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Carve-Out Transactions

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A Practice Note highlighting the key issues that arise in a carve-out transaction. This Note addresses financial statements, taxes, the allocation of assets and liabilities, employee benefits, and other significant matters in a carve-out transaction.

A carve-out transaction is the sale of a subsidiary, division, or other part of a larger business enterprise. These transactions raise several unique issues. Being prepared for these issues before they arise can make the difference between a successful transaction and a failed transaction (or a transaction that never happens at all).

After deciding which assets and liabilities are staying with the seller and which are being sold (and how to unwind them), there are a series of hurdles that must be overcome in a carve-out transaction. This Note highlights key issues to consider at all stages of a carve-out transaction, including preliminary planning, due diligence, and transaction agreement negotiations.

For more information on private acquisitions generally, see Practice Notes:

- Asset Acquisitions: Overview.
- Stock Acquisitions: Overview.
- Private Acquisition Structures.

Financial Statements

Preparing financial statements for the assets or business units that are being divested is one of the most critical tasks in a carve-out transaction.

Although the vast majority of sellers prepare audited financial statements at the top company (or enterprise) level, the degree of financial statement preparation for subsidiaries and divisions varies widely. Most of those financial statements (if prepared at all) are inadequate for a potential buyer's purposes, whether for due diligence or raising bank or public debt financing to fund the acquisition. Accordingly, the preparation of more comprehensive financial statements often becomes a condition precedent to an acquisition and raises several related issues that affect deal mechanics, timing, and expense allocation. Although the best way to address these issues depends on the particular facts of the deal, they should always be dealt with early in the deal process to maximize deal value and maintain credibility among deal parties.

Specific issues that arise include:

- Ensuring financial statements are completed in time to avoid transaction delays.
- Determining which parties are responsible for paying preparation expenses.
- Identifying conflicts or concerns that may come up regarding personnel involved with preparing the financial statements.
- Understanding the implications of having the delivery of the financial statements as a closing condition.

Avoiding Delays and Maximizing Deal Value

Advance planning is essential to avoid unexpected and costly transaction delays. Because the financial statements and the balance of the due diligence materials provided to interested parties represent the prospective buyer's initial view into the target assets, they must properly reflect the assets and liabilities being divested. The financial statements must often be created from scratch, and the timeline for any auction of the carve-out assets must accommodate the realistic completion of the financial statements and supporting materials. Even a big four accounting firm working with an experienced in-house accounting staff may need more time than expected to complete carve-out financial statements. This is due, in part, to the nature of carve-out accounting and the many assumptions regarding attributed costs.

Inadequate financial statements can result in potential buyers raising serious credibility concerns about the carve-out assets. These concerns can decrease the value of the assets in a potential buyer's eyes, taking their focus away from the potential synergies and financial upside of the assets.

Preparation Expenses

Parties entering into a carve-out transaction should agree in advance on the payment of all expenses associated with preparation of the financial statements. Usually this agreement is a detailed covenant in the purchase agreement. When pre- and post-closing purchase price adjustment mechanisms are built into the transaction, care must be taken to ensure that the purchase price adjustment provisions do not alter the agreed deal regarding the payment of preparation expenses. For example, a closing balance sheet might include an accrual for preparation expenses that would result, absent any provision to the contrary, in the seller bearing these costs even if that was not the business deal.

In addition, in a transaction that will involve public debt, the financial statements may need to be revised due to comments from the Securities and Exchange Commission (SEC). If the financial statements must be revised or restated, an issue may arise about which party is best positioned to perform the necessary work.

Pre-closing, the seller is generally the best-suited party, having presumably prepared the original set of financials. Post-closing, however, the seller is unlikely to be in a position to revise the financial statements. Therefore the burden would likely fall on the buyer, who has operated the business since closing. Accordingly, an agreement on payment for the expense of preparing the statements should be negotiated as early as possible during the transaction and take into account any foreseeable contingencies such as SEC-required revisions.

Personnel

Before the closing, the individuals primarily involved in the preparation of the carve-out financial statements will most likely be employees of the seller. However, these employees may be a mix of employees that the seller will retain and employees that will be transferred to the buyer in the transaction, sometimes resulting in split loyalties and divergent goals (see Identifying Employees).

Sellers in particular must appreciate these practicalities and be prepared to deal with employees who start working for the buyer (whether officially or unofficially) before the financial statements are completed. Buyers should recognize the degree of cooperation required from both sets of employees, including assistance for the preparation of debt offering documents and participation in due diligence, drafting sessions, and road shows.

Sellers must also be aware that individual employees involved in the preparation of carve-out financial statements might be held liable to third parties (such as lenders). It is generally good practice to include waivers, indemnities, or other devices limiting the personal liability of those employees in the purchase agreement covenant governing the cooperation of seller employees in the preparation of financial statements.

Closing Conditions

In transactions in which the delivery of the carve-out financial statements is a condition to the buyer's obligation to close, the specific language in the condition can be a critical part of the transaction. If there is a requirement that the financial statements must be satisfactory to the buyer (whether or not this satisfaction must be reasonable), sellers should recognize that the condition acts in certain ways as a due diligence condition in favor of the buyer.

Even if there is no satisfaction element to the delivery of the financial statements, sellers should realize that, as a practical matter, the preparation of the financial statements essentially gives the buyer the opportunity to engage in further due diligence. This due diligence may reveal a breach of the seller's representations and warranties (whether concerning the financial statements or not).

US Federal Income Tax

A carve-out transaction raises a variety of tax planning opportunities and hazards. While these overlap with tax considerations that apply generally on a sale of a business, the particular circumstances of a carve-out transaction, where other business operations are continued by the seller, can raise significant issues. Although the discussion below focuses on a high-level overview of key US federal income tax considerations, international, state and local income, and other tax considerations must be considered.

Key variables that may affect the tax treatment of a carve-out transaction and related structure choices include:

- The tax classification of the seller.
- The number of businesses being sold and entities involved in the transaction.
- Available tax attributes of the seller.
- The sale of the business at a loss.

For more information about tax considerations in an asset and stock sale, see Practice Notes, Asset Acquisitions: Tax Overview and Stock Acquisitions: Tax Overview.

Tax Classification of the Seller

In a carve-out transaction, the seller's tax classification must be considered. Businesses are generally formed under state law as:

- Corporations.
- Partnerships (as general partnerships, limited partnerships, limited liability partnerships, or limited liability limited partnerships).
- Limited liability companies (LLCs).

For tax purposes, a business is treated as one of the following:

- A disregarded entity.
- A C-corporation.
- An S-corporation.
- A partnership.

The state law classification of a business entity is not always the same as the tax classification of a business entity. For example, a state law partnership can often elect partnership or corporation tax status. Unlike partnerships and corporations, LLCs do not have a specific set of tax rules that apply only to LLCs.

The tax classification of a business is important because of the different tax rules that apply to a disregarded entity, C-corporation, S-corporation, and partnership. For more information, see Practice Note, Choice of Entity: Tax Issues.

Seller is a Pass-through Entity

Partnerships, multiple-member LLCs, and S-corporations are treated as pass-through entities for tax purposes, absent a tax election to be treated as a C-corporation. A pass-through entity does not pay an entity level tax. Instead, the pass-through entity's profits and losses generally pass through to its partners, members, or stockholders, who include their respective share of those items on their individual income tax returns (whether or not distributed).

If the seller is a pass-through entity and the divested business consists of assets directly held by the seller or held through another pass-through entity, a buyer of the assets of the divested business (or of the pass-through entity that holds those assets) receives a cost basis in the purchased assets. This reflects the purchase price paid, rather than the seller's historic basis in these assets.

Where the purchase price reflects value in excess of the fair market value of the purchased tangible assets, part of the resulting basis is allocated to the goodwill, going concern value, and other intangible assets of the purchased business. The basis of goodwill, going concern value, and other intangible assets generally is eligible to be written off for tax purposes on a straight-line basis over a 15-year period beginning with the month of acquisition (IRC § 197). A buyer typically evaluates the present value of these future tax deductions when calculating its purchase price.

Seller is a C-Corporation

A C-corporation, unlike a pass-through entity, is generally subject to two levels of tax on its income:

- At the entity level when earned.
- At the stockholder level when distributed.

If the seller is a C-corporation and the carve-out transaction consists of part but not all of its business, the sale at a gain generally results in taxable income for the seller (for a sale at a loss, see Sale of the Business at a Loss).

If the divested business is operated in a corporate subsidiary of a corporate seller, the seller must decide whether to structure the carve-out transaction as an asset sale or a stock sale. If the seller's basis in the stock of the corporate subsidiary (referred to as outside basis) is higher than the subsidiary's basis in its assets (referred to as inside basis), the seller may prefer to structure the carve-out transaction as a sale of subsidiary stock.

The seller would choose a stock sale if its gain on a sale of the subsidiary's stock would be less than the gain that would be triggered if the subsidiary sold its assets at the same price. One situation where the seller's outside basis is likely to be higher than the subsidiary's inside basis is where a seller acquired a subsidiary in a prior stock purchase without a Section 338(h)(10) election.

Buyers generally prefer to structure a carve-out transaction to receive a cost basis in the subsidiary's assets. A buyer can achieve this by structuring the transaction to either:

- Purchase the subsidiary's assets.
- Treat the purchase of the subsidiary's stock as a deemed purchase of assets by using:
  - a Section 338(h)(10) election (where the buyer is a corporation); or
  - a Section 336(e) election (where the buyer is a partnership or other non-corporate entity).

In a stock acquisition, the subsidiary's basis in its assets generally remains unchanged. Buyers generally prefer a cost basis because a cost basis often is higher than the basis that the subsidiary had in those assets (referred to as a stepped-up basis).

A seller is generally unwilling to structure a carve-out transaction as an actual or deemed asset sale if it triggers a higher tax than a sale of the subsidiary's stock.

In the following example, assume that:

- The seller's outside basis in its subsidiary's stock is $500.
- The subsidiary's inside basis in its assets is $100.
- The subsidiary's tangible assets have a fair market value of $100 (matching inside basis) and that any additional value in the subsidiary's assets is attributable to goodwill, going concern value, and other intangible assets (for example, customer lists, workforce in place, and know-how).
- The seller, subsidiary, and buyer are all subject to an effective combined US federal, state, and local tax rate of 26%. This tax rate reflects the 21% US federal income tax rate for corporations introduced by the Tax Cuts and Jobs Act (TCJA), and that the actual applicable state and local tax rate, and the resulting effective combined US federal, state and local rate, will depend on specific circumstances.

If the buyer purchases the subsidiary's stock for $1,000, the seller has a gain of $500, resulting in a tax of $130 and net proceeds to the seller of $870. If instead the buyer purchases the subsidiary's assets for $1,000, the subsidiary has a gain of $900, resulting in tax of $234 and net proceeds to the seller (through the subsidiary) of $766.

However, because an asset purchase would permit the buyer to write off $900 of goodwill and other intangible assets over 15 years (resulting in a tax benefit over 15 years of $234), the buyer may be willing to increase its purchase price to reflect all or a portion of this future tax benefit.

The buyer's evaluation of the present value of this future tax benefit can take into account, among other factors:

- The discount rate the buyer applies in its business planning.
- The likelihood of full use of the benefit, reflecting the buyer's future taxable income and potential changes in tax rates or tax law.
- The buyer's investment plans. For example, a private equity business or a buyer contemplating an initial public offering may conclude that the market's evaluation of a future tax benefit will reflect a sharp discount.

If the buyer increases its purchase price for the subsidiary's assets by $117 (or half of the anticipated future tax benefit), the net proceeds to the seller (through the subsidiary) increases by about $87 (net of tax on the increased purchase price) to about $853. This is still less than the $870 of net proceeds to the seller in a straight stock sale.

Sale of Multiple Businesses or Business Held in Multiple Entities

Tax planning opportunities and hazards become more complex where the divested business is held in more than one entity or where more than one carve-out transaction is underway. For example, where a parent corporation is selling both one of its direct subsidiaries and a subsidiary of that direct subsidiary (often referred to as a grand-sub), and the parent and the subsidiary file consolidated US federal income tax returns, a multi-step carve-out transaction may be more tax desirable for the buyer and the seller.

In the following example, assume that:

- Parent has a tax basis of $100 in the subsidiary's stock.
- The subsidiary has a tax basis of $50 in the stock of the grand-sub.
- The grand-sub has a tax basis of $10 in its assets.
- The subsidiary's stock has a fair market value of $500, of which $200 reflects the value of the grand-sub.

If the parent sells the stock of the subsidiary for $500, it triggers a gain of $400, resulting in a tax of $104 (assuming a federal, state, and local income tax rate of 26%) and net proceeds of $396.

If instead the subsidiary sells the grand-sub stock for $200, as a first step, in a transaction treated as a deemed asset sale (meaning a stock sale with a Section 338(h)(10) election or a Section 336(e) election), the sale triggers a gain of $190. Under the consolidated return rules (Treas. Reg. § 1.1502-32), the parent's basis in the subsidiary's stock is increased by this gain, resulting in a basis for the parent in the subsidiary's stock of $290. Assuming that the subsidiary distributes the $200 of proceeds from the sale of the grand-sub, the parent's tax basis in the subsidiary's stock is reduced as a result to $90.

As a second step, if the parent sells the subsidiary's stock for $300 (which is the subsidiary's value after the distribution of $200 from the sale of the grand-sub), this second step triggers a gain of $210. The parent's total gain from the two-step transaction is the same amount as the one-step sale of the subsidiary's stock ($400). However, the buyer of the grand-sub often is willing to increase its purchase price (resulting in more proceeds, as well as more tax, but a net benefit for the parent) if the transaction is structured as a multi-step transaction (for example, if the buyer receives a stepped-up basis in the grand-sub's assets). In this situation, both the buyer and seller generally prefer the multi-step carve-out transaction.

Available Tax Attributes of the Seller

A corporate seller may have tax attributes, such as net operating losses (NOLs) or capital losses, that are available to offset the gain from the carve-out transaction. A taxpayer has an NOL when its allowable deductions exceed its gross income in a specific taxable year. For NOLs arising for taxable years beginning before January 1, 2018, NOLs could generally be carried back two years and carried forward up to 20 years to offset taxable income (IRC § 172). The TCJA eliminated the carryback of NOLs for NOLs arising in taxable years ending after December 31, 2017, allowed an indefinite carryforward of these NOLs, and generally limited the use of post-2017 NOLs to 80% of taxable income. However, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) temporarily suspended the elimination of NOL carrybacks, allowing taxpayers to carry back NOLs arising in taxable years beginning after December 31, 2017, and before January 1, 2021, to the previous five taxable years and repealed the 80% income limitation for taxable years beginning before January 1, 2021. The availability of tax attributes may increase the seller's willingness to structure a carve-out transaction as a sale of the subsidiary's assets.

For the following example, assume that parent has NOLs, and the parent and the subsidiary file consolidated US federal income tax returns. By using the parent's NOLs, the subsidiary can offset its gain on a sale of assets (subject to various limitations in the Internal Revenue Code (IRC)). If the buyer is willing to pay a premium for an asset sale (if, for example, the buyer receives a stepped-up basis), the seller is more likely to agree to structure a carve-out transaction as an asset sale (either with an actual asset sale or with a stock sale accompanied by a Section 338(h)(10) election).

Sale of the Business at a Loss

In down economies, carve-out transactions may involve the sale of businesses that have depreciated in value. If the basis of the seller in the stock or assets being sold is more than the amount received on the sale, the seller in certain circumstances may be able to:

- Use the resulting tax loss to offset other taxable income.
- Carry the tax loss forward to later years (offsetting future income).
- Carry the tax loss back to a prior year (resulting in a refund of prior taxes). However, for US federal income tax purposes NOLs arising in taxable years beginning on or after January 1, 2021 can generally only be carried forward.

However, if the loss is from a sale of stock that results in a capital loss, the loss generally can only be used to offset capital gains of the seller (and not operating income like NOLs). Among other limitations for a corporate seller, capital losses can in general be carried forward only five years (although capital losses also can be carried back three years). Also, where the stock of a subsidiary member of a consolidated group is sold at a loss, special tax rules can reduce or eliminate all or part of the tax loss (Treas. Reg. § 1.1502-36).

Even if the loss is an NOL (as may be the case for many losses from a sale of assets), the seller may not anticipate sufficient other taxable income to take advantage of the NOL (for example, if the seller is financially distressed).

In addition, if stock of a subsidiary is sold and the subsidiary has either prior NOLs that may be carried forward or built-in losses in its assets (reflecting basis in excess of value), special tax rules can limit the use of these types of tax losses following an ownership change.

Generally, there is an ownership change under these rules if the ownership by stockholders owning 5% or more of the corporation has increased in any three-year period by more than 50 percentage points (IRC § 382). These rules are designed to preclude so-called trafficking in tax losses, where a buyer buys and makes use of tax losses. If the limitation on the use of NOLs from an ownership change is economically significant, other approaches can be considered to preserve the benefit of tax losses for a buyer.

For example, assume the seller holds assets of the carved-out business with a basis of $200 and a fair market value of $80 (that is, reflecting a built-in loss of $120). If the assets are sold for $80, the seller may not anticipate a current ability to use the resulting tax loss of $120. Alternatively, the buyer and seller can form a new corporation (Newco). In a transaction intended to qualify as a tax-free formation of a corporation under IRC Section 351:

- The seller contributes the assets to Newco.
- The buyer contributes cash of $80 to Newco.
- Newco borrows $60 and uses the $60 to fund a payment to the seller of $60 in exchange for the contributed assets, together with 20 shares of common stock in Newco.
- The buyer receives 80 shares of Newco stock for its $80 contribution.
- The seller elects to reduce its tax basis in Newco shares received from $200 (its tax basis in the contributed assets) to $20 (the $80 value of the contributed assets, minus the $60 cash received) (IRC § 362(e)).

As a result of this transaction:

- Newco retains the $200 historic basis of the seller in the contributed assets.
- The seller receives $60 and has a continuing equity interest in Newco (the 20 shares it receives, out of 100 total shares outstanding), rather than an unusable tax loss of $120.

Other Important Tax Considerations

When considering the tax planning for a carve-out transaction, other important factors include whether:

- The seller or existing management intends to hold a continuing interest in the business post-sale.
- The seller, the carved-out business or the buyer, in whole or part, are non-US persons or entities.
- The sale may trigger special taxes from prior transactions (for example, deferred gains or amounts reflecting prior loss deductions taken by a corporate subsidiary or the built-in gains tax imposed on an S-corporation that was formerly a C-corporation).
- The transaction can be structured as tax-free (for example, as an acquisition in exchange for buyer stock or an interest in a buyer partnership).
- There are historic tax liabilities or exposures that are to be the risk of either the buyer or the seller.

Intellectual Property

The ownership of intellectual property (IP), and the rights of certain subsidiaries and business units to use it, can be difficult to untangle when the use of IP by subsidiaries and business units does not correspond to the corporate structure contemplated for the transaction. These issues should be identified early in the transaction process to ensure that:

- The deal is structured properly.
- The value of the IP rights conveyed is built into the overall deal value.

Each party must conduct considerable due diligence to ensure the rights are conveyed properly. Similarly, if there are software licenses and maintenance and support agreements that exist on an enterprise level (and are not transferable as part of the sale), this can negatively impact deal value due to the high replacement costs for prospective buyers.

Therefore, all relevant IP rights and related documents, and all software license agreements and related support and maintenance agreements should be carefully reviewed. The review should focus on issues related to:

- Divestment of the business unit.
- IP used in that business that is also used by retained business units of the seller.

Significant IP issues common to carve-out transactions relate to:

- Software licensing.
- Licensing IP rights.
- Selling IP rights.
- Trademarks and trade names.
- Other associated concerns, including third-party consents, departing employees, ongoing litigation proceedings, and post-closing maintenance.

For more information on IP issues that may arise in a carve-out transaction, see Practice Notes, Intellectual Property: Asset Purchases and Intellectual Property: Stock Purchases and Mergers.

Software Licensing Issues

Software license agreements (together with any related maintenance or support agreements) governing the use of software by the divested business in its day-to-day operations are typically held by the corporate parent or some other higher-level holding company so that the software is available for use by all the divisions and subsidiaries of the company. These types of enterprise-level software license agreements typically will not allow the divested business to continue to use the software after the sale. Accordingly, the buyer must factor the contract negotiation and purchase of that software into its valuation of the purchased business as well as its expected timeline for closing. Because the seller may have obtained favorable pricing based on economies of scale, the buyer may not be able to obtain the same favorable pricing. These software replacement costs can affect the value of the deal for the buyer.

It is equally important for the seller to review the terms of the software license agreements to determine whether the fees it pays should be adjusted following the sale. This may be the case if the fees were based on certain usage or headcount numbers that are too high following the divestiture.

In addition, the seller should determine whether it can provide transitional services under its licenses after closing and whether it needs the consent of the software licensor to do so. If the seller cannot provide transition services for critical software licenses, then the negotiations with the buyer should factor in the buyer's time and expense in obtaining standalone licenses. Identifying these issues early in the carve-out process allows the seller the greatest flexibility for renegotiating a contract with the software vendor. For information on how transition services are typically documented, see Box, Transition Services.

For additional information on software license agreements, see Practice Note, Software License Agreements.

Licensing IP Rights

A carve-out transaction may involve the sale of a business unit that uses IP rights that are also used by the retained business. In this case, the parties to the transaction often consider entering into a licensing agreement which allows the divested business to use certain IP in a manner that is appropriately limited in scope to its use of that IP before the sale.

The scope of this license is often the subject of intense negotiations. The parties heavily debate how to define the scope of the IP rights (for example, all the IP rights "used by," "primarily used by," "exclusively used by," or "necessary for the operation of" the business as divested). Accordingly, the license must be drafted carefully, and the seller must consider whether to include particular shared IP rights.

The buyer must consider what impact any changes in the seller's business may have on the license. For example, if the seller were to sell the IP subject to the license in a separate transaction at a later date, the new owner may not be as friendly to the buyer. Because most licenses contain quality control and termination provisions, the new owner may be able to terminate the buyer's rights to use the IP under the license. To avoid this risk, the buyer of the carve-out business should consider actually acquiring the relevant IP (see Selling IP Rights).

For more information on defining the scope of IP rights and a form of IP cross-license agreement that can be used in a carve-out transaction, see Article, Carve-Out Transactions: Exclusively Related or Primarily Related Intellectual Property and Standard Document, Intellectual Property Cross-License Agreement (Carve-Out or Spin-Off).

Selling IP Rights

An alternative to licensing IP rights to a buyer is an outright sale of those rights. Although this is a typical structure in most transactions, a carve-out transaction is more complicated because the rights being sold may be limited in some way. For example, the seller may be selling IP rights only in a specific geographical region and retaining the rights in other geographical regions.

Determining the appropriate scope of what rights are being sold and how best to document the sale requires considerable effort by both the buyer and the seller. Although the purchase of IP may represent a higher upfront cost than licensing those rights, it may more closely reflect the business deal than a licensing arrangement.

Trademarks and Trade Names

As soon as a seller decides to divest a business unit, it should consider whether the divestiture will include the use of corporate names and related trademarks. In some instances, those marks represent a large part of the value to the buyer. In other transactions, the seller must determine whether the divested business will be required to change its corporate name in connection with the transaction. This decision must be made as early as possible to allow the buyer to:

- Conduct trademark clearance searches.
- Prepare and file new trademark applications (potentially in multiple jurisdictions).
- Secure new domain names.

Other Key IP Issues

Other important issues parties should consider include:

- **Consents**. The parties should decide which party will bear the responsibility of obtaining any necessary third-party consents and have a plan in place in case all the consents cannot be obtained.
- **Employees**. In certain cases, the parties must negotiate which employees should be part of the divestiture. This becomes particularly important in connection with any ongoing efforts regarding source code development and maintenance, as well as undocumented technical know-how of key employees.
- **Litigation**. If any of the relevant IP becomes the subject of ongoing litigation proceedings, the parties must set out their respective roles and financial obligations following the closing.
- **Post-closing maintenance**. IP must continue to be maintained following the closing. The seller should be required to identify all IP maintenance deadlines over some reasonable period of time after closing and provide a list of its IP maintenance counsel or services. Acquisition counsel and clients should be clear on who is responsible for maintenance of the IP portfolio (for example, in-house counsel, the law firm acting as counsel in the transaction, or some other firm).

Advance Preparation

If the seller anticipates divesting more than one business unit, it can take certain steps to limit IP issues. The seller can structure its IP holdings in a manner that simplifies the piecemeal divestiture of affected IP rights and obligations. In addition, when licensing and related agreements come up for renewal, the seller should build in provisions that recalculate fees and permit certain divestitures without consent if the buyer assumes the liabilities under the contract. This can greatly expedite the deal process and add value for both the buyer and the seller.

Information Technology

Information technology (IT) and the people, software, hardware, and services that provide a company with instant connectivity and information are an increasingly large part of any corporate budget. Companies make every effort to bundle and package these products and services to achieve the desired result at an acceptable price. Larger companies can take advantage of economies of scale to achieve favorable pricing. In doing so, however, companies may unintentionally create obstacles to divesting business units that benefit from these shared services. This may occur as the result of:

- Pricing terms that are not automatically adjusted for the divestment of a business unit.
- Licensing issues.
- How employee time and equipment usage are apportioned among various business units.

Although the business unit may seem easy to separate, the realities of divesting a single unit may be much more complex than they initially appear. To reduce IT-related obstacles in a carve-out transaction, the seller must identify:

- What IT services, assets, and employees will be divested.
- What IT services, assets, and employees will stay with the retained business.
- How data will be transferred and stored.

The buyer must understand what personnel, services, and equipment are not being acquired and how to address those issues post-closing. In addition, the buyer must analyze potential future costs as part of its due diligence to ensure that a deal that looks financially attractive at the outset does not yield unexpected costs down the road.

Key Issues Involving IT Services, Assets, and Employees

Several IT issues may emerge during the carve-out transaction process, including:

- Whether the seller will provide transition services.
- How open-source software will be used in the divested business unit.
- Whether shrink-wrap or off-the-shelf software licenses will be transferred to the divested business.
- Which IT employees will transfer to the divested business.

For more information on IT issues that may arise in a carve-out transaction, see Practice Notes, Intellectual Property: Asset Purchases and Practice Note, Intellectual Property: Stock Purchases and Mergers.

Transition Services

IT services are often shared among a company group and not easily separated in a carve-out transaction. Several back-office services and related functions may require considerable build-out by the buyer (both in terms of personnel and infrastructure) and the seller should consider in advance whether to provide transition services to the buyer.

Although a seller may prefer to make a clean break from the divested business, agreeing to provide transition services may increase the value of the divested business to the buyer and justify a higher purchase price. An increased purchase price and deal certainty may outweigh the cost of providing the services. For more information on how transition services are documented, see Box, Transition Services.

Open-Source Software

The vast majority of companies use some form of open-source software as part of their operations. Therefore both the buyer and the seller must identify the specific open-source products and applicable licenses used in the divested business. The buyer must carefully review the specific products with counsel to determine what risks, if any, there are in continuing to use the open-source software (including after the closing, when the divested business is combined with the buyer's business). Depending on the risk analysis, the buyer may also need to consider the technical feasibility and cost of replacing the open-source software with proprietary software. For more information on open-source software, see Practice Note, Open-Source Software.

Shrink-Wrap Licenses

Another important IT consideration in a carve-out transaction is shrink-wrap or off-the-shelf software licenses. Although these products are generally replaceable and are often dismissed by principals for this reason, replacement costs can be significant and should be considered in transaction planning.

The buyer should ensure that a sufficient number of licenses are transferred to the divested business to allow it to operate the business post-closing. If the licenses are not transferred, the buyer should ensure that new licenses can be purchased (and factor in the cost).

The seller should determine how a transfer of those licenses could impact the retained business and should also consider evaluating all of its licenses before pursuing a carve-out transaction. This type of evaluation helps the seller ensure that it retains sufficient licenses to operate the retained business but is not paying for more licenses than necessary.

IT Employees

The seller must identify its IT employees and determine which employees should stay with the seller or leave with the divested business. Because some employees are likely to have roles that extend beyond a single business unit, this decision is not always readily apparent. Doing advance work on these issues early in the transaction allows a seller to take well-reasoned positions if negotiations arise.

Electronic Data and Records

If the divested business uses data stored in an electronic database that is shared across multiple business units, the seller must carefully review that data to ensure that only data relevant to the divested business is transferred to the buyer. Data migration issues can be complicated by the use of proprietary software and enterprise-level data usage. If the data of the divested business cannot be separated from company-wide data, a licensing agreement may be needed. The licensing agreement would allow the buyer to use data necessary for the acquired business, and the seller would retain rights to data used in other aspects of its business. The buyer must consider how new data, particularly if created by the buyer post-closing, is treated and whether that data is included within the scope of the license agreement.

If proprietary software is used in the management or storage of data, additional licensing issues may arise. Identifying any of these potential issues early in the transaction process will enable the parties to structure the transaction and related agreements in a way that minimizes their impact on deal certainty and avoids reductions in deal value.

Employees and Benefits

Although the emotional capital invested in any transaction is high (whether from the deal team or employees unsettled by the change in status quo), these issues are heightened in carve-out transactions. This is because some employees will remain with the seller and others will be transferred to the divested business. Employees may have concerns about:

- Bonus payments.
- Benefit terms.

- Outstanding stock options.
- Job security.

Employers will likely have concerns about plan terminations and satisfaction of deal conditions related to post-closing employee issues. In addition, employers will need to deal with the mechanics of transitioning a group of employees from one employer to another (and from one set of benefit plans to another). Predicting how employees will react to a transaction and the impact on the future business also become critical issues.

To address these matters, both parties must evaluate the impact of the deal early in the transaction process and organize their benefits and human resources teams to aid in a smooth post-closing transition. Although each transaction raises unique considerations, key issues include:

- Identifying which employees will transfer to the divested business unit.
- Determining whether steps must be taken to retain key employees.
- Understanding how the divestiture will affect benefit plans.
- Determining the cost of providing benefits to employees of the divested business following completion of the transaction.

For information on other employee and employee benefit issues that may arise in a carve-out transaction, see Practice Note, Employee Benefits and Executive Compensation Attorney's Role in M&A Transactions and Significant Employee Benefits and Executive Compensation Issues in Corporate Transactions Checklist.

Identifying Employees

Deciding which employees will remain with the seller and which will go with the divested business unit can be one of the most fundamental decisions for a seller. Where a seller has multiple business units and uses certain centralized or shared services, there can be a sizable pool of employees who provide services to the divested business **and** also provide necessary services for retained business units. Whether the seller will keep those employees may be the subject of negotiation because the employees may provide functions that the buyer does not have in-house.

Other employees may work primarily with the divested unit, but the buyer does not want to take them with the business. In that case, the seller must determine whether those employees can be reassigned within the company or whether it must make post-closing staff reductions. Large staff reductions may pose greater concerns if the divested business represents a sizable portion of the seller's business as a whole because of obligations arising under the WARN Act (and state law analogs). See Practice Note, Worker Adjustment and Retraining Notification (WARN) Act: Overview.

The buyer's considerations are generally the opposite. For example, the buyer must consider whether:

- It is getting the employees it needs to run the business.
- Certain employees are unnecessary for the business. As part of this analysis, the buyer should carefully review the duties of each proposed new employee to ensure that the seller is not using the transaction as a way to unload unnecessary personnel.
- It has sufficient support and back-office personnel to support the acquired business.

Retention of Key Employees

Once the parties agree on which employees are affected by the divestiture, they should consider how to avoid the defection of key employees. If the buyer conditions the sale on the retention of certain employees, those employees will likely need to be informed of the transaction in advance so that the buyer can negotiate employment or retention agreements as needed. For other employees, the seller may need to provide incentives for the employees to remain with the business before closing. This can take the form of a retention or stay bonus arrangement or a covenant in the purchase agreement requiring the buyer to retain certain employees for a specific period post-closing.

Benefit Plan Considerations

Depending on how the seller's benefit plans are structured (separated by business unit or universal across all company employees), the carve-out transaction may result in a plan termination or partial termination. This also depends on the percentage of employees involved in the divestiture. Sellers must carefully weigh these benefit plan issues to determine the viability of their plans for remaining employees. Buyers must either fold acquired personnel into existing plans or create new plans (which would be more likely in the case of a financial buyer). The time and costs of establishing these plans will factor into the overall timeline of the transaction and can delay closing.

Identifying Underlying Costs

Because many costs associated with employee benefits are not specifically identified in a company's financial statements, buyers must carefully review available data and related costs. A seller must also be mindful of these costs if it agrees to provide some form of transition services (see Box, Transition Services). In the case of a financial buyer, new benefit plans and human resources functions (or a transition services agreement under which these functions are provided by the seller) must be in place at closing. The most critical aspect of the buyer's employee benefits due diligence is to ascertain the actual costs of providing benefits to the employees of the divested business going forward. This process traditionally involves a coordinated effort by counsel and benefits consultants as well as in-house benefits specialists.

Real Estate

Fundamental considerations to a carve-out transaction include identifying, financing, equipping, and maintaining the physical space the business will occupy after the transaction closes. Relocating a business in connection with a transaction could result in significant disruption to business functions.

A company with multiple business lines often operates all of its business units out of a single facility or, especially in the case of a large corporation, multiple shared facilities. This type of arrangement has obvious advantages in terms of cost savings and accessibility. For purposes of a carve-out transaction, however, shared facilities present unique issues, regardless of whether the properties in question are leased or owned by the seller.

Leased Real Property

Where the divested business unit operates out of a shared leased facility and the buyer desires to use the facility post-closing, two principal options are available: sublet the space or enter into a new contract directly with the landlord.

Sublease

If the lease agreement permits subleasing, the seller may enter into a sublease agreement for the facility and may need the consent of the landlord. There are numerous considerations that sellers should take into account in this situation, including the risks assumed by the seller. To preserve deal value, the seller must carefully examine shared costs that will be split with the new sublease including:

- Maintenance costs.
- Costs for shared spaces (for example, conference facilities and reception).
- Security costs.
- Other hard and soft costs (such as for HVAC and electricity) that must be built into the financial terms of the sublease.

In addition, if the facility has an open floor plan, the seller must consider what space the buyer will occupy and whether modifications must be made to the space to protect confidential information. The seller must also examine all possible costs in advance so they can be appropriately allocated to the buyer. If the seller's lease agreement requires landlord consent for a sublease, obtaining the consent (and planning for the time involved in obtaining that consent) must be built into the deal process along with the negotiation of the sublease.

Contract with Landlord

The second option is for the buyer to enter into a direct contractual relationship with the landlord. As with a sublease, the parties must be sensitive to the timing required for the buyer to negotiate the lease, particularly because it may involve the negotiation of a broader set of terms than in the negotiation of a sublease. In general, each party is best served by working together to avoid a situation where the landlord holds the deal hostage in an effort to extract higher rents or other concessions.

The seller may want to take advantage of the opportunity created by the new lease for the buyer to reopen discussions on its current lease. These discussions may be necessary because space leased by the seller will be reduced and certain costs must be allocated to the divested business. The timing of these discussions, however, must be considered carefully within the overall context of the deal and should only be conducted after assessing the landlord's receptiveness to them.

Owned Real Property

If an owned site will be shared by the business to be divested and the business units retained by the seller, there are also two principal options: enter into a lease agreement or transfer title to the relevant portion of the property.

Lease

The first option is for the seller to lease a portion of the owned site to the buyer. In this situation, similar issues arise as when subleasing but the seller has greater control over timing and the terms of the lease. In this instance, the lease agreement (and the value derived by each party under the lease) can become a more central component of the transaction. As in the sublease scenario discussed above, the seller must consider all costs that should be allocated to the buyer. This planning can be started even before identifying a buyer and can have the added advantage of reducing costs in future transactions if additional business units at the facility are also candidates for divestiture.

Title Transfer

The second option is for the seller to convey fee title of the applicable portion of real property to the buyer. In this case, there are additional issues to consider. For example:

- Does the conveyance of a portion of an owned real property trigger local zoning or subdivision issues?
- Does the transferred real property have access to roads, utilities, and facilities needed to operate?
- Are there any environmental liabilities that must be apportioned?

If the entire property is sold with the business unit, the seller may need to lease back space for retained businesses. This can be a short-term lease until a new facility can be identified or a long-term lease if the parties desire to maintain a landlord-tenant relationship.

For more information on real property issues that may arise in a carve-out transaction, see Practice Note, Real Estate Considerations in Corporate Transactions (United States).

Transition Services

In a carve-out transaction, certain services essential to the business are often intertwined with the seller's own operations and not included in the sale.

The seller and buyer often solve this problem by entering into a transition services agreement.

This agreement between the buyer and seller of the business calls for the seller to continue to provide those shared services to the buyer for a period of time. Entering into this agreement allows the transaction to proceed without any delay for the buyer to try to secure those services on its own (whether through its existing service support or through new contractual arrangements with third parties). Some common examples of the services covered by transition services agreements include:

- IT support.
- Accounting services.
- Payroll and other human resource services.
- Insurance administration.
- Litigation support.
- Shared facilities.
- Shared benefits plans.

In most carve-out deals, the buyer requires more than one transition service. When that is the case, the parties usually treat each service as its own specific arrangement, each with its own fee and term. Unless the buyer requires few and relatively simple services, it is rare for the entire agreement to expire at the same time or for the seller to be compensated with one lump sum.

The transition services agreement is usually ancillary to the underlying purchase agreement and is often negotiated in full before the parties sign the purchase agreement. The form of transition services agreement is then typically attached as an exhibit to the purchase agreement and signed and delivered at closing. For an example of a transition services agreement, see Standard Document, Transition Services Agreement.