CARVE-OUT TRANSACTIONS
USING M&A SOLUTIONS TO UNLOCK VALUE

Andrew Hart, Theo Jones and Isaac Dundas of BCLP explain some of the key considerations for a corporate group that is seeking to unlock value in its business by undertaking a carve-out transaction.

Carve-out transactions have become an increasingly notable feature of the market for mergers and acquisitions in recent years. The use of carve-outs by large corporates can provide an important means to raise additional cash, allow de-leveraging or create scope for further investment in other priority areas.

Historically, the areas of the business that are selected for a carve-out are those that have been underperforming, are non-core to the main business, or would require additional investment to grow further but which are not strategic priorities themselves. However, more recently, leveraged corporates have been forced to sell off some of their more profitable business divisions to raise cash to pay down debt before an expensive refinancing deadline.

This article considers some of the key legal issues that will need to be addressed when preparing for and executing a carve-out sale. It is important to recognise at the outset that, by their nature, carve-out deals are complex and time consuming, typically involving a pre-completion reorganisation to establish the transaction perimeter before completion of the sale to a third party. Any missteps in the reorganisation phase, either from a legal, tax or accounting perspective, are likely to create issues in connection with the onward sale.

ESTABLISHING THE TRANSACTION PERIMETER

In its simplest terms, a carve-out transaction is the sale by a corporate group of a particular division, subsidiary or other segment of its business. The target business is typically transferred to a third-party buyer through a share sale or an asset sale, or some combination of the two. As the business that is to be sold will not necessarily be neatly located within a subsidiary legal entity, the first step in the process is to clearly identify the boundaries of the transferring business. A detailed review of the assets and liabilities associated with the transferring business will need to be undertaken to determine ownership and ensure that the correct assets and liabilities are transferred in and out of the transaction perimeter.

If there are any shared assets, the seller will need to decide:

- Whether the asset will be included in the sale and, depending on the outcome, whether it needs to be transferred in or out of the transaction perimeter.
- What sharing, or replacement, arrangements will be required after completion for the party that is not the owner of a relevant asset.

For each relevant contractual arrangement, the seller will need to consider:

- Who the contracting party is.
- Whether that party is remaining in the seller group or being transferred.
- Whether the contract itself is to be included as part of the disposal.
- Whether any arrangements are required to be put in place to share the benefits and obligations under the contract after completion.
- Whether the contract contains any assignment or change of control provisions and, if so, what novations or waivers from third parties will be required.

If guarantees and indemnities have been provided by a member of the seller group in relation to the business that is being sold, releases and replacement arrangements will need to be put in place. The seller will require robust contractual protections if any of these obligations are to remain in place for the benefit of the transferring business for a period following completion.

The buyer will seek comfort that the transaction perimeter has been established correctly through one or more of the following:

- Undertaking its own legal, tax and accounting diligence on the reorganisation process.
- Ensuring that there is general protection in the purchase agreement warranties (to be given by the seller or transferring business management team and, potentially, supported by a warranty and indemnity insurance policy) which should include a robust sufficiency of assets warranty.
- Negotiating specific indemnity protection for tax and any other liabilities arising as a direct result of any reorganisation steps.
- "Wrong pocket" provisions that seek to relocate misplaced assets or liabilities either inside or outside of the transaction perimeter (*see box "Wrong pocket provisions"*).

Wrong pocket provisions

Because of the complexities of a carve-out transaction, there is a heightened risk that assets and liabilities may be misplaced, that is, either transferred or retained by mistake. To help address this risk, a wrong pocket provision may be included in the purchase agreement to:

- Require a party that has a misplaced asset to transfer it to the other party and to account for any benefits that it has received in relation to that asset.
- Allow a party that has a misplaced liability to require the other party to take responsibility for that liability.

In practice, a number of issues need to be considered when determining whether to include a wrong pocket provision (and, if so, on what terms), such as:

- Determining which risks is it required to address: not; the buyer's risk or the seller's risk, or both. Of course, the buyer's risk is that assets relating to the business that it is acquiring are retained by the seller and/or that liabilities relating to the seller's retained business transfer to the buyer. Whereas the seller's risk is the reverse of this: that it transfers assets that relate to its retained business and/or retains liabilities that relate to the business it is selling. A buyer is often seen as needing more protection because it generally does not have the same visibility that the seller, as the current owner, is expected to have.
- Dealing with issues that may complicate any transfer, such as third-party consents or releases of guarantees, and putting in place interim or alternative arrangements, such as holding on trust arrangements and additional transitional services.
- Determining what additional consideration, if any, is payable. Often there is no, or only nominal, consideration, on the basis that the purchase price paid by the buyer was based on a valuation of the business that assumed that the asset in question would be included. Although if that is not the case, it could result in a windfall to the buyer.
- Ensuring that the terms of the wrong pocket provision are in line with the intentions of the parties and consistent with any specific provisions in the purchase agreement that relate to the treatment of certain assets and liabilities, for example, an asset or liability relating to the transferring business may have been intentionally excluded from the sale.

Overall, a wrong pocket provision is very much a safety net; that is, it is not a provision the parties should set out to rely on, rather it is there in case there is a mistake. If it does need to be relied on, implementing its terms may not be straightforward. As such, it is no substitute for thorough due diligence and precise documentation when determining, defining and effecting the transaction perimeter.

STAFF AND BENEFITS

While some employees may dedicate all of their time to the transferring business, others may undertake activities for both the transferring and non-transferring parts of the business; for example, where there are shared services. The seller will therefore need to identify, at an early stage, which employees will transfer with the sale and whether they are already contractually employed by a transferring entity. This may result in a certain number of employees needing to be transferred within the group in advance of the sale.

Employment obligations

As part of these restructuring arrangements, and any associated potential redundancies, the seller will need to consider the applicable consultation obligations and factor the required timescales into the transaction timeline.

Under UK and EU employment law, for example, the transfer of an employee intra-group as part of a pre-sale reorganisation can still give rise to a consultation obligation and may afford the transferring employees additional statutory protections. In addition, if the transaction involves the transfer of employees in EU jurisdictions, consideration should be given as to how works council obligations will be dealt with. These obligations can fundamentally affect the transaction process and timeline, as some EU jurisdictions apply criminal law sanctions if a purchase agreement is entered into before a consultation process has been completed. It may be possible in these circumstances for the parties to use a carefully drafted put option arrangement to avoid a breach and the related sanctions.

Existing employee terms and conditions will also need to be reviewed and any bespoke arrangements identified.

Pensions and benefits

Generally, employees transferring to third parties as part of a carve-out sale will be entitled to receive the same terms and conditions following the transfer that they enjoyed before, including benefits. In respect of pensions, if the buyer of the transferring business does not operate equivalent pension schemes to those that employees benefitted from under the seller, there could be a material deterioration in terms that could constitute a breach of employment law. Although it should be noted that, if the seller has an occupational defined benefit pension scheme, the transferee does not have to replicate this, but has to provide a minimum level of defined contributions in respect of the transferring employees.

In relation to short- or long-term incentive schemes, it is not uncommon for sellers to continue to honour some cash-based incentive payment obligations that fall due after completion. This is notwithstanding the fact that, by leaving the seller group, the employees may not have been entitled to receive them. As the buyer will be the employer at the time of payment, these payments will be funded by the seller but paid through the buyer's payroll provider. In those circumstances, the buyer will want to ensure that the purchase agreement makes it clear that the seller's funding obligations are gross of all applicable employment-related taxes.

Transitional services agreement

A carve-out transaction generally involves the transfer of a business that is integrated in, and supported by, other parts of the seller group that are to be retained. Even if the buyer already has the systems and resources to replicate this support, it is often not practicable for it to do so straightaway. So it is common for the buyer to seek a transitional services agreement (TSA) with the seller group while it puts its own arrangements in place. Conversely, it is sometimes the case that systems and resources used in the seller's retained business are transferred to the buyer, in which case it is likely that the seller will seek a "reverse" TSA.

Issues to be considered when drafting a TSA include:

- Who requires the relevant services, the buyer or the seller.
- The services to be provided.
- The charges for the services and related payment terms.
- The extent of the service provider's liability.
- The period during which the services are to be provided, including any options to extend that period in respect of some or all of the services, as well as early termination rights.
- Arrangements to be made with third parties whose systems or resources are used in connection with the services, such as under software licences.

Although TSAs can sometimes be in relatively short "framework" form if time does not permit the negotiation of a full-form agreement, they are more commonly extensively drafted, as the services in question are likely to be fundamental to the operation of the transferring (or retained) business after completion.

FINANCE AND FUNDING

One of the key elements of the carve-out transaction will be determining the value of the transferring business and how the consideration is going to be financed. The usual approach on a share sale is to use the relevant company accounts as the basis from which to determine the enterprise value. However, when the business that is being sold is not a standalone business, the seller may not have accounting information on a business-by-business basis that would help to establish its value and enable the buyer to undertake financial due diligence. It may therefore be necessary for additional financial information to be prepared specifically for this purpose, a process which will need to be factored into the overall deal timetable.

If the buyer is intending to raise third-party debt to fund the acquisition, the quality of this financial information will affect the range, and cost, of available financing options. Also, as it is unlikely to have been audited, this will affect the terms of the accounts warranties that are given in the purchase agreement.

TRANSFERRING ASSETS

Certain asset classes may require specific steps to be taken in readiness for a third-party transfer.

Data

All of the data that is relevant to the transferring business will need to be identified. This may include purely financial, transactional information as well as personal data of employees, customers (particularly if the business is consumer facing) and suppliers. A carve-out will often involve the disclosure of personal data from one entity to another to some extent. The disclosing entity will need to comply with applicable data protection law whenever it shares personal data.

Additional complexities will arise if there are significant amounts of personal data or where cross-border transfers of data are proposed. The timing and proportionality of the data sharing, and the protective measures surrounding it, must all be kept in mind; for example, the parties need to consider if it is justified for a buyer to receive historic health and leave records for transferring employees either before the transaction is certain to proceed or even once it has occurred. Similarly, the seller should consider what records it is appropriate to retain following completion in relation to transferring employees.

The accountability requirements of the General Data Protection Regulation (*679/2016/EU*) (GDPR) and the retained EU law version of the GDPR (UK GDPR) mean that the preparation of data sharing agreements, data transfer agreements, reviews of employee privacy notices, data protection impact assessments (DPIAs) and legitimate interest assessments (LIAs) may all be expected by a seller. Where employee personal data is being transferred, engagement with works councils, in EU jurisdictions, can also significantly affect the process.

The time and cost involved to migrate large volumes of data should also not be underestimated. The terms that apply to the data transfer, such as migration costs, transfer mechanism and responsibility in the event of a data breach, will be included as part of a transitional services agreement (TSA) between buyer and seller (*see box "Transitional services agreement"*).

Intellectual property

Some intellectual property (IP) assets, such as registered trade marks or patents, may be easily identified as relating only to the transferring business. The process for transferring or licensing that type of key IP asset is relatively straightforward, although assignments or licence agreements may need to be entered into by other members of the seller group if the IP is held centrally in an IP holding company.

However, the intangible nature of IP, with valuable rights such as copyright often subsisting without the need for registration in most jurisdictions, and the fact that some of the IP may need to continue being used both by the seller and the transferring business, can make it difficult to procure a clean split of IP in a carve out. This issue can be approached in a number of ways. For example, the parties could agree that, under an assignment and transitional licensing arrangement, the buyer or seller agrees to cease use of particular IP assets after a specified run-off period, which ensures business continuity and a path for one of the entities to plan migration away from a shared IP asset.

Shared IP, that has been created by the seller and which is fundamental to the transferring business, will also require consideration; the buyer will need rights of use in that scenario and the seller may consider it appropriate to charge an additional licence fee. In some circumstances, the parties may agree co-existence arrangements (most typically in relation to use of trade marks after the sale) where the parties agree that both will use the shared IP and agree the standards that each will maintain in respect of their respective use.

Specific issues may also arise around IP that is owned by third parties, such as software, where third-party consents, novations or assignments may be required before the buyer can lawfully use them.

Further assurance provisions in the transaction are also important, as the path to transferring registered title will require the parties to collaborate, sometimes for significant periods after completion, to record the change of title at national IP registries. This will also entail official fees and legal costs and, for large registered IP portfolios, the parties will want to agree how costs of the registration process will be allocated and managed. Typically, the mechanics involved in transferring domain names, social media accounts and handles, and control of key websites will also be prescribed in the transaction documents.

Finally, wrong pocket provisions may help to ensure that any overlooked or wrongly categorised IP can be reallocated as appropriate (*see box "Wrong pocket provisions"*).

Real estate

If real estate is included in the transaction perimeter, the following steps should be taken to avoid delays to the transaction timeline:

- Identify any leasehold properties and review the terms of the leases to ascertain whether they contain any change of control provisions or restrictions, which will be relevant on a share sale, or any obligations to obtain the landlord's prior consent to the assignment, which will be relevant on an asset sale.

- Check if any charges over the freehold and leasehold properties need to be discharged on or before completion.

- On an asset sale:

  - as the leasehold and freehold properties will be transferred to a new entity, consider any tax consequences, such as stamp duty land tax arising on the transfer of the properties, and whether any applications need to be made to the Land Registry to register the transfer of the properties to the new entity; and

  - identify any properties that are held under a licence to occupy, as they are usually granted on a personal basis and are not capable of assignment to a new entity and so new licences will be required from the landlord.

OPERATIONAL ARRANGEMENTS

In addition to the identification and transfer of assets, the parties need to consider a variety of practical operational issues.

Head office functions

Any shared centralised services, such as company secretarial support, human resources and marketing, need to be identified and consideration given as to how the separated undertakings will obtain the support they need after completion. A TSA can be put in place to enable the buyer to receive services from the seller group for a period after completion while it transitions the acquired business over to its own structure (*see box "Transitional services agreement"*). Typically, a seller would charge the buyer a market standard rate for these post-completion services.

Particular consideration needs to be given to what will happen with any centralised tax and accounting arrangements. The parties will need to agree who has responsibility for preparing the transferring business tax and accounting returns for the period before completion and paying any related taxes.

Insurance

Most corporates will operate group insurance policies rather than insure on a business-by-business basis. As such, a new set of insurance arrangements will need to be entered into by the buyer with effect from completion. These may be at a higher cost than was previously the case if the policy does not attract the same benefits of economies of scale that the business received as part of the seller group's policies.

The buyer will want to check whether the seller has in place claims-made policies (those that only cover incidents that are reported within the policy's timeframe) or claims-occurring policies (those that provide lifetime cover for incidents that take place during a policy period, regardless of when the claim is reported).

If pre-completion liabilities relating to the business are to pass to the buyer, it should ensure that it receives the benefit of any claims-occurring policies held by the seller which will continue to provide cover notwithstanding the transfer of the business. As these policies will remain in the name of the seller, the purchase agreement should detail any rights, such as conduct and access to information, and obligations, such as the payment of deductibles, that will be received by the buyer. If only claims-made policies are in place, the buyer may, subject to the costs involved, wish to put in place tail coverage to cover claims made after completion.

Litigation disputes

The transferring business may have pending or ongoing disputes relating to the period before completion. The buyer and seller must agree where the risk or reward will sit after completion and include specific provisions in the purchase agreement. For example, if the seller stays on risk for certain claims against the transferring business, it will want to be able to continue to obtain relevant information relating to the transferring business; the buyer, on the other hand, is likely to seek contractual protection from losses incurred in relation to such historic claims.

Regulatory

If the transferring business operates in a regulated or sensitive sector, or falls within the thresholds prescribed by any relevant competition or antitrust or foreign direct investment (FDI) authority, then regulatory consent, antitrust or FDI approval, will be required before completion, although it is typical to enter into a binding purchase agreement that is conditional on any such approvals being granted.

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In some circumstances, such as under the National Security and Investment Act 2021 and similar regimes in other jurisdictions, certain pre-sale reorganisation steps may also require regulatory consent (*see feature article "National Security and Investment Act 2021: taming the M&A dragon", www.practicallaw.com/w-032-2847*). Given the timescales for review of the transaction under these regimes, the approval processes will need to be factored into the overall timetable.

Seller group debt arrangements

If security has been granted over the transferring assets in connection with any seller group debt arrangements, this will need to be released by the lender. The seller should factor into its calculations any fee that the lender may charge or whether security will be required over replacement assets with an equivalent value. Debt covenants in underlying facility agreements should also be checked to ensure that the removal of assets, revenues or profit from the group will not trigger an event of default.

TAX

While carve-out transactions are often multi-jurisdictional, and so the list is far from exhaustive, the following taxes are likely to be relevant:

- Capital gains taxes. These may be payable in relation to the gain made by the seller on the sale of a particular asset.
- Transfer or "stamp" taxes. These are a one-off charge on the transfer of specific types of asset. In the UK, these would apply to certain types of real estate and securities transfers.
- Valued added, or sales, taxes. These can be added to the cost of sale of certain assets and so are often added to the consideration, although in many cases an exemption may be available if the transferred business constitutes a "going concern".

In addition, if the seller has previously relied on any tax group reliefs for transfers of assets in or out of the transferring group before completion, the underlying tax liabilities may crystalise when a relevant entity leaves the group. The risks relating to these types of liabilities will need to be agreed and set out in the transaction documents. A relevant question will always be whether the tax position is better or worse if it is the company that is sold or the business assets held by it.

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