applicable (including marketing if public debt financing)
- Process may take longer if business is in a highly regulated industry or if restructuring is complex

Closing and Post-Closing

- Buyer pays consideration to company
- Execute ancillary agreements
- Post-closing integration, including via transition services arrangements if established

Key Documents / Workstreams

Structuring / Organization	▪ Determination of scope of the Business including assets and liabilities to be transferred ▪ Structure of sale transaction ○ Consideration of tax impact ▪ Completion of internal reorganization, if any
Data Room	▪ Coordinate collection and uploading of documents to virtual data room ▪ Review of key documents in connection with (1) preparation of disclosure schedules, (2) determination of third-party consents and / or (3) redaction of competitively sensitive information
Financing Matters	▪ Preparation of standalone financial statements ▪ Determine whether lender consent / release of subsidiary guarantees are required in connection with company's existing financing arrangements
Employee Matters	▪ Determination of management / employees to be transferred with Business ▪ Analysis of employee benefit plans / liabilities and whether to transfer with Business ▪ Analysis of legal / regulatory impact of transferring employees (*e.g.*, trigger of contractual or statutory severance, any works council consultation requirements)
Regulatory Approvals	▪ Analysis of required antitrust approvals ▪ Analysis of any other governmental consents, notifications or approvals, either in connection with internal reorganization, if any, or sale

Key Documents / Workstreams (continued)

Transaction Documents

- Acquisition Agreement
- Disclosure Schedules
- Transition Services Agreement
- Reverse Transition Services Agreement
- Sublease
- Intellectual Property Licenses
- Other Commercial Agreements

Board Materials

- Board updates regarding transaction
- Fairness opinion
- Board summary / approval documents, including resolutions

Communication Materials

- Press Release
- Investor deck / script / Q&A
- Communications to customers / vendors / partners
- Internal communications, including employee communications

Regulatory Filings

- SEC filings
- Antitrust filings
- Other governmental and third-party consents / notices

Key Tax Issues

Key Issue: Tax Considerations for Buyers and Sellers

Sale of Assets

- Buyer obtains a stepped-up tax basis in purchased assets equal to purchase price plus liabilities
- Tax attributes do not carry over
- Asset sale can have different considerations for seller, depending on facts

Sale of Equity

- Generally no asset basis step up and attributes carry over
- Certain transactions treated as deemed asset sales for U.S. tax:
  - Section 338(h)(10) election for U.S. target acquired from consolidated group or S corp
  - Section 338(g) election for U.S. or non-U.S. target
  - Purchase of equity in a flow-through entity (partnership or LLC)

Pre-Sale Restructuring

- Pre-sale restructuring to separate businesses can have tax consequences for buyer and seller
- Can affect tax attributes of acquired business
- May also be relevant to buyer's post-acquisition integration of acquired business within its structure

Non-U.S. Tax Issues

- Carve-outs often involve businesses and entities in multiple jurisdictions
- Structuring to minimize withholding taxes, indirect taxes
- Transactions may involve multiple purchaser entities and steps

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Key Employee-Related Issues

Key Issue: U.S. Employee-Related Considerations

Defining Workforce

- Identify employees who are dedicated to the Business and will be transferred to the Buyer
- Identify shared services employees who support the Business and determine if any will transfer
- Determine process for allocating employees to the Business between sign and close if allocation not complete at signing
- Determine whether all employees will transfer at Closing or remain on Parent payroll for a period post-closing

Treatment of Benefit Plans

- Does the Business maintain standalone benefit plans that would transfer to Buyer
- Do Business employees participate in Parent-level benefit plans
- Consider whether any Parent-level benefit plans will transfer to Buyer
- Determine whether Buyer will need transition services with respect to HR systems//benefit plans

Incentive Arrangements

- Consider whether to implement special incentive compensation arrangements to motivate key employees in connection with the Transaction
- Consider whether to require Buyer to guarantee compensation/benefit levels post-closing
- Consider treatment of Parent-level long-term incentives (i.e. equity awards) in connection with the Transaction

Key Issue: European Employee-Related Considerations

Defining Workforce	▪ As with the US, identifying who and what will transfer ▪ Consultation requirements ▪ Indemnification in respect of pre-closing liabilities
Shared Employees	▪ Voluntary transfers pre-closing ▪ Stock acquisitions vs asset deals ▪ Enhanced protection of compensation and benefits under ARD / TUPE ▪ Contractual commitments to maintain compensation and benefits
Attrition	▪ Right to object under ARD / TUPE ▪ Retention arrangements
Layoffs	▪ Information and consultation ▪ Severance Rights ▪ Penalty for non-compliance
Works Council	▪ Types of works council ▪ Rights of works council ▪ Impact on timing and structure of deal

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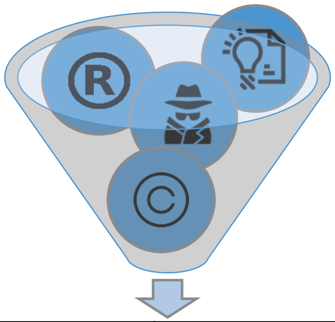
Key Intellectual Property Issues

Allocation of IP in Carveout Transactions

Intellectual Property



Retained IP	Shared IP (Licensed)	Shared IP (Grant-back)	Transferred IP

- Exclusive/non-exclusive
- Field of use/Scope
- Improvements

- Assignability
- Sublicensable
- Termination Rights
- Warranties

Identify early in process IP that will stay with parent, will be transferred to carveout, and will be shared by the parties

Allocation of IP in Carveout Transactions

- Identify Intellectual Property Used in the Business
  - Owned IP
  - Third Party Licensed IP
- Identify Shared IP
  - Determine ownership of shared IP, which may be difficult to untangle in the case of unregistered IP.
  - Determine scope of use of shared IP by the Business and the retained businesses.
  - Assess the relative significance of use of each item shared IP by the Business and by the retained businesses.

Allocation of IP in Carveout Transactions

- Allocation of Rights in Shared IP
  - Rights retained by Seller or granted to Buyer could be sole ownership, joint ownership, exclusive license or non-exclusive license
    - A party may assume that ownership of a particular IP asset is of critical importance when in fact an irrevocable non-exclusive license is sufficient to achieve the party's objective.
    - If enforcement of the relevant IP against third party infringers is an important factor, ownership or exclusive rights would be needed.
  - Ownership usually is allocated based on the same rule that applies to the other assets being transferred, which most often is a "primarily relates to the Business" or similar test.
- Patents and trademarks (including pending applications) are usually reviewed on a case-by-case basis with the Seller and Buyer ultimately agreeing on a specific list of which patents and trademarks are to be transferred to the Buyer.
- It generally will not be practicable to specifically identify all relevant unregistered copyrights and trade secrets used in the Business and therefore the parties will rely on one more general descriptions of such IP both for purposes of identifying IP to be transferred as well as for purposes of identifying shared IP to be licensed.
- Third party license agreements generally need to be reviewed on a case-by-case basis to determine whether the third party IP in question is used principally in the Business purchased by the Buyer or the businesses retained by the Seller.

Shared IP Licenses

- Scope of Licensed IP
  - The Seller generally seeks to limit the retained IP that is licensed to the Buyer to the retained IP being used in the conduct of the Business as the Closing.
  - The Buyer often seek rights in retained IP (including newly-acquired IP) that isn't being used as of the closing but may be contemplated to be used in new or enhanced versions of products of the Business after the Closing and seeks to minimize risk that Seller ever will assert infringement claims against the Buyer in connection with the Buyer's conduct of the Business, as it may evolve and expand following the Closing.
- Scope of License
  - The Seller generally seeks to limit scope of its license to use in the conduct of the Business as conducted as of the Closing.
  - The Buyer generally seeks a license that, at a minimum, extends to improved and new versions of products of the Business being shipped as of the Closing and preferable extends to entirely new products within a defined field of use.

Key Terms for Shared IP

Key Terms

Type of IP

	Term of License	Exclusive / Non-Exclusive	Field of Use	Assignability	Sublicensable	Enforceability
Trademarks						
Patents						
Trade Secrets						
Copyrights						

Address Key Terms for each Type of IP - balancing a successful carveout with retaining value for the Seller

Less negotiated

Occasionally negotiated

Often negotiated

Licensing of Shared Proprietary Software

Special Considerations Applicable to Proprietary Software

- The treatment of shared proprietary software used in the Business that will be retained by the Seller and licensed to the Buyer raises special concerns.
- The parties must agree on whether source code or only object code will be transferred.
  - If only object code is transferred, the Buyer will require ongoing technical support for the software licensed by the Seller.
  - If source code is licensed, Seller will desire to restrict any sublicensing and disclosure of source code and may seek to license or own Buyer enhancements to the software.
- The scope of the license of proprietary software often is the subject of extensive negotiations
  - The Seller usually seeks to limit the scope of the license to the usage by the Business at the time of the Carve-Out transaction.
    - If the Business is using the proprietary software solely for internal purposes, the Seller usually seeks to limit the scope of the license to internal use rights only
    - In the case of shared software incorporated in products, the Seller may seek to limit the scope of the license to use with products shipping at the time of closing and possibly upgraded or new versions (sometimes subject to a “natural evolutions” limitation).

Third Party Software Licenses

Software licenses are typically held by corporate parent so that software is available for use by all divisions and units

- Software licenses typically prevent use by or for the benefit a third party, with no sublicensing or partial assignment of rights permitted.
- Buyer may need to “mirror” certain critical software licenses
- The cost of obtaining replacement shrink-wrap licenses could be significant
- Buyer needs to factor in re-licensing cost third party licenses that will be retained by Seller, which could be significant
- Seller may be entitled to reduction in price if user base is reduced

Transition Services Agreements

There is usually a need for shared services to continue to be provided to or by the Business for a specified period after the carveout

- TSA provides mechanism to ensure continuity of service pending Buyer’s implementation of alternative arrangements.
- A provision for transitional services of limited duration (usually not more than one year after the Closing)
- Cost-based pricing, with possible price increases implemented later in term or any renewal term
- No performance guarantees and very limited liability on the part of services provider
- Wide variety of services often are provided under a TSA: IT support, finance and accounting, marketing, supply chain, treasury, facilities

Transition Services Agreements

- Key negotiation issues for Transaction Services Agreements include the following:
  - Pricing: will the service provider receive payment of fully-burdened costs only or will the services be charged on a “cost pus” basis, and will the fees be subject to possible increases?
  - Omitted Services: will the Buyer have the right, for a specified period to add services that the Business obtained prior to the closing from the Seller but that were not identified at the time the TSA was signed?
  - Responsibility for obtaining third party consents (and associated costs).
  - Termination rights and responsibility for stranded costs upon early termination.
  - Liability caps; exclusions.

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Additional Resources

Additional Resources

[Recorded Webcasts (Available for CLE Credit)]

[Gibson, Dunn & Crutcher's Mergers and Acquisitions Practice Group]

Our Offices

Beijing
Unit 1301, Tower 1
China Central Place
No. 81 Jianguo Road
Chaoyang District
Beijing 100025, P.R.C.
+86 10 6502 8500

Brussels
Avenue Louise 480
1050 Brussels
Belgium
+32 (0)2 554 70 00

Century City
2029 Century Park East
Los Angeles, CA 90067-3026
+1 310.552.8500

Dallas
2001 Ross Avenue, Suite 2100
Dallas, TX 75201
+1 214.698.3100

Denver
1801 California Street
Denver, CO 80202-2642
+1 303.298.5700

Dubai
Building 5, Level 4
Dubai International Finance Centre
P.O. Box 506654
Dubai, United Arab Emirates
+971 (0)4 370 0311

Frankfurt
TaunusTurm
Taunustor 1
60310 Frankfurt
Germany
+49 69 247 411 500

Hong Kong
32/F Gloucester Tower, The Landmark
15 Queen's Road Central
Hong Kong
+852 2214 3700

Houston
811 Main Street, Suite 3000,
Houston, TX 77002-6117
Tel: +1 346.718.6600

London
Telephone House
2-4 Temple Avenue
London EC4Y 0HB
England
+44 (0) 20 7071 4000

Los Angeles
333 South Grand Avenue
Los Angeles, CA 90071-3197
+1 213.229.7000

Munich
Hofgarten Palais
Marstallstrasse 11
80539 Munich
Germany
+49 89 189 33-0

New York
200 Park Avenue
New York, NY 10166-0193
+1 212.351.4000

Orange County
3161 Michelson Drive
Irvine, CA 92612-4412
+1 949.451.3800

Palo Alto
1881 Page Mill Road
Palo Alto, CA 94304-1125
+1 650.849.5300

Paris
16 Avenue Matignon
75008 Paris
France
+33 (0)1 56 43 13 00

San Francisco
555 Mission Street
San Francisco, CA 94105-0921
+1 415.393.8200

São Paulo
Rua Funchal, 418, 35°andar
Sao Paulo 04551-060
Brazil
+55 (11)3521.7160

Singapore
One Raffles Quay
Level #37-01, North Tower
Singapore 048583
+65.6507.3600

Washington, D.C.
1050 Connecticut Avenue, N.W.
Washington, D.C. 20036-5306
+1 202.955.8500