

Mergers & Acquisitions 2009

Preparing for “Carve-Out” Transactions: Information Technology

June 29, 2009

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 certain 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.

Even during periods where the economy and “business” in general are doing well, corporate managers pay close attention to the proverbial bottom line. Information technology (IT), and the myriad of people, software, hardware, and services that provide a company with instant connectivity and information, is an increasingly large part of any corporate budget. Not surprisingly, companies make every effort to bundle and package these products and services to achieve the desired result at an acceptable price. Larger companies in particular are able to take advantage of economies of scale to achieve favorable pricing. In doing so however, companies may unintentionally create obstacles to divesting business units that are benefiting from these “shared” or “pooled” services. This may occur as the result of pricing terms that are not automatically adjusted for the divestment of a business unit, licensing issues, or an understanding of how employee time and equipment usage are apportioned among various business units.

As such, while the business unit may seem easily segregable on its face, the realities of divesting a single unit may be much more complex than initial perceptions suggest. In order to reduce the IT-related obstacles associated with a carve-out transaction, it is important to understand the impact of the divestiture from an IT perspective. A few of the key areas of focus include:

- **Electronic Data and Records:** To the extent the business being sold involves the use of an electronic database or information, and that database is shared across multiple business units, a seller will need to carefully review such data to ensure that only data relevant to the divested business is transferred to the buyer. The data migration issues can be complicated by the use of proprietary software and enterprise-level data usage. To the extent such data is not segregable from companywide data, then a licensing agreement may be needed so that the buyer can utilize data necessary for the acquired business while the seller retains rights to data used in other aspects of its business. Consideration will need to be given to how new data, particularly if created by the buyer post-closing, is treated, and whether such data is included within the scope of the license agreement.

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

- **Due Diligence and Advance Planning:** From the seller's perspective, advance planning is critical to a successful carve-out transaction. In particular, the seller needs to identify what services and assets will be divested, what will stay behind, and how data will be transferred and stored. Similarly, employees of a seller engaged in IT-related functions will need to be identified, and a determination made as to whether such employees will stay with the seller or leave with the divested business. Since some employees will likely have roles that extend beyond a single business unit, the decision on who will stay and who will go is not always readily apparent. However, doing advance work on these issues early in the transaction will allow a seller to take well-reasoned positions on issues that can be difficult points of negotiation.

From a buyer's perspective, it is imperative to understand what personnel, services, and equipment are not being acquired and how to address those issues post-closing. Moreover, the buyer will need to analyze potential costs going forward 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.

- **Contract Specificity and Deal Structure:** When evaluating how to structure a carve-out transaction, one of the first things to consider is how the divested business is structured. If the assets to be sold are already held in a stand-alone subsidiary, the deal team has considerable flexibility as to structuring the transaction as a stock or asset sale. If, on the other hand, the assets of the business are intertwined within larger corporate entities, an asset deal may be most appropriate in that only the relevant assets are sold. Obviously, a seller can perform some restructuring in advance, so as to obtain the desired flexibility.

Ambiguity in a contract can be the difference between a financially successful deal and a disastrous one. For example, if a server that is physically located within the offices of the business unit being sold is also used for data storage for other business units that are not being sold, the parties will want to be clear in the transaction documents as to who keeps the server post-closing. One way or the other, the time and costs of data migration or asset relocation need to be factored into the costs of the transaction.

- **Transition Services:** Because a number of back-office services and related functions may require considerable build-out by the buyer (both in terms of personnel and infrastructure), the seller should consider in advance whether it would be willing to provide transition services to the buyer. While it may be more desirable from a seller’s perspective to have a clean break from the divested business, agreeing to provide transition services may serve as a deal sweetener and may allow the deal to close on an expedited basis. Such deal certainty, particularly given the current economic climate, may outweigh the costs involved in providing the services.
- **Open Source Software:** The vast majority of companies use some form of open source software as part of their operations, and it is important for both the buyer and the seller that the specific open source products and applicable licenses utilized in the divested business be identified. The buyer must carefully review the listed items with counsel who are knowledgeable about the relevant open source licenses so as to determine what risks, if any, are presented by continuing to employ open source software in the company’s business (including, following the closing, employing open source software in the business as it is combined with the buyer’s business). Depending on the risks presented by the open source software, the buyer must also consider the technical feasibility and cost of replacing the open source software with proprietary 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, for this reason alone, they should be taken into consideration in transaction planning. The buyer should ensure that the licenses transferred as part of the business (if such licenses are indeed transferred) are sufficient in number for the business going forward; if the licenses are not transferred, the buyer should ensure that new licenses can be purchased (for which there would of course be a cost) so that the business is able to operate following the closing. The seller should determine whether and how a transfer of such licenses will impact its retained businesses. As such, the seller should consider evaluating all of its licenses in advance of pursuing a carve-out transaction so that it can ensure that it retains sufficient licenses necessary (but is not paying the licensor for more licenses than are necessary) for it to operate its retained businesses.

As evidenced above, many of the issues that arise in a carve-out transaction can be addressed when identified early in the sale process and incorporated into the terms of the deal. That said, when these issues come to light later on in the transaction, they can be more difficult to address—particularly when an issue impacts deal value. Experienced deal professionals can play a key role in identifying potential pitfalls early on and help ensure the transaction’s financial goals are met.

Additional LawFlashes relating to carve-out transactions can be found at <http://www.morganlewis.com/carveouttransactions>.

