

Mergers & Acquisitions 2009

Preparing for “Carve-Out” Transactions: Financial Statements

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We anticipate that the current economic climate will increasingly lead companies to engage in carve-out transactions (i.e., the sale of subsidiaries or divisions of a larger business enterprise). Not unlike the increase in distressed company acquisitions, we expect that carve-out transactions will be a dominant part of the M&A market over the next few years. Virtually every financial and strategic investor and intermediary will need to be well versed in these projects and the unique and challenging issues they present.

This LawFlash is one of a series of LawFlashes, each highlighting the complex technical, financial, and legal issues that need to be addressed in splitting off parts of a larger business. Morgan Lewis, with its broad array of relevant practice areas such as technology outsourcing (technical transitional services having become perhaps the most difficult aspect of carve-out transactions), intellectual property, labor and employment, and sophisticated tax analysis, is positioned to skillfully assist with these increasingly complex transactions.

Although the process of selling a business is never easy, particularly in today’s economic climate, the process of selling a piece of a business is often even more difficult. These carve-out transactions raise unique issues in that they typically involve the sale of assets, such as subsidiaries or unincorporated divisions that are partially integrated—whether in the form of back-office operations, labor, distribution, management, or intellectual property tie-ins—into core assets of a business that will remain behind in a divestiture of such assets. Deciding which assets and liabilities are staying and which are going—and how to unwind them—are the first in a series of hurdles that must be overcome. Once that is out of the way, one of the most critical tasks is to prepare financial statements for the assets or business line that is being divested.

Although the vast majority of sellers prepare audited financial statements at the top company level, the degree of financial statement preparation for subsidiaries and divisions varies widely. The common feature of most such financial statements (if prepared at all) is that they are often 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 a number of related issues that impact deal mechanics, timing, and expense allocation. How best to address these issues can depend on the particular facts of the deal, but it is almost always the case that these issues should be addressed early in the deal process, so as

to maximize deal value and maintain credibility among deal parties.

Specific issues that arise in connection with the preparation of financial statements for carve-out transactions include the following:

- **Timing and Maximizing Deal Value:** Advance planning is essential for avoiding unexpected and costly transaction delays. Because the financial statements—together with the balance of the due diligence materials provided to interested parties—will be a prospective buyer’s initial view into the target assets, it is essential that those financial statements properly reflect assets and liabilities that are 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. In our experience, one should expect that even a “big four” accounting firm, working together with an experienced in-house accounting staff, will need a longer period of time than one might expect to complete carve-out financial statements 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, which often manifest themselves in the form of decreasing the value of the assets to the potential buyer and take the focus away from the potential synergies for strategic buyers and the financial upside buyers see in the assets. In addition, working through the buyer’s concerns will often delay or extend negotiations.

- **Expenses:** Parties entering into a carve-out transaction are best served by agreeing on the payment of all expenses associated with preparation of the financial statements in advance; usually this agreement takes the form of a detailed covenant in the definitive purchase agreement. This is particularly true where pre- and post-closing purchase price adjustment mechanisms are built into the transaction, and care must be taken to ensure that the broader purchase price adjustment provisions do not eviscerate the specific deal as to preparation expenses.

In addition, in a transaction in which the carve-out financial statements will be used to raise public debt, the financial statements may need to be revised due to comments from the Securities and Exchange Commission (SEC). If the financial statements need to be revised or restated, an issue may arise as to which party is best positioned to perform the necessary work. Pre-closing, the seller would generally be the logical party, having presumably prepared the original set of financials. After closing, however, the seller will likely not be in a position to revise the financial statements and thus the burden would likely fall on the buyer, which has operated the business since closing. Accordingly, agreement as to payment for the expense of preparing the statements should be negotiated as early as possible during the transaction, taking into account any foreseeable contingencies such as SEC-required revisions.

- **Personnel:** Prior to the closing, the individuals primarily involved in the preparation of the carve-out financial statements will most likely be seller employees, although they may be a mix of employees to be retained by the seller and employees to be transferred to the buyer in the transaction, sometimes resulting in split loyalties and divergent goals. Sellers in particular must appreciate these practicalities and be prepared to deal with employees to be transferred who “flip” prior to completion of the financial statements. Buyers should recognize the degree of cooperation that will be required from both sets of employees, including assistance with respect to the preparation of debt offering documents and participation in due diligence, drafting sessions, and road shows.

