# Maximizing Value & Minimizing Risks in Carve-Outs: Seller's Pre-Sale Preparation

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*By Eva Davis, Kyle Gann and Rachel Ingwer*

In an increasingly frothy M&A marketplace, where the proprietary deal is little more than a unicorn rumored to have once been seen, investors seek competitive advantages by identifying transactions in which their sophistication and experience creates an edge over other suitors.

The ability to expeditiously execute on complex carve-out opportunities, in which one or more business divisions are acquired from a larger enterprise, is one such method of differentiation for the seasoned private equity fund or strategic acquirer. But, just as opportunity springs from complexity, so too does peril.

This is the first in a series of articles that explores the ways to maximize value, and avoid hazards, in carve-out acquisitions. In this first article, we explore the basic nature of a carve-out transaction and key issues for a seller to consider when preparing for a carve-out transaction.

## A Carve-Out Transaction Described

At its most basic level, a carve-out transaction is a deal in which a subset of assets and liabilities are separated from, and disposed by, a larger enterprise. It typically involves the transfer of one or more (nearly) intact business lines. The phrase "carve-out transaction" is most commonly used by practitioners to refer to a transaction in which the assets or stock of the carved-out business are actually sold to a third-party buyer.

While the primary focus of this article is on carve-out sale transactions, many of the issues discussed in this article are also key considerations in other, closely-related cousins to the carve-out sale, such as a spin-off, split-off, or equity carveout, which we will address in later articles.

## A Seller's Motivation

A seller's primary motivation for pursuing a carve-out sale is often to convert non-core assets, which may be underfunded and undermanaged, into cash. This allows a business to focus financial resources—together with management time and energy—on the operations of its core, retained businesses.

A source of seller reluctance in the carve-out sale is the fear of selling low (and therefore failing to maximize shareholder value). However, in addition to the value of freeing management time to focus on core assets, there are sometimes direct pecuniary benefits to selling low: namely, recognizing tax losses. A seller may be able to utilize tax losses to offset taxable income, thereby increasing the cash value of a transaction.

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While the reduction in the corporate tax rate under the Tax Cuts and Jobs Act may reduce the value of tax losses in some circumstances, it also increases the attention a seller should place on properly structuring a loss transaction. In particular, by eliminating net operating loss carrybacks, by imposing restrictions on net operating loss carry forwards for all taxpayers and by limiting the deductibility of trade or business losses for non-corporate taxpayers, the Tax Cuts and Jobs Act makes it particularly important that taxpayers consider appropriate timing of any tax loss transaction to best match such transaction with taxable income.

Another key consideration is determining the manner in which sales proceeds will be deployed. Debt financing

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agreements typically will obligate a seller to reinvest cash proceeds in the retained business (whether through M&A activity or organically) or to use the proceeds to deleverage the balance sheet.

Notably, many corporations are reassessing appropriate leverage levels in light of the Tax Cuts and Jobs Act, which has made leverage less appealing both by reducing the tax benefit arising from interest deductions (as a result of lowering the corporate rate more generally) and by capping deductions for net business interest expense at 30% of a business's adjusted taxable income. The ability to tax-optimize the balance sheet by using proceeds from carve-out sales to pay down debt may tilt the scales for waffling sellers.

It is not unreasonable, therefore, to expect a healthy volume of carve-out transactions, making this a timely topic of consideration for deal-makers.

## Pre-Sale Preparation

### 1. The Carve-Out Financial Statements

The first step in a carve-out process is defining the business that will be subject to the transaction and backstopping that definition with financial statements. This can be a key determinant in the purchase price obtained by the seller. If seller thinks through the business that will be subject to the transaction and provides financial, legal and operational information that closely aligns with that business definition, it can serve to increase buyer confidence in the diligence process.

Furthermore, the type of financial statements provided on the business may expand (or limit) the pool of potential buyers and the financing options available for the transaction. In small deals, buyers may get comfortable with unaudited financial statements.

However, in larger deals, audited financial statements for at least a full fiscal year, and possibly up to three fiscal years, may be required if the pool of buyers includes public companies (or buyers that intend to finance the transaction through the issuance of registered debt securities) and if the acquired business is considered "significant" relative to buyer's existing business. [1]

Thus, before the seller goes to market with the assets, it should be in a position to provide historical GAAP financial statements for the acquired business. [2] A number of thorny issues arise in preparing the carve-out financial statements.

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Over the last decade there has been a trend toward ever tighter integration of business divisions within an enterprise, due in part to the widespread implementation of enterprise resource planning (ERP). This trend has made it rare for a business division to truly operate on a stand-alone basis within seller's larger enterprise. The interdependency of business divisions significantly increases the complexity of preparing carve-out financial statements and implementing a carve-out transaction.

As a result, in order to prepare carve-out financials, the seller will need to take a position on a number of important subjects. These subjects include treatment of shared assets, the manner in which working capital is handled, and the allocation of liabilities.

### 2. The Legal Structure

In many circumstances, the legal entity structure of an enterprise may be driven by tax and/or jurisdictional considerations that do not necessarily align with the seller's business segments. Even in situations in which a business segment is clearly delineated for financial reporting purposes, it is not atypical for the assets and liabilities to be housed in a number of legal entities.

1 *See* Rule 3-05 of Regulation S-X promulgated under the Securities Act of 1933, as amended.

2 A seller that is a public reporting company looking to dispose of the entirety of a sizeable operating segment may already have the relevant financial statements for the carved-out business due to its past compliance with FAS 131.

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These legal entities may also host assets and liabilities for other operating segments that are not being sold in the transaction, further driving transactional complexities.

A carve-out transaction may be structured as an asset sale, an equity sale or a combination of the two transaction types. In addition, even if the transaction is structured as an equity sale only, it often will contemplate a complex pre-closing restructuring as assets and liabilities are shifted inside and outside of the deal perimeter. Thus, it is rarely the case that a carve-out looks like a "plain vanilla" equity deal.

In considering the legal structure needed to implement the carve-out transaction, parties generally consider three key issues: (1) optimizing tax efficiency, (2) minimizing business disruption and (3) allocating historic liabilities. Often these objectives are in tension.

***Optimizing Tax Efficiency***

One of the first issues to consider in structuring a carve-out transaction is the tax implications to both the buyer and the seller of any proposed structure. The ideal structure will be driven by a number of complex factors, examples of which include:

- The existing structure of the business (e.g., whether it is housed in a pass-through, c corporation or multiple entities);
- The importance to potential buyers of achieving a basis step up;
- The tax attributes of the parties;
- Existing tax liabilities;
- The nature of any foreign operations; and
- The tax consequences of any pre-transaction restructurings.

Because there are so many factors that need to be weighed, there is no cookie cutter structure. For example, if a parent corporation is carving out a business that it operates through a corporate subsidiary, it generally should be possible to structure the transaction to permit the buyer to obtain a basis step-up (e.g., through a Section 338(h)(10) election).

However, if the subsidiary was acquired in a prior acquisition (and was not always a part of the parent corporation's consolidated group), the basis in the subsidiary's stock might exceed the subsidiary's basis in its assets. This could result in a significant tax cost to seller for structuring the transaction in this manner.

In addition, a buyer and seller will need to pay careful atention to changes in law resulting from the Tax Cuts and Jobs Act. Because of the speed of the law's adoption (and a corresponding lack of guidance on how ambiguities will be resolved), the impact of the Tax Cuts and Jobs Act on deals is not always clear.

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Consolidated groups, in particular, are struggling with how various rules will be applied (e.g., whether the new interest limitation or the tax on certain income of foreign subsidiaries (Global Intangible Low Tax Income or GILTI) will be applied on an entity-by-entity basis or at the consolidated group level), and the resolution of these matters may cause them to reassess various aspects of their operations.

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What is clear, however, is that the changes in law could impact how deals are valued. Most fundamentally, in many instances, the Tax Cuts and Jobs Act makes structuring a transaction as an asset sale for tax purposes even more appealing. Buyers now have the ability to immediately expense most amounts allocated to tangible property, whether new or used, instead of having to depreciate such amounts over the useful life of the property.

In the cross-border context, obtaining a basis step up (including by making a Section 338(g) election) is likely to be even more critical to U. S. buyers, as the new GILTI tax is calculated on income in excess of an assumed return on tangible assets. Being able to accommodate a buyer in structuring a carve-out transaction to provide a basis step up may make a target more appealing.

Another example of changes that will potentially impact valuation include the one-time deemed repatriation tax and the corresponding ability of corporate taxpayers to bring foreign cash back into the United States, generally without incurring further U. S. tax liability for doing so. . Historically, buyers and lenders were unwilling to pay dollar for dollar for cash trapped in foreign jurisdictions, but these changes may result in sellers obtaining greater value for trapped cash (and for foreign operations generating cash).

***Minimizing Business Disruption***

In landing on a legal structure for the deal, a seller must also consider the potential for business disruption that results from various structuring alternatives. As a general rule, a stock sale results in a less burdensome consent process than does an asset deal.

In a stock deal, the purchaser is acquiring the stock, and all the assets and liabilities travel with the entity being acquired by operation of law. This form of transaction may trigger change-in-control provisions in key agreements of the target business, which may require consent from the contract counterparties. However, failure to obtain consent in a stock deal usually results in a breach of contract (as opposed to an inability to transfer the contract or permit at all in an asset deal).

Conversely, in an asset deal, a seller must assign each of the assets of its business. If a contract requires consent in connection with assignment and consent is not obtained, the transfer may be ineffective in an asset deal as a matter of law. This issue is exacerbated by the fact that contracts tend to require consent more often in connection with an assignment (in an asset deal) than upon a change-in-control (in a stock deal).

It is not atypical for a buyer to require that consents for certain material contracts or permits, which materially impact the revenue model or cost basis, be obtained as a condition to closing. Thus, minimizing the scope of material consents required will often be a key concern for a seller. In the current seller-favorable market, some buyers may be willing to take the risk of assuming a contract without consent of the contract's counterparty and simply focus on keeping the customer happy post-closing.

Similarly, permits or licenses may travel with the legal entity and not with the assets of the entity. If the transaction is structured as an asset deal, it could result in an extensive amount of work for the buyer to replicate the governmental (or semi-governmental) approvals that are critical to the continued operations of the business.

This often will be an important concern if the business operates in a regulated space; even more so if the buyer is a financial sponsor. A financial sponsor will face a number of challenges in replicating necessary permits or licenses. First, the acquirer, as a newly formed acquisition vehicle, will not employ personnel with industry expertise. Often such personnel can be of invaluable assistance in navigating byzantine approval processes. Secondly, in instances where approval of permitting or licensure involves a balance sheet or similar test, the acquiring entity simply will not have the requested historical financials (and private equity funds are loath to provide guarantees of the obligations of the portfolio companies they own)—and difficult conversations explaining the transaction may need to occur with the governing body. These types of permitting and licensure issues can be a source of significant transactional uncertainty and delay.

The workforce also presents another source of potential risk for business disruption in an asset deal. Employees can become consumed by concerns with the stability of their employment and future opportunities during an M&A transaction.

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Asset deals are even worse. Unlike a stock deal where the employees naturally travel with the employer entity being sold, in an asset deal in the United States employees need to be offered new employment by the buyer entity. (Note that this is not always the case in foreign jurisdictions and can raise other problematic issues parties need to sort through overseas.) Under this construct, the selling entity usually terminates the employee, and the buyer entity makes an offer to the employee.

This structure can lead to workforce confusion, thus requiring more advance planning, communications and coordination with employees than a stock transaction. No buyer wants a valued employee to hear the "terminated" message and fail to understand that the termination is a mere legal technicality, with employment continuing seamlessly at the buyer acquisition vehicle (assuming the offer of employment is accepted).

In addition, parties will need to ensure that liabilities do not result from the technical termination (e.g., severance rights) and if they do, that those liabilities are waived by the employee or otherwise appropriately allocated among the parties.

***Allocating Liabilities***

As noted above, in a stock deal, the assets and liabilities travel with the entity that is sold. Conversely, subject to successor liability doctrines, in an asset deal only those assets and liabilities that are contractually specified are transferred.

Thus, an asset deal offers the parties an opportunity to efficiently allocate liabilities amongst themselves in creative ways. By convention, if the deal is structured as an asset deal, a buyer tends to assume only those liabilities arising after the closing—even if pre-closing liabilities relate to the business it is acquiring.

Although this may seem like a material disadvantage to a seller, the ability to allocate included and excluded liabilities may be a valuable way for a seller to protect purchase price. For example, a seller with a long operating history may have entities housing the business which have an equally lengthy history. If that operating history includes business lines that are not related to the business, a buyer may be reluctant to acquire the entity in question (or may discount its purchase price to account for any risk associated with those liabilities).

Although a buyer can seek indemnity for pre-closing liabilities unrelated to the business, an indemnity—which is a contractual creature entitling buyer to reimbursement for its losses—is an intrinsically weaker protection than never acquiring the liabilities at all. And, the value of that indemnity is entirely dependent upon the credit-worthiness of the seller.

If the prior operations are particularly problematic (e.g., a manufacturer of rockets, a producer of nuclear energy, an industry that has had asbestos issues) a buyer may, due to information asymmetry, more heavily weight the liability exposure than does a seller. An asset deal, unlike a stock deal, generally allows the parties the flexibility to slice and dice liabilities in an efficient manner.

## Conclusion

A seller's primary motivation for pursuing a carve-out sale is often to convert non-core assets into cash, thereby allowing the seller to focus its financial resources and management time and attention on its core, retained businesses.

By presenting a buyer with creative ways to carve up the assets and liabilities in order to optimize tax efficiency, minimize business disruption and position ongoing liabilities in a more easily calculable manner, a seller can increase buyer's comfort level with the underlying business being acquired. With careful, advanced preparation, a savvy seller will be in the best position to get the best price for its non-core, carved-out business.

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## Key Contacts

**Eva Davis**
Partner, Los Angeles
evadavis@winston. com

**Rachel Ingwer**
Partner, New York
ringwer@winston. com

**Kyle Gann**
Partner, Chicago
kgann@winston. com

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