Practice
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SWISS M&A

Third Edition

Contributing Editors
Ueli Studer, Kelsang Tsün and Joanna Long

LEXOLOGY
Getting the Deal Through

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Carve-out Transactions

Christoph Vonlanthen and Oliver Triebold[1]

Introduction

The key defining feature, and source of complexity, of a carve-out transaction is that it involves the separation of a business integrated in the operations of the seller. Carve-out transactions can take the form of a disposal of subsidiaries, divisions or assets. In the public markets, it can be the spin-off or split-off of business units.

At a strategic level, companies turn to a carve-out 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. Historically, carve-out transactions have accounted for a healthy percentage of deal activity, with bursts of activity in the wake of market upheavals. It is therefore not surprising that volumes have been spurred in the recent past by the pandemic, supply chain disruptions and geopolitical events. In this chapter, we review a range of challenges that the parties need to anticipate and navigate when considering these complex transactions.

Financial statements

A key underpinning of an M&A transaction is the availability of financial statements for the target business. Financial statements are critical for pricing the deal. In addition, they are a crucial area of due diligence and the basis for important representations and warranties. Carve-out financial statements can also be essential to support the buyer's capital-raising efforts.

There may, however, not be any financial reporting at the level of the target business, 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.

Carve-out accounting or the determination of the assets, liabilities, revenues and costs attributable to the target business can be a particularly complex and time-consuming process.

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Pricing the carve-out transaction

Interdependencies between the target business and the business to be retained by the seller 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 however are generally significant, with the potential of diverting value of the target business 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, 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 sale and purchase agreement (SPA).

Corporate reorganisation and transaction structuring

A carve-out will typically involve a separation or corporate reorganisation ahead of the consummation of the transaction. This means that the seller and the buyer will have to identify which assets, liabilities and contracts are within the scope of the transaction and which ones will remain with the seller. In a second step, the parties will need to analyse how the target business can be separated and transferred to the buyer in the most efficient manner.

Separation

Generally, a separation of the carve-out business can be done by way of a formal demerger pursuant to the Swiss Merger Act or an 'old-fashioned' split-off involving a contribution of assets, liabilities and contracts into a newly formed subsidiary and a distribution of the shares of the new subsidiary to the seller. The contribution itself can be implemented by means of a registered transfer of assets pursuant to the Swiss Merger Act or individual transfers. There are pros and cons to each form of separation, including:

- the complexity and length of the process;
- financial statements requirements;
- the 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 of 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 buyer's due diligence investigation will be on separation issues.

The separation process often raises many complex structuring issues for the parties. For example, some assets or contracts may be shared between the target business and the remaining business of the seller, and may need to be transferred, replaced, duplicated or partially terminated. In addition, 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 business. These may become 'stranded assets' if the required consent is not forthcoming, for which the parties will need to devise the applicable regime.

Typically, a plan of reorganisation or step plan will be attached to the SPA and its completion will be a condition precedent to closing.

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 business 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 pose difficulties under Swiss law (to the extent that they involve active duties by one of the parties, such as maintenance by the licensor). An alternative can be for the seller to sell IP rights for specified products or regions.

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 businesses are, how the separation can be done and whether this is achievable prior to completion.

Employees

The parties will need to determine which personnel need to transfer to the target business or be retained by the seller, whether 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. These rules may pose an issue in the separation of the target business because even a transfer of assets and liabilities may have the effect of triggering the automatic transfer of employment contracts (together with insurance and pension entitlements).

If the buyer does not want some of the employees who would automatically transfer to the target business, the parties will have to determine whether to formally re-assign these employees. Alternatively, layoffs may need to be undertaken post-closing. If that happens, the parties may be required to comply with the mass layoff provisions of articles 335d et seq of the Swiss Code of Obligations.

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 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.

The parties will also have to address the apportionment of the seller's pension fund. Sizeable carve-outs often lead to a 'partial liquidation'. Such 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.

Intra-group interdependencies

In addition to ensuring that assets and contracts sit in the right business, there will be interdependencies to terminate or rearrange, such as group-wide insurance policies, group IT, cash-pooling arrangements or intra-group debt and guarantees. The buyer is likely to be required to subscribe for 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 regulated industries, the buyer may need to submit applications for the granting of new licences and permits or their transfer. 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, carve-out transactions can be tax-neutral under Swiss law. This is generally the case where the following requirements are cumulatively met:

- 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 entities after the demerger carry 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 considerations apply to satisfy the operating business requirement.

In particular, the 'transparency principle' was recently introduced for the split or demerger of holding companies. On the basis of this principle, holding companies are no longer restricted to satisfying the operating business requirement by ensuring that each holding company (resulting from the split or separation) hold participations of at least 20 per cent in at least two active subsidiaries. It is now sufficient if each resulting holding company controls a 'business operation' (ie, if it holds more than 50 per cent of the voting rights in an active subsidiary).

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 subsequent disposal of the newly established, demerged 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. In some cases, these tax consequences can be mitigated, but this can then lead to other restrictions (eg, a blocking period).

Tax consequences of a share deal

Where the sale of the target business by a corporate entity or an individual holding the target as business assets is structured as a share deal, the transaction will generally result in taxable income for the seller 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 especially applies to holding companies with participations with a book value of more than 10 million Swiss francs), a share deal will be subject to securities transfer tax of up to 0.3 per cent.

Tax consequences of an asset deal

As an alternative to a tax-neutral demerger 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 path to get there is defined in the SPA, 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, procurement and software licensing or sourcing may be managed group-wide. These internal arrangements will need to be unwound upon completion. As this task usually takes time, the parties often agree on a certain post-completion transition phase.

For the seller, offering transitional services can open the field to more potential buyers, and so can help maximise 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 business.

Client's involvement

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 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.

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 business 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 consistent 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 wilful misconduct or gross negligence.

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 business to provide the transitional services and may insist on including an obligation to maintain employees for the provision of these services.

As with other aspects of carve-out transactions, the negotiation of transitional services can be complex. Advance preparation and readiness to anticipate all the details of post-completion operations are crucial.

Appendix 1

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

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