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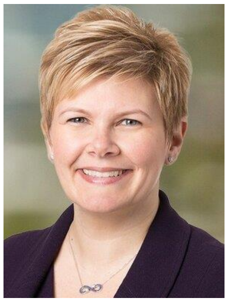
9 Considerations For Divestitures, Carveouts And Spinouts

By **Kimberly Petillo-Décossard and Kristen Rohr** (February 22, 2024, 6:02 PM EST)



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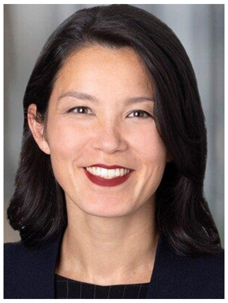

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Bolstered by growing optimism for both an economic soft landing and an end to the Federal Reserve's rate-hiking, deal-makers and CEOs remain intensely focused on creating long-term strategic value for shareholders and investors.

But no matter where the economic and policy winds may shift, divestitures, carveouts and spinouts can deliver on the promise of value creation. Business leaders across the spectrum continue to seek these types of transactions.

For example, 29%, nearly one-third, of CEOs are planning an asset sale in 2024, per a January survey of 1,200 global CEOs conducted by EY. The same survey revealed 70% of the 300 global private equity leaders polled believe that corporates will accelerate divestment activity this year.

While divestitures, carveouts and spinouts offer a straightforward value proposition to the seller, the process itself can be extraordinarily complex.

Often it feels a bit like untangling a plate full of spaghetti. Deal-makers must be prepared to roll up their sleeves and consider how interlocking and interrelated business operations, financing, contracts, and personnel, to name a few, can each be safely unwound to create business units ready and able to operate independently.

Yet, for companies willing to dig in, the advantages are potentially significant.

Unlocking Value

Whenever the pieces are likely to be more valuable than the whole, a company split may be worthwhile, delivering revenue to the parent and higher, market-matching multiples as well as for the hypothetical, newly independent company.

We will call the hypothetical company "SpinCo" — while SpinCo commonly refers to a company created by a spinoff, this article will use it as an umbrella term, applicable to hypothetical companies created by divestiture and carveout transactions as well.

Activists have long pushed the concept of "pure play," and today many management teams engage in activist simulations to uncover such value-unlocking scenarios.

Focusing on the Core Business

These transactions allow the parent and SpinCo to focus on their core competitive advantages and may create opportunities to pursue new types of customers or expand into new markets.

Uncovering Potential Tax Benefits

Tax treatment may diverge significantly based on the transaction. For example, spinoffs might be tax-free to the parent company and shareholders. To be certain, the word "might" carries a heavy burden in that sentence.

Tax consequences will depend significantly on the company, the industry, the assets in question and the relevant tax regimes, among other elements. Nearly every deal leads to unique tax questions.

While these arguments in favor of exploring such transactions are tantalizing, the untangling process involves numerous and complex issues.

To succeed, company leaders should first review the following nine elements and related recommendations. Consider it a first taste of the spaghetti challenge.

1. Perimeter, Structure and Process

Define the deal's perimeter and consider the overall deal structure and process, including contracts and tax treatment. Proper preparation is everything. These early steps guide the process, create a timetable and map potential problem areas.

Consider the type of sale — share sale, asset sale or merger. The sale process will affect all of the subsequent workstreams.

Determine which assets and liabilities belong with SpinCo and those which should remain with the seller, or which need to be divided or shared.

Is a reorganization necessary, and will a likely buyer require indemnities or other comfort related to the liabilities of SpinCo?

Next, deal-makers should identify likely buyers and whether to run a full auction process or a more targeted outreach process.

Outline key terms of the transaction agreement, such as how to allocate regulatory risk and limit closing conditions. Build an anticipated timeline with this information.

Tax considerations are among the most consequential to any deal and must be understood at the earliest possible stage. Evaluate jurisdictional issues, tax losses, indemnity protection and the tax burdens of the different structures. Engage tax counsel early.

2. Contracts

While contracts were considered in Step 1, they require closer scrutiny. Contracts required by SpinCo may need to be replicated, reassigned, partially assigned or split.

Some contract counterparties may have contractual rights to approve or be given notice in connection with the deal. Deal-makers must identify and minimize any adverse change of control risks, which could include consent and termination rights, penalties, and cross-defaults, among others.

Contracts pertinent to both businesses may be split, shared or renegotiated. Commercial factors, contract duration and the likelihood that a counterparty may seek to extract more favorable terms will all play a role.

When splitting contracts, determine the timing and third-party consents required, including the possibility of incurring related costs. When considering a sharing arrangement, parties should consider the term, complexity and importance of the contract to each business. Then the parties will need to create a framework agreement to address the challenges that arise from sharing.

3. Dividing Intellectual Property

Deal-makers must detail the intellectual property that will remain with the parent and the IP that will be transferred to or shared with SpinCo. This includes technology, trade secrets, designs and patents, copyrights, trademarks, domain names, social media accounts, email addresses, licenses, and software.

Branding issues will be driven in part by the future relationship between the two entities. Company leaders may need to consider how best to avoid market confusion, especially if the two companies will operate in similar fields or geographies.

Do not forget to examine any third-party IP that is shared. Also assess the impact on any key IP that is licensed out. Again, specialist IP counsel should be part of the deal team.

4. Employee and Management Matters

Employees engaged primarily in each business must be identified, any employment agreements and benefits must be reviewed, and, if transfers or a reduction in workforce are contemplated, especially for multinationals, those steps must be considered in light of local law.

Determine whether the companies will share employees for a transitional period. Map how all employees will be allocated.

Develop a retention strategy for key management, considering change of control bonuses, or covenants in the purchase agreement requiring the buyer to retain certain employees for a specific period post-closing. Take care in drafting the transaction documentation to ensure key employees cannot hold the deal hostage.

Companies must also identify and engage any employee representative groups, such as unions or work councils, which may have mandatory consultation procedures. Jurisdictional rules vary, but in some cases that consultation process may require several months.

5. Regulatory and Compliance Approvals

Identify all relevant legislative and regulatory regimes. Map all permits, licenses or other government authorizations SpinCo may require. Determine whether new applications will be needed and the timeline for each.

Analyze whether other approvals may be necessary — antitrust, Committee on Foreign Investment in the U.S. or other foreign direct investment, or other regulatory approvals. The relevance of various regulatory regimes may differ based on the industry, whether the buyer is foreign or domestic, and whether the purchaser is engaged in SpinCo's business.

6. Property

Deal-makers must consider where SpinCo will be located, whether there will be shared real property and the timetable for these changes. Where real property must be transferred or divided, examine consent or other requirements.

When considering sharing any leased real property, examine lease restrictions, whether subleases are permissible, and existing guarantees. It may be necessary to replace guarantors. When those hurdles are overcome, physical modifications to the shared space may still be necessary, for example, to protect confidential information.

If transferring property, consider leases, title transfers, landlord consents, additional security and the negotiations involved in each, which may be lengthy.

7. Transitional services

In most instances, before undertaking a transaction, some combination of finance, accounting, human resources, procurement, sales, distribution, marketing and IT services have been shared.

Will these services be replaced or shared for a transitional period? Or will SpinCo retain the capabilities to provide certain services and become a service provider to the retained business? Examine the decoupling process and whether transitional or migration support is necessary.

Consider regulatory, legal and other risks in making each of these assessments. Then, as necessary, prepare high-level service descriptions and service term durations for inclusion in a transitional services agreement.

Map where there are material third-party dependencies and identify any required third-party consents. Determine how both migration costs and ongoing costs should be allocated, the latter under the TSA, which will influence the overall deal value.

8. Data protection

Consider data migration, any necessary notices and required consents. Deal-makers need to assess how data is divided or shared between the parent and SpinCo, and the data storage and management processes required. It will be necessary to review existing notices regarding disclosure and consider whether amendments are needed. Consider personal data consent contracts to ensure compliance after closing.

9. Financial Accounting and Indebtedness

Consider what financial reports SpinCo requires, and whether these are available or must be prepared. Are audited financial statements available, or can they be prepared, ideally before a sales process is initiated?

Consider the appropriate accounting policies and the basis of the reporting. The cost and timing of these statements may play a role in the larger process.

Consider the banking facilities and related arrangements that implicate both SpinCo and the retained business, including credit agreements, notes, cash-pooling, guarantees and hedging. Extracting SpinCo from such arrangements, or structuring the transaction so they transfer to SpinCo, often requires careful upfront analysis and coordination with lenders.

Conclusion

With so many spaghetti-like issues to untangle, the best deal-makers will begin the process early, identify relevant concerns at the outset, and then carefully manage those risks through closing day. After all, nobody wants the power suit they set aside for the closing dinner to be splattered with marinara sauce.

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