PRACTICE GUIDES

Swiss M&A

Second Edition

Contributing Editors
Ueli Studer, Kelsang Tsün and Joanna Long

LEXOLOGY®
Getting The Deal Through

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Practice Guide

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Contents

10

Carve-out Transactions

Christoph Vonlanthen and Oliver Triebold[1]

Introduction

Carve-out transactions involve the disposal of subsidiaries, divisions or assets or the spin-off or split-off of business units in the public markets. Companies turn to these transactions in an effort to focus on their core assets, improve their value proposition, become operationally more agile or simply raise cash to shore up their balance sheet. For a long time, carve-out transactions have accounted for a healthy percentage of deal activity, with bursts of activity in the wake of market upheavals. The recent pandemic has propelled a number of industries, while others have been battered. Market indicators thus point towards an increase in carve-out activity as companies are looking to divest from non-core assets and protect their cash position. Carve-out transactions are by nature complex processes. In this chapter, we review a range of challenges that the parties need to anticipate and navigate.

Financial statements

A key underpinning of an M&A transaction is the availability of (optimally complete) financial statements for the target business. Financial statements are critical for pricing the deal. They are also a crucial area of due diligence and the basis for one of the most important representations and warranties. If the buyer finances a portion of the acquisition with bank or capital market debt or fresh equity in the public markets, carve-out financial statements will be essential to support the buyer's capital-raising efforts.

There may, however, not be any financial reporting at the level of the target group as a business unit, or the consolidating financial information used to compile the seller's consolidated financial statements may lack the necessary granularity. This means that a critical task in a carve-out transaction will often be to prepare suitable financial statements for the target business.

1 Christoph Vonlanthen and Oliver Triebold are partners at Schellenberg Wittmer Ltd.

Carve-out accounting and the many assumptions as to the assets, liabilities, revenues and costs attributable to the target business can be a particularly complex and time-consuming process. Often draft carve-out financial statements will be available prior to signing, while audited financial statements, if required, will be delivered between signing and closing.

Pricing the carve-out transaction

Depending on the structure of the seller's group, there may be a significant amount of inter-company trading. Interdependencies matter in a carve-out transaction. In particular, they can make it challenging to price a carve-out on a 'locked-box' basis, the most favoured pricing mechanism in Europe, including Switzerland.

One of the features of the locked box is to turn over the profits and cash accumulated since the locked-box date to the buyer. In a carve-out transaction, opportunities for hidden or disguised leakages are generally significant, with the potential of diverting value of the target group for the benefit of the seller.

A locked-box pricing will thus require carve-out financial information to serve as a basis for the equity value bridge, a close due diligence review of all inter-company arrangements and transfer pricing (to gain an understanding of historic levels of cash flowing in and out of the target group), and tight negotiation of prohibited and permitted leakages. It will also regularly involve post-completion due diligence to ensure that permitted inter-company trading occurred in compliance with those arrangements and the sales and purchase agreement (SPA).

Corporate reorganisation and transaction structuring

A key feature of carve-out transactions is that often the target business is not neatly contained within one subsidiary of the seller. This means that both the seller and the buyer must closely review any required pre-closing corporate reorganisation. They must also pick the most appropriate transaction structure, whether a share deal, an asset deal or a combination of both.

Specifically, the first step will be for the seller to identify which assets, liabilities and contracts are remaining and which ones will be divested. In a second step, the seller will need to analyse how the target business can be transferred in the most efficient manner, including from a management, corporate, contractual and tax point of view. Groups tend to evolve over time into integrated business units with a significant amount of interdependencies. Accordingly, the separation process is typically complex. It is also unique to each business.

Separation

Generally, a separation of the carve-out business can be done by way of a formal demerger pursuant to the Swiss Merger Act, a spin-off by means of a distribution of the shares of a newly created subsidiary, a registered transfer of assets pursuant to the Swiss Merger Act or individual transfers. There are pros and cons to each form of transfer, including complexity and length of the process, financial statements requirements, consultation of creditors, employees and shareholders, consent of contracting parties, creditors' rights and secondary liability for historic claims (which can be offset contractually).

From the buyside perspective, the goal is to gain a detailed understanding as to the separation process and whether and how the target business can operate on a stand-alone basis or be integrated in the buyer's group upon completion of the transaction. Accordingly, a key focus of the financial, tax, pension and legal due diligence will be on separation issues.

The parties often face many complex structuring issues. For example, there may be assets and contracts sitting within entities of the retained group that will be required to be transferred to the target group (and vice versa) to ensure they are within the correct 'pocket' at completion. Some assets or contracts may be shared between the two groups, and may need to be transferred, replaced, duplicated or split or partially terminated.

Contracts in general and sometimes certain types of assets, such as joint venture interests, require the consent of the contracting party to be transferred into or out of the target group. These may become 'stranded assets' if the required consent is not forthcoming, for which the parties will need to devise the applicable regime (eg, depending on the importance of the contract or assets, termination of the SPA or back-to-back arrangements such as subcontracting, possibly combined with a price adjustment).

Typically, a plan of reorganisation or step plan will be attached to the SPA and its completion will be a condition precedent to closing. The buyer will want to bargain into the SPA as much oversight as possible to gain visibility on the implementation of the pre-closing restructuring. From a competition law perspective, such arrangements may raise gun-jumping issues. It will be important to clearly establish what is suitable and permissible and how evidence of completion of separation steps will be provided to whom and when. Last but not least, the parties will need to discuss and agree upon a suitable allocation of the restructuring and separation costs (which can be substantial).

Wrong pockets clauses

The SPA will contain 'wrong pocket' and mutual indemnification clauses. The goal is to ensure that, post-completion, each party has all the necessary assets and contracts to conduct its business and is not exposed to liabilities that should attach to the other group. Wrong pocket clauses go both ways. They aim to return to the retained business those assets that ended up with the target business but belong to the retained business. They also serve to transfer to the buyer or the target group those assets that should have been transferred but were held back by the retained business.

A practical difficulty is that it may not be clear cut whether an asset or contract belongs to the retained or target business. The parties often define the assets belonging to a group by reference to assets 'exclusively' or 'predominantly' used in the business of that group. They will also determine whether the group to which an asset will be transferred post-closing needs to pay value for the assets.

Intellectual property and data

Intellectual property, or IP, will raise additional considerations, especially if it has been historically shared within the seller's group. The parties may agree that IP will be retained by the group making the greatest use of it and licensed to the other group. Parties should, however, keep in mind that perpetual licences are not permissible under Swiss law (and thus whenever that is feasible, they may want to elect for the application of foreign law). An alternative can be for the seller to sell IP rights for specified products or regions.

A particular difficulty typically arises with shared brands. The parties will have to determine whether one of them will no longer use the brand post-closing or whether the brand will be split. They may also agree upon contractual safeguards to protect the value of the brand.

Data, nowadays one of the most important assets for companies, can also result in complex separation issues. It will need to be determined how integrated the data of the target and retained groups are, how the separation can be done and whether this is achievable prior to completion. The seller will have to ensure that only data relevant to the target group is transferred to the buyer. If data of the target group cannot be separated from group-wide data prior to completion, a licensing agreement may be needed.

Employees

With regard to employees, the parties will need to determine which personnel need to transfer to the target group (or be retained by the seller), which personnel are likely to transfer automatically by operation of law, and whether any consultation process needs to be undertaken with the works councils or the employees.

Switzerland has its own version of Transfer of Undertakings (Protection of Employment) rules. If a business or a portion thereof is transferred by way of an asset deal (rather than a share deal), the employment contracts will transfer by operation of law along with the business or the portion thereof (together with insurance and pension entitlements).

If the buyer does not want some of the employees that would automatically transfer to the target group, the parties will have to determine whether to formally re-assign these employees. Alternatively, layoffs will need to be undertaken post-closing. In that case, the parties may have to comply with the mass layoff provisions of articles 335d et seq of the Swiss Code of Obligations. The buyer's concern will be to carefully review the workforce that would transfer with the target business to ensure that the seller is not using the transaction to unload unnecessary personnel.

If the transferring employees are covered by a collective labour agreement, the buyer will be liable to adhere to the agreement for at least one year. If such an agreement applies by law or is part of the employment contracts, the buyer will remain bound by it even after the one-year period.

Each employee may object to the transfer by operation of law, in which case the relevant individual employment terminates upon the expiration of the statutory (rather than the contractual) notice period (one to three months, depending on seniority).

The transfer of a business or a portion thereof via an asset deal will require a pre-transfer notification to the works councils or employees and, if measures affecting the employees are contemplated, a consultation process. Works councils or employees' feedback during the consultation must be considered, but is not binding. Employees may particularly be concerned with treatment of pension, share incentive awards and performance-based bonuses, to name just a few key considerations.

The parties will also have to address the apportionment of the seller's pension fund. Sizeable carve-outs often lead, based on the relevant pension fund's regulation, to a 'partial liquidation'. Such a partial liquidation triggers a closely regulated process for the transfer of insured employees, data, entitlements and assets. On the buyer's side, it has to be decided whether to fold acquired personnel into existing plans or create new plans.

For target businesses that are particularly reliant on the skillset, know-how or client relationships of the workforce or key employees (eg, in the asset management or investment banking industry, or for companies active in technology, life science or engineering), the buyer may insist on a condition to closing linked to the implementation of new employment agreements or a retention plan. This may involve incentives in the form of retention or stay bonuses. There

may also be employees with split roles, which may raise the question of transitional services while replacements are recruited.

Intra-group interdependencies

In addition to ensuring that assets and contracts sit in the right group, there will be interdependencies to terminate or address appropriately, such as group-wide insurance policies, group IT, cash-pooling arrangements, intra-group debt and guarantees issued by the retained group to financial or trade creditors of the target group or vice versa. The buyer will likely be required to bind new insurance policies at completion. It may, however, seek to obtain that the seller maintains insurance policies to cover outstanding insurance claims or past events (in which case the seller will be concerned with conduct of claims, reimbursement for its costs and assumptions of any premium increase).

In regulated industries, such as the financial or pharma industries, there are likely to be licences and permits required to be held by the target group. The buyer may need to submit applications for the granting of new licences and permits or their transfer, often on a cross-jurisdictional basis (since most businesses are active regionally or globally). Such a regulatory process will require close cooperation from the seller, the contours of which ideally will be delineated in the SPA.

Tax considerations

Tax considerations are generally critical in a carve-out transaction. They will feature heavily both in the pre-closing reorganisation and the structuring of the disposal.

High level considerations on demergers

Provided that they satisfy a number of conditions, reorganisations can be tax neutral under Swiss law. This is the case where:

- the surviving entities continue to be subject to Swiss taxes;
- income tax values are being maintained;
- the transferred assets or participations constitute an operating business or part of an operating business; and
- the remaining entity after the demerger carries on pursuing an operating business or part of an operating business.

Where the carve-out concerns purely holding companies, as well as finance or real estate companies, additional requirements apply.

Importantly, where the reorganisation can be structured as a tax-neutral demerger in compliance with the conditions outlined above, there is no 'blocking period' that would preclude the disposal of a newly established entity.

Where the reorganisation is not tax neutral, it may crystallise income tax, withholding tax and stamp duty leakages at the level of the entities concerned, as well as the shareholders.

Tax consequences of a share deal

Where the sale of the target business is structured as a share deal, the transaction will generally result in taxable income to the extent of the difference between the tax book value and the realised purchase price.

However, participation relief can be claimed on the realised capital gain if certain conditions are met (including the holding of a participation of at least 10 per cent for a period of more than one year).

Furthermore, if any of the involved parties qualifies as a securities dealer for Swiss securities transfer tax purposes (a qualification that may apply to holding companies), a share deal will be subject to securities transfer tax.

Tax consequences of an asset deal

As an alternative to a tax-neutral reorganisation on the basis of the general conditions outlined above, assets can also be transferred within a group as single operating assets on a tax-neutral basis (without complying with the requirement that the assets constitute a business or a portion thereof), with a blocking period of five years.

Where the sale of the target business is structured as an asset sale, the transaction will generally crystallise income tax over the realised gain.

Furthermore, VAT consequences need to be addressed (usually by means of notification procedure to the Swiss Federal Tax Administration).

Transitional services

Once the target business is defined, the deal is priced and the way to get there is defined in the contracts, carve-out transactions usually pose one more challenge: designing and implementing appropriate arrangements between the parties regarding services during a transitional phase following completion.

Rationale for post-completion transitional services

Prior to completion of a carve-out transaction, services such as legal, accounting, IT, payroll, procurement, software licensing or sourcing may be managed group-wide with internal transfer pricing and cost share mechanisms. These internal arrangements will need to be unwound upon completion. As this task usually takes time and the buyer can only start once it has taken control over the target group at completion, the parties often agree on a certain post-completion transition phase.

While most often the seller will look for as clean a break as possible, it may, however, have its own vested interest in providing transitional services. Offering transitional services can open the field to more potential buyers, and so can be a lever to maximising value in an exit. This consideration will be balanced with the fact that transitional services may require the seller to have in place employees, licences and supply arrangements that it may not otherwise need to maintain. Transitional services can also be a distraction and a burden in the management of the retained group.

Structure of transitional services agreements

It is not unusual for a buyer to request the continuation of a range of services (rather than just one single transitional service). In that case, a typical approach is to negotiate a master transitional services agreement with service level agreements contained in annexes. Service level agreements include a detailed description of the services, specific performance requirements, their term and costs.

The key feature of transitional services agreements and, in particular, service level agreements is that they require substantial attention and time from operational people from both parties. In our experience, value is added in the precise definition of the services, a clear structure of the costs associated with these services, and the ability to terminate or extend specific services (rather than all of them) before their scheduled end date. The parties to a Swiss-law-governed transitional services agreement should, however, also keep in mind that the agreement may qualify as a mandate with the effect that, as matter of mandatory law, it may be terminable by both parties at any time (as per article 404 paragraph 3 of the Swiss Code of Obligations).

Key drivers in the negotiation process

There are a number of key drivers that colour the negotiation process. It is important for both parties to be aware of the parties' incentives to facilitate the negotiation and focus their attention on the points that matter.

From the seller's perspective, a key consideration is that it is typically not in the business of providing the services that it will agree to supply to the target group post-completion. Transitional services are a facilitating device. This fact will underpin the position that the seller will take across a number of important clauses.

- Prompt transition: the seller will often insist on including an acknowledgement from the buyer that the services are transitional in nature paired with an effort-based commitment from the buyer to integrating or migrating as promptly as practicable.
- Standard of care: the seller will generally only accept to provide transitional services in a manner generally consist with, and with the same standard of care, as they were historically provided to the target group (pre-completion).
- Fees: the seller will seek to at least cover its costs, and may seek to earn a profit by charging market price. The seller may seek to include an adjustment mechanism if the fee structure is materially insufficient to compensate it for the cost of providing the services. The pricing structure can also be used by the seller as a lever to incentivising the buyer to accelerate the transition, for example, by contemplating an uptick in the price of the transitional services over time.
- Indemnification: the seller will often object to an indemnification clause or at least to limit the scope of any indemnity to cases of the seller's gross negligence or wilful misconduct.

On the other hand, the buyer will be focused on preserving business continuity and a successful migration or integration. Among other key considerations, the buyer may be concerned with the continued ability of the seller or the retained group to provide the transitional services and may insist on including an obligation to maintain employees for the provision of these services.

The level of complexity around transitional services is a good indicator of the challenges that a carve-out transaction may face. Advance preparation and readiness to anticipate all the details of post-completion operations are simply crucial in these transactions.

Appendix 1

About the Authors

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Christoph Vonlanthen is a specialist in mergers and acquisitions, growth equity, corporate governance and capital markets.

Christoph is a partner based in both the Geneva and Zurich offices, and has vast experience accumulated in Switzerland, New York and London in market-leading transactions, including buyouts, divestitures, spin-merge transactions, exchange offers, divestitures, carve-outs, rights offerings and IPOs in a range of industries. He regularly advises strategics, financial sponsors and investment banks on complex cross-border assignments. Christoph also assists fund managers and institutional investors on structured investments, co-investments and secondary sale transactions.

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