Legal Considerations for Carve-Out Transactions

Though the business community continues to recover from the economic collapse of 2008 and the more recent international debt crisis, the M&A market has experienced steady activity and even growth in recent months. This is principally the result of converging interests within the business community as sellers explore exit options and opportunities to downsize operations while buyers seek to acquire high-value businesses at discounted prices. An increasingly popular transaction structure that accommodates these harmonized interests is a “carve-out transaction,” through which a company sells a stand-alone portion of its business, generally a division or subsidiary (which we will refer to in this article as a “Target Business”), to one or more acquirers. Frequently, such carve-out acquirers are private equity-backed. In an economy where cost efficiency is more crucial than ever, carve-out transactions allow sellers to divest business segments that simply do not mesh with the company’s operational focus.

Notwithstanding these economic benefits, the very nature of carve-out transactions raises a host of unique legal issues absent from more typical “whole business” M&A transactions. Aspects of the Target Business will be almost inextricably linked to the seller’s remaining business, requiring the parties to conduct significantly heightened due diligence to evaluate the viability of the Target Business. Further, once comfortable with the results of their due diligence, the parties and their counsel must engage in difficult negotiations to document the terms of their post-closing relationship, an association that is far more involved than in standard M&A deals. Though the myriad of challenges that arise will often be unique to the parties involved and their respective businesses, there are several issues that are important to recognize at the outset of any carve-out transaction.

Financial Due Diligence

Because it constitutes only part of a seller’s larger corporate structure, sellers often do not maintain stand-alone financial statements for a Target Business. As a result, both buyer and seller must invest substantial time and resources to understand the financial performance of the Target Business on a stand-alone basis. The challenge arises in determining which portions of the seller’s assets and overall expenses and revenues are attributable to the Target Business. Oftentimes, overhead expenses and other costs (e.g., insurance, marketing expenses and human resources) are allocated among the seller’s overall corporate structure, and therefore do not provide clear insight into the costs in operating the Target Business as a stand-alone entity. The parties frequently will require outside financial advisors to run a cost analysis of the Target Business to estimate expenses once the Target Business is separated from the seller. This analysis becomes complicated as the parties estimate additional expenses to be incurred by the Target Business after closing (e.g., additional employees and software upgrades) and adjust for the termination of internal transfer pricing arrangements, discounted vendor fees and other cost-saving measures the Target Business will not benefit from on a going-forward basis.

Similar challenges arise in determining the Target Business’s revenues on a stand-alone basis. The parties must account for intercompany sales arrangements and the Target Business’s access to integral assets owned at the enterprise level (e.g., trade names and goodwill) and other intercompany benefits that will cease after closing. Especially critical is the evaluation of the Target Business’s customer base, which may be skewed by favorable cross-selling arrangements with the seller’s other business units and product lines. The buyer will often supplement the stand-alone financial statements with additional due diligence to approximate customer attrition after the Target Business is excised from the seller. This in itself creates logistical and timing issues because the buyer frequently will require access to key customers prior to closing while the seller will desire to keep the transaction strictly confidential to minimize customer and employee attrition before the transaction is consummated.

Employees and Benefits

One of the more complicated aspects of a carve-out transaction is the treatment of the Target Business’s employees after closing, particularly if the deal involves employees outside of the United States. Seller’s employees may provide services critical to the other entities within seller’s corporate structure or that exceed those services necessary to operate the Target Business as a separate business. Understanding specific job functions becomes central to this analysis. Once the Target Business employees are identified, the parties must negotiate the transfer of those employees in a manner that accounts for potential employee attrition while ensuring that the Target Business has the human resources to operate post-closing. For example, the buyer may require that certain key employees come with the Target Business or that a certain negotiated threshold of identified employees sign employment agreements with the buyer as condition to closing. On the other hand, the seller may conclude that certain employees...
provide services essential to seller’s remaining business (e.g., accounting, IT and other back-office staff) and require that they remain under seller’s employ after closing. In such event, the parties may negotiate a transition services agreement through which the seller will provide core services to the buyer for a period of time and negotiated fee arrangement after closing to reach a mutually acceptable resolution with respect to employees.

Further complicating these negotiations, however, is the backdrop of employee benefits. Both parties will be required to spend considerable time and resources to understand the effect that the sale of the Target Business will have on their respective employee benefits plans. In particular, the buyer, assuming it has employees, must determine whether it will be able to include the transferred employees on its existing benefits plan and, if not, whether the costs associated with establishing a new benefits plan would be prohibitive or decrease the overall value of the Target Business. The seller must also examine whether the disposition of the Target Business’s employees will result in the termination of its existing benefits plan in which its remaining employees are enrolled. Each of these issues is complex and must be well in hand for closing to proceed smoothly.

**Intellectual Property**

In most instances, the intellectual property rights of the seller’s parent company will be vital to the Target Business, both before and after closing. For example, the Target Business may incorporate a trademark registered by a parent company in packaging or marketing materials or sell software the source code of which is protected by a registered copyright owned by seller. Once the parties determine which intellectual property rights are essential to the value of the Target Business, they will often negotiate a limited-use license to the Target Business so that the seller can maintain ownership of the intellectual property while granting the buyer use rights post-closing. Such agreements are heavily negotiated as the seller will want buyer’s use limited to the minimum extent required for the Target Business to maintain operations as historically conducted while the buyer will seek assurances from the seller that the intellectual property will be maintained and protected after the closing.

Similar issues arise with respect to software, license and ancillary maintenance agreements to which the seller is a licensee. Such agreements are frequently entered into at the enterprise level and provide all entities within the seller’s corporate structure site licenses or other usage rights, which, as a result of user volume, offer the seller discounted license fees. Both buyer and seller must review these contracts closely to evaluate their terms and the effect they will have on both buyer and seller from a cost perspective post-closing. For example, license agreements are often non-transferable, requiring buyer to obtain a separate license for the Target Business following closing. In addition, many software license agreements charge penalties in the event of decreased user volume. Therefore, the seller must determine if the divesture will prohibitively increase license fees once its user volume decreases, and the buyer must evaluate the cost of obtaining a separate license for the Target Business and the impact on the overall value of the Target Business in the event the license cannot be transferred.

**Contracts and Business Records**

If the carve-out transaction is structured as an asset sale, the parties will likely discover logistical issues when assigning certain assets, namely customer contracts and seller’s books and records. For example, if the seller conducts multiple business operations, a single customer contract may require the seller to perform services provided by both the Target Business and seller’s remaining business units. Thus, the seller and the buyer must decide how to service the contract once the assets of the Target Business are assigned to the buyer while complying with any notice or “consent-to-assignment” language contained in the contract itself. With certain customer contracts, provided such an arrangement is permitted, the parties may agree to enter into a subcontracting relationship after closing to jointly honor the obligations under the contract. Another possible solution is for the seller to obtain consent from the relevant customers to partially assign the contracts as necessary to reflect the sale of the Target Business to buyer and the distinct obligations of the seller and the buyer on a going-forward basis. In any event, both parties will need to review each customer contract carefully for prohibitions on assignment or subcontracting and to determine the logistics in obtaining any necessary consent from the customers given the timing of the transaction and other confidentiality concerns. Similar challenges may also arise if the carve-out is structured as a stock sale if the relevant customer contracts contain “change of control” provisions requiring the customer’s consent for the seller to engage in the carve-out transaction with the buyer.

Additionally, it is not uncommon for seller’s books and records to be maintained on a consolidated basis. As a result, many of seller’s books and records will include information specific to the seller’s remaining business, including confidential sales and customer information. Depending on the seller’s retention practices, some records may be maintained on business software or other archiving formats from which information specific to the Target Business cannot be separately transferred from that of seller’s remaining business units. In such event, the seller must weigh the risks involved in providing the buyer access to non-pertinent information or negotiate a confidentiality agreement or negative covenants in the purchase agreement to limit the buyer’s use of non-Target Business records. These confidentiality provisions can involve lengthy negotiations because the seller will often want them binding on any third party acquirer of the buyer to protect its remaining business.
Understanding the Big Picture

Today’s challenging economic environment requires M&A activity that is carefully designed to achieve well-defined goals. Carve-out transactions are a natural byproduct of this focus by enabling parties to pare down the business to be sold in order to optimize business efficiency while monetizing non-core operations. Without an understanding of the unique and inevitable issues that arise when negotiating a carve-out transaction, the parties may quickly become overwhelmed with the complexity of the deal. By taking the time to discuss a proposed carve-out transaction with counsel in advance of signing a letter of intent, both the buyer and seller can gain a solid understanding of the transaction, better identify and anticipate future issues and be in a position to control costs before, during and after closing. In today’s economy, that is an outcome everyone can appreciate.

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