

Guideposts for a Carveout

Acquiring a corporate subsidiary or business unit can present as many challenges as opportunities

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A recurring, yet nonetheless always challenging M&A scenario involves the situation where a buyer seeks to acquire a business unit that is being sold off by a large company.

The reasons for the sale can be varied. The business unit may no longer be a good fit with the larger enterprise's overall business strategy. The business unit may require a significant infusion of cash or other resources that the parent is not prepared or equipped to contribute. Or the larger enterprise may be struggling and eager to raise cash for its core business.

Whatever the reasons (and it is advisable for a buyer to ferret out what are the true reasons), such transactions present unique opportunities as well as challenges. Unless attuned to the distinctive aspects of such corporate dispositions, a prospective buyer can easily be tripped up by unwelcome surprises.

For would-be buyers exploring such a transaction, it's important to consider certain key guideposts.

Tailoring Due Diligence

Business units, whether they be unincorporated divisions or separate subsidiaries, are typically dependent in some fashion on their parent or affiliates and are therefore seldom able to operate as self-sufficient companies. Prospective buyers must constantly keep this reality in mind when tailoring due diligence for such transactions.

First, the business unit's financial statements, to the extent historical financials are even available, may

be incomplete and unaudited, and consequently may not provide a true picture of the unit's financial position and performance. Accounting adjustments, such as allocation of overhead, may not properly reflect business realities. Related-party transactions, such as the leasing of real property, the provision of raw materials or services, and the purchase of the unit's finished goods, can also dramatically impact operating results and therefore must be closely examined. Even external payables and receivables may be intermingled with other members of the consolidated group and not allocated. Such shortcomings and the lack of Sarbanes Oxley-mandated procedures and controls may pose problems for buyers that are public or plan to become public.

There may also be group liabilities for which the business unit is and may continue to be liable on a joint and several basis, such as those associated with pension plans, tax liabilities, environmental liabilities and borrowings under credit facilities. The buyer must identify all such potential liabilities and, unless it is willing to assume them, either eliminate them or secure satisfactory indemnification from the seller.

From an operational perspective, it is imperative that the buyer identify and understand all the group support functions that will disappear once the transaction closes and what it will take to replace them, especially if the business is operating on a standalone basis post-closing. In addition to typical accounting, legal and IT support, examples include insurance coverage, letters of credit, benefit plans, en-



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terprise-wide licenses of mission critical software, and the usage of telecommunications systems.

In short, the buyer must carefully assess what is needed to operate the business successfully and how many of those necessary elements will actually be acquired, and how many the buyer must itself supply or purchase from external sources.

Structuring the Transaction

If the seller has structured the business unit disposition as an asset sale, the buyer must ensure that it is acquiring all the assets necessary to operate the business. The buyer should likewise confirm that no extraneous unneeded assets or liabilities have been gratuitously included by the seller. As in any asset purchase, the seller should take care as to what liabilities it is expressly assuming as well as any liabilities that might be imposed upon a successor owner by operation of law.

If the transaction has been structured as a sale of a subsidiary, particularly a recently formed entity into which the seller has dropped operating assets, the buyer must resist the temptation to assume that it is acquiring a self-sufficient entity. As in any stock acquisition, buyer must be particularly careful that in acquiring all the equity, it is not unwittingly assuming unwanted liabilities.

Depending on the relative bargaining strength of the parties and the number of bidders vying for the business unit, the corporate seller may resist a prospective buyer's efforts to cherry pick assets and liabilities and insist that the buyer take the mix of assets and liabilities chosen by the seller.

From a tax perspective, an asset purchase allows the buyer to write up its tax basis in the acquired assets to their purchase price, thereby yielding the buyer tax benefits derived from higher levels of depreciation in the ensuing years. The sale of a subsidiary will yield the same result if the seller offers or can be persuaded to file a so-called Section 338(h)(10) election under the Internal Revenue Code. The result is that the transaction will be treated as stock sale for corporate purposes, but in general as an asset sale with a basis step-up for tax purposes. If the seller is unwilling to agree to a Section 338(h)(10) election, then the buyer should adjust its valuation of the business to reflect the tax benefits not being realized.

Negotiating Deal Terms

When it comes time to negotiate the terms of the

transaction, a buyer of a business unit must be sensitive to the peculiar aspects of a business unit sale that should be reflected in the acquisition agreement.

First and foremost, there is the issue of price. As noted above, it may be difficult to get a firm handle on the business unit's profitability given the lack of audited financials. Also, the buyer must take into account support services that it might have to furnish at its own expense in order to maintain operations. All this makes pricing of such transactions particularly difficult. The buyer will also need to gauge the corporate seller's focus on speed and certainty of closing if it is to differentiate itself from the competition. Most corporate sellers will not be keen on earnouts, seller paper and indemnification escrows.

There are often lengthy discussions regarding what representations the seller is willing to make regarding the financial statements and whether the seller will be required to upgrade the quality of the financial statements.

Also important are representations as to the adequacy of the assets and potential joint and several liability with regard to tax, ERISA and environmental liabilities.

Certain third-party consents may be required, such as consent of the seller's senior lenders and release of the business unit's assets from the lien of the credit facility. If the business unit has important contracts with change-in-control termination triggers, consents must be obtained or the contracts renegotiated.

If the name of the business unit or its products is to change, the parties must address the logistics of how and over what time period signage and labeling on everything from buildings to instruction manuals will be updated. The buyer may need an interim license to use the old name for limited purposes during a transitional period.

Post-Closing Obligations

The unique nature of corporate business unit dispositions will often heighten the importance of post-closing obligations between the parties. Vendor and customer agreements, non-compete clauses, and non-solicitation provisions are a few areas worthy of focus.

The unit, for instance, may have transacted significant business with other operations of the seller. Raw materials or component parts may be two examples. Or the seller may be a significant customer of



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the business units' finished goods and services. While a member of the consolidated group, such arrangements may have been transacted on an open account basis and not reduced to a written contract. A buyer in such circumstances, however, will have a strong interest in formalizing such arrangements since they may significantly impact the continuing profitability of the business unit. Also, the pricing of such inter-company arrangements may not necessarily reflect current market conditions and so a buyer should carefully examine them and, when appropriate, seek to negotiate such terms.

Trade secrets are also an important component. Information pertaining to the business unit may be spread throughout the seller's corporate group. Beyond the normal confidentiality covenants, the buyer may have a keen interest in requiring the seller to collect and destroy all such information.

The scope of non-competition covenants, meanwhile, can also require extensive negotiation. The seller may still have other operations in the same space, or not wish to curtail its ability to expand into or make acquisitions in the same space. The buyer, on the other hand, does not want to pay for the business unit only to discover that the seller is soon competing with its former subsidiary. Non-solicitation agreements are another consideration. Many employees of the business may have over the years developed close ties with others in the seller's group. The buyer does not want to risk losing key employees of the newly acquired business unit to the seller. The buyer will want to impose tight non-solicitation obligations on the seller and perhaps non-competition obligations on its new key employees.

Access to corporate records can also come up, as the new owner of the business unit may need access to income tax, sales tax, and other records in the event that there are tax audits or other governmental requests for information that pertain to periods prior to the closing.

Transitional Services Agreement

Sometimes, a business unit is highly dependent upon the seller for certain services that are critical to its operations, and the buyer is not in a position to supply or externally secure those services at closing, particularly if the closing is on a fast time track. In such circumstances, the parties must negotiate a transitional services agreement or TSA under which the

seller will provide services for a limited time.

From the seller's point of view, it is a necessary accommodation to get the deal done, but the seller would prefer to move on and focus on its core business. From the buyer's point of view, the securing of such transitional services is essential to maintaining the going enterprise value of the business unit.

Negotiation of a TSA is driven by deal timing considerations, the capabilities and resources of the business unit and the buyer, and, as is always the case, the relative bargaining strength of the parties. A negotiated TSA will commonly address a number of issues.

The buyer, based on its due diligence findings and its own internal capabilities, is typically the party that drives what services will be included in the TSA. The following are among the services commonly included: use of real estate, warehousing, distribution and procurement, data processing, telecommunications, employee benefits, finance and accounting, and training. The seller must be sensitive to whether there are third party contractual restrictions (e.g., software license agreements) on its ability to provide services to a business unit that post-closing is an unrelated party.

Moreover, the buyer will want to ensure that the duration of the transitional services arrangement is sufficient and that it is not left high and dry. Similarly, the buyer will resist any right of the seller to terminate the arrangement prematurely. In fact, the buyer may seek certain rights of extension if the transition takes longer than expected. The seller is apt to resist such extension rights.

Pricing can also warrant negotiation. Services can be priced on a service-by-service basis or at a flat rate. The pricing levels may increase for any extended term so as to serve as an incentive to the buyer to complete the transition.

The buyer may also ask that the business unit be treated the same as seller's other business as to the quality of services and timeliness. Because the seller is providing such services as an accommodation and not as a primary profit center, it may insist upon a generally lower level of care (e.g., breach for only gross negligence and willful misconduct) than is customary in a typical commercial arrangement. **MA**

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