NORTON ROSE FULBRIGHT

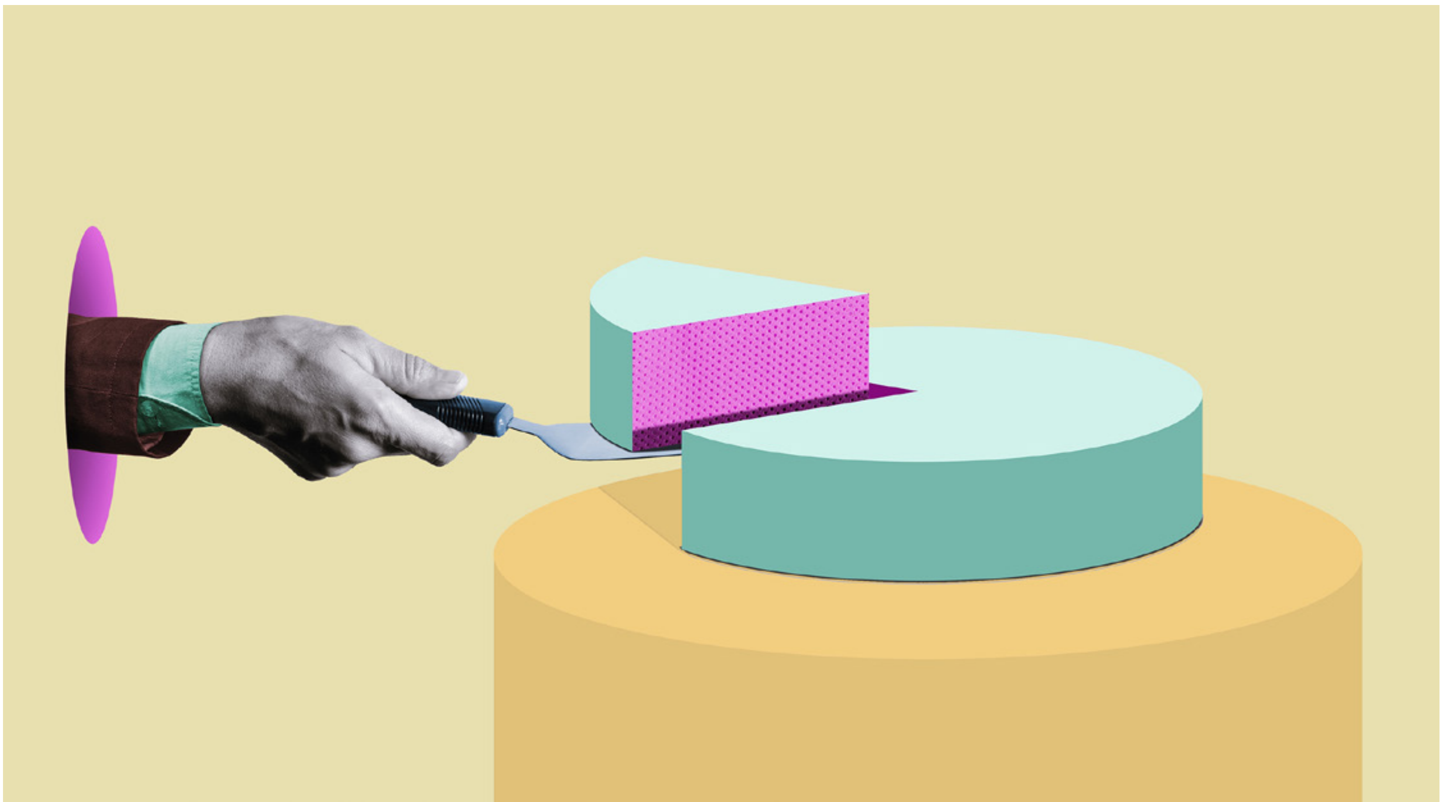
Published by Financier Worldwide Ltd
©2023 Financier Worldwide Ltd. All rights reserved.

Permission to use this reprint has been granted by the publisher.

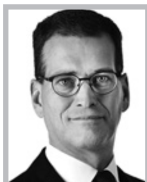
ROUNDTABLE REPRINT May 2023

SPIN OFFS AND CARVE OUTS

The market for spin off and carve out transactions has been strong over the past 12 months, although activity has plateaued more recently due to corporate boards' concern over a potential recession, high interest rates and inflationary trends. Nevertheless, dealmakers remain poised to use spin off and carve outs to adjust their companies' portfolios and chart new strategic paths, with many observers expecting the pace of such deals to increase later in 2023. ■



THE PANELLISTS



Michael J. Ulmer
Partner, Cleary Gottlieb Steen & Hamilton LLP
T: +49 (69) 97103 180
E: mulmer@cgsh.com
www.clearygottlieb.com

Michael J. Ulmer's practice focuses on domestic and international private and public M&A transactions, joint ventures, general corporate advice (including activism defence), private equity transactions and advice on foreign direct investment regulations. His work extends to a broad range of industries and clients, including leading German corporates, Mittelstand companies, and domestic and international financial and strategic investors. He has vast experience in assisting clients from the Middle East with outbound investments.

Stephen I. Glover
Partner, Gibson, Dunn & Crutcher
T: +1 (202) 955 8593
E: siglover@gibsondunn.com
www.gibsondunn.com

Stephen I. Glover is a partner in the Washington, DC office of Gibson, Dunn & Crutcher and is the recent co-chair of the firm's global mergers and acquisitions practice. Mr Glover has an extensive practice representing public and private companies in complex transactions, joint ventures, equity and debt offerings and corporate governance matters. His clients include public corporations, emerging growth companies and middle market companies in a wide range of industries.

Karsten Kühnle
Partner, Norton Rose Fulbright LLP
T: +49 69 505096 304
E: karsten.kuehnle@nortonrosefulbright.com
www.nortonrosefulbright.com

Karsten Kühnle is a corporate and M&A lawyer and head of the Frankfurt office at Norton Rose Fulbright LLP. He concentrates on corporate transactions including M&A, joint ventures, commercial agreements and general corporate matters such as corporate governance and compliance. He has particular experience in carve out transactions and international joint ventures acting for global businesses and German Mittelstand companies.

Joshua Ford Bonnie
Partner, Simpson Thacher & Bartlett LLP
T: +1 (202) 636 5804
E: jbonnie@stblaw.com
www.stblaw.com

Joshua Ford Bonnie is co-head of the firm's global capital markets practice and co-managing partner of the firm's Washington, DC office. He is one of the preeminent initial public offering (IPO) lawyers in the US and regularly counsels public companies on spin offs and other significant strategic transactions, capital markets offerings and general corporate and securities law matters. His transactional experience also includes business combinations involving special purpose acquisition companies (SPACs).

Thomas W. Greenberg
Partner, Skadden, Arps, Slate, Meagher & Flom LLP
T: +1 (212) 735 7886
E: thomas.greenberg@skadden.com
www.skadden.com

Thomas W. Greenberg is a corporate attorney whose practice focuses on M&A, both negotiated and hostile, private equity investments, securities transactions and other corporate matters. Mr Greenberg represents public and private buyers, sellers and target companies, private equity firms and investment banks in a variety of US and cross-border acquisitions and dispositions, investments, joint ventures, restructurings and financings. He also counsels companies on shareholder activism, securities law compliance and corporate governance matters.

This article first appeared in the May 2023 issue of Financier Worldwide magazine. Permission to use this reprint has been granted by the publisher. © 2023 Financier Worldwide Limited.

FINANCIER WORLDWIDE corporatefinanceintelligence

FW: Over the last 12 months or so, have you seen an increase in carve outs and spin offs? How would you describe the market for these transactions, including the appetite of financial and strategic buyers to acquire these assets?

Glover: The market for carve out and spin off transactions remained quite active through the end of 2022, even though the market for M&A transactions generally had begun to slow. Carve out and spin off volumes have been lower in early 2023, at least in part because of concern about a potential recession, high interest rates and inflationary trends. Having said that, companies have continued to use carve outs and spin offs to adjust their portfolios and chart new strategic paths, and many market observers believe that the pace of these deals will increase in late 2023. On the sell-side, companies continue to review their strategic plans and identify non-core assets that they can spin off or sell. Activists stir the sell-side pot by encouraging companies to streamline their business portfolios and generate value. On the buy-side, both strategic and private equity purchasers continue to look for good acquisition opportunities.

Greenberg: Over the past 12 months, we have seen continued interest by corporate boards in pursuing carve outs and spin offs, with the number of US spin offs increasing year over year while the number of US carve outs was down slightly from the previous year. Companies with diversified businesses, facing investor pressure to generate greater shareholder returns, have looked to spin offs and carve outs as a way to unlock value and refocus on their core businesses while shoring up their balance sheets. While financial and strategic buyers with cash resources continue to seek opportunities in the current market to acquire carve out businesses that can generate growth, carve out sales have faced some headwinds in recent months due to mismatches in valuation expectations between buyers and sellers and greater uncertainty about the macroeconomic outlook given recessionary concerns, persistent inflation, higher interest rates and financing costs, geopolitical developments and greater market volatility. At the same time, spin offs have become an attractive alternative to a traditional carve out sale or initial public offering (IPO) of a business unit, as M&A and capital markets conditions have become more challenging.

Ulmer: Over the last few years, we have seen quite a number of spin offs and carve outs. 2022 was a bit slower though. The war in Ukraine, rising inflation and costs of borrowing as well as volatile markets created a macroeconomic environment that is increasingly difficult to navigate, especially if you are running complex and lengthy processes like the ones that usually come with spin off and carve out transactions. In the past, financial investors were lining up to acquire resulting assets. Sometimes, they themselves suggested a carve out be considered. While financial investors still sit on a lot of dry powder, leverage has become costly. In consequence, these investors are less bullish than they used to be. This offers opportunities for strategic investors. However, taking on and justifying the risks associated with significant acquisitions in the current market environment can be challenging for them as well.

Kühnle: As far as Germany, Austria and Switzerland are concerned, the past 24 months have shown both spin off and carve out transactions, mostly in the automotive and energy sector, and for 2023 a few spin off transactions are being planned, such as in the healthcare and pharmaceutical sectors. In terms of carve outs, within the same period, there were several deals with industrials dominating the deal flow, and it is fair to assume that this will remain the case. Increasingly, divestures are driven by sustainability regulation such as the European Union (EU) Green Deal and EU Taxonomy, in particular, in the automotive, energy, chemicals and mechanical engineering space. Profitable and sustainable businesses will always attract a financial and strategic investor universe. Conversely, if the business lacks profitability and a green sustainability score, the majority of financial and strategic buyers will be hesitant, and turnaround investors will come into play.

Bonnie: Last year was an historically challenging time for equity capital markets activity with a number of factors contributing to significant market volatility and decreased investor demand for new issues, including concerns over inflation, rising interest rates and uncertainty from the war in Ukraine. There were, however, a number of carve outs and spin offs completed in 2022 despite this challenging environment. These transactions tend to be driven by long term strategic and competitive rationales, and so they are less sensitive to current trading multiples and the immediate market environment than more opportunistic capital markets activity. Although challenging conditions have persisted into the first part of this year, with markets most recently buffeted by instability in the banking system, the present environment should not dissuade businesses for which a spin off or carve out is strategically compelling from beginning to prepare for such a transaction. These are complicated transactions with significant lead times. Over a longer horizon, carve out and spin off activity will doubtless return to more normalised levels. Companies and their boards will always regularly engage in portfolio review and seek strategic options that can create value for their owners, and a carve out or spin off is a proven way to do this where the embedded value of a particular business does not seem to have been given appropriate credit by public markets.

FW: What kinds of factors typically compel a company to divest a unit? What benefits and opportunities does it potentially create for the parent company?

Greenberg: Companies often begin to consider divesting a business unit when the performance of one unit diverges from overall company performance or when there is a perception that a ‘conglomerate discount’ is affecting the company’s overall valuation. Divestitures allow the management teams of separated businesses to focus on their own separate businesses

and strategies and potentially attract greater valuations by the market as 'pure play' companies. Institutional and activist investors have frequently been supportive of divestitures as a value-enhancing action for companies whose businesses are not achieving their full potential or are no longer aligned with the company's strategies or priorities. The proceeds from a divestiture – which can include the sales proceeds in a carve out or the proceeds from borrowings or parent company debt reduction in a spin off – can provide the parent company with an enhanced liquidity profile and resources to fund the growth of its retained businesses. Furthermore, spin offs have the added benefit that they may be accomplished on a tax-free basis, subject to meeting certain tax requirements.

Ulmer: Valuation still is a key driver for this kind of transaction. If the value of the whole is significantly below the combined values of its parts, this is a strong argument for splitting up the group. Activists have made the 'pure play' argument for years, resulting in management now engaging in such valuation exercises even without pressure from activists. Further, a shift of corporate strategy to focus on core businesses triggers separation processes. The chance to get rid of energy intensive or environmentally unfriendly businesses also resonates with management who are under increasing scrutiny from stakeholders and the public in general. Finally, the proceeds resulting from a divestiture may be used to strengthen the core business.

Kühnle: Carve out and spin off deals are employed by companies for a range of reasons and, usually, follow a meaningful prior analysis of strategic alternatives. Pure plays are frequently driving spin offs whereas carve outs are often perceived as responses to the relevant unit not fitting into the parent group's evolving strategy, being underperforming, lossmaking or considered as part of a joint venture with a strategic partner. Where a divestment turns out to be the preferred option – 'sell, fix or close' – this will permit a strategic repositioning of and, in most cases, unlock value for, the parent company and the divested business. Dealmakers may increase the benefits from the divestment if they use the momentum to implement value-enhancing measures that relate to margin or working capital optimisation, reorganisation of operational structures and processes, and restructuring of loss-making parts. However, implementation of such measures is frequently replaced by fast-tracked deal execution.

Bonnie: A trend in public equity markets over the past decade has been the increased preference for so-called 'pure play' issuers over more diversified companies. Carve outs and spin offs allow a parent company to divest an ancillary business line so that both companies can focus on their core businesses. Management may conclude that separating an ancillary business line would maximise shareholder value because the separate parts of the larger business would be valued higher than the combined enterprise. This can be the case particularly where the businesses have different growth rates for which the equity markets are not providing enough credit or if the businesses attract divergent investor bases. The parent business and the carve out may also differ in their relative capital intensity, and separation can allow both to implement balance sheet strategies and access capital resources that are tailored to their respective needs. The separation may also lead to top-line growth potential by eliminating operational or regulatory conflicts currently existing between business units.

Glover: A company may decide to divest a business unit when it determines that continuing to operate the business no longer fits with its strategic plan. It may conclude, for example, that the business offers fewer opportunities for growth or less profit potential than its other businesses, or it may decide that the business has different capital needs, serves different types of customers, operates in a different regulatory environment or requires a different workforce than its other businesses. A company may also decide to divest a business unit for financial reasons. If the company feels pressure to generate cash, a carve out transaction, in which it sells a business unit to a third party, may provide a good solution. Spin offs can also be structured in ways that produce cash for the parent company. For example, the parent might cause a subsidiary being spun off to incur new debt and dividend the proceeds to the parent.

FW: How important is it to fully understand the scope of a carve out or spin off from the outset, and to assess and define the perimeter?

"FINANCIAL AND STRATEGIC BUYERS SITTING ON UNDEPLOYED CASH RESOURCES MAY SEE ATTRACTIVE BUYING OPPORTUNITIES FOR CARVE OUT BUSINESSES AS VALUATIONS COME DOWN FROM WHERE THEY WERE AT THE HEIGHT OF THE MARKET."

THOMAS W. GREENBERG
Skadden, Arps, Slate, Meagher & Flom LLP

Ulmer: Without understanding the scope of a carve out or spin off, it is impossible to assess whether a transaction will create value. The more complex a situation, the more difficult it is to develop a shared understanding, even among members of the deal team. It is not uncommon that over the course of a project this understanding evolves or changes, sometimes significantly. Often, this is merely a consequence of the changing economic environment. Sometimes though, changes within senior management can make a difference as well. Since carve outs and spin offs require thorough preparation, the period in which a project remains vulnerable to a changing environment and resulting challenges can be rather long.

> "SIGNIFICANT ATTENTION IS REQUIRED TO CRAFT THE AGREEMENTS GOVERNING THE SEPARATION TO EFFECTIVELY ALLOCATE ASSETS, RIGHTS, LIABILITIES AND OPERATIONS."
>
> JOSHUA FORD BONNIE
> Simpson Thacher & Bartlett LLP

Kühnle: Determining the target operating model (TOM) and its perimeter is fundamental to the success of the carve out and spin off, respectively. Components that structure the TOM will typically comprise products and services, customers and suppliers, employees and management, processes and data. Those establish the perimeter which in turn stipulates the level and degree of separation measures that the seller must take to ensure that level of standalone capability that has to be available at closing. Furthermore, the perimeter sets the scope for a risk mapping that forms part of planning the carve out or spin off. Depending on the level of autonomy, transition services agreements will support the divested business for a certain limited period of time. Having the TOM, its perimeter and the level of standalone capability diligently determined from the outset increases transaction certainty and minimises the risk of post-transaction disputes.

Glover: Defining the perimeter of the business that will be carved out or spun off is one of the most important tasks that the transaction planners will face. Without a clearly defined perimeter, they will not be able to identify which assets and liabilities will go with the business to be carved out or spun off and which will stay behind. Similarly, they will not be able to identify assets and liabilities that both the spin off business and the parent will need, and develop the terms on which they should be shared. For example, the planners will be unable to determine the intellectual property that the carve out or spin off business will require, or the scope of any required intellectual property cross-licences. In addition, they will not be able to decide which employees will go with which business or prepare financial statements for the business to be divested. As the work on a proposed spin off or carve out progresses, the planners will almost always adjust and refine the perimeter definition.

Bonnie: The contractual agreements in the transaction will define the assets, liabilities, employees and obligations that are intended to be separated and those that are intended to remain. Demarking this division becomes more difficult the more closely integrated the carve out business is with its parent company. Dedicated resources and collaboration across functions, including with specialists in areas such as tax, intellectual property (IP) and environmental and employee benefits, are necessary in order to ensure that the contractual agreements work as intended and to establish appropriate protective measures under circumstances arising prior to, at and after the separation. Further, although separation agreements can define the relative rights and obligations of a parent company and a carve out business as between each other, they may not be effective to bind a third party. For instance, a parent company might agree with its SpinCo that a particular litigation or other contingency is the SpinCo's responsibility, but frequently this will not stop litigants, creditors or other claimants from seeking recourse against the parent company nonetheless.

Greenberg: It is very important to clearly define the scope of the assets and liabilities to be included in a carve out or spin off at the outset of the transaction. This is particularly the case for shared assets, shared contracts and employees used by each of the businesses to be separated. Buyers will want assurance they will receive the assets and employees needed to run the business independently of its former parent and will not have to worry about operational interruption once the deal has closed. Sellers will want to be comfortable that they will be able to continue to operate their retained businesses unimpaired by the separation. These issues are equally important in spin offs where the SpinCo will need to have operational autonomy once the spin off is completed. Where there are significant shared assets, parties will need time to negotiate licences and service and supply agreements to ensure business continuity. There should also be a clear

understanding of the allocation of liabilities, as those allocations could impact the valuation of the business to be separated.

FW: What change of ownership considerations need to be made when structuring the deal? What steps should be taken to organise the separation and transition process?

Bonnie: Significant attention is required to craft the agreements governing the separation to effectively allocate assets, rights, liabilities and operations and to design principles and mechanisms that can address unforeseen issues, such as bankruptcy or termination risk for each party. Parties will need to undergo a careful diligence exercise when structuring the deal to uncover potential issues, including each party's needs after closing. Existing proprietary assets should be diligenced to determine their rightful owner, which is ordinarily the primary user, and existing contracts will need to be reviewed carefully to determine whether a divested or retained entity is the counterparty and whether assignment, change of control provisions or other key provisions would be triggered as a result of the transaction. For example, depending on the language in each contract and the applicable governing law, sometimes when a business that is a licensee or party to a contract is being divested, the transaction may be deemed an impermissible assignment due to the change in the owner of the carve out or spin off business, notwithstanding that the identity of the contractual counterparty did not change.

Greenberg: In any carve out or spin off, there will need to be a careful assessment of the transaction's impact on change of control and anti-assignment clauses in contracts, licences and permits. Shared contracts may need to be split, partially assigned or replicated or addressed in a services agreement. Determining the scope and terms of services to be provided between the companies can take time to develop and involve multiple functional areas. There may also be guarantees in place by the parent that will need to be released or replaced as part of the separation. In addition, parties will need to conduct an assessment of regulatory filings and approvals that may be required to complete the transaction, taking into account the evolving regulatory landscape. The divesting party should organise itself early in the process and, with the assistance of its advisers, conduct self-diligence to identify any potential change of ownership issues and develop a plan and timeline to address them.

> GETTING THE DEAL DONE MEANS IDENTIFYING RISKS EARLY, ANTICIPATING THEIR RESPECTIVE MAGNITUDE, AND MANAGING THEM EFFECTIVELY.
>
> KARSTEN KÜHNLE
> Norton Rose Fulbright LLP

Glover: Some deals will result in changes of ownership and some will not. A traditional spin off, in which shares of the business to be spun off are distributed to the parent company's public stockholders, does not result in a change in control, at least immediately. More complicated spin offs, such as a spin off involving an investment by a sponsor in the spun off business, or a spin off effected in part by means of an IPO of the spun off company's equity, may result in a change in ownership. A carve out that is accomplished via the sale of the business unit to a third party, by definition, results in an immediate change of control of the business unit. A change of control may have both contractual and regulatory consequences that the transaction planners must consider. The transaction planners may need to obtain consent from contract counterparties that have contractual rights to approve the change in control. They may also need to seek approval from the antitrust authorities or other regulators. In addition, they may need to consider rules governing foreign direct investment (FDI) if the transaction results in the transfer of ownership from domestic to foreign owners.

Kühnle: Structuring carve out and spin off transactions means ensuring deal structures that minimise risk arising from a change of ownership, such as special termination rights in contracts or pre-emptive rights in joint ventures affected by the transaction. Other risks in that context include recertification of production processes, reissuance of permits and approvals, special termination rights conferred to key employees and management, mandatory consultation procedures with employee representatives without completion of such no definite transaction steps may be taken, consent requirements in asset-deal structures, and, more indirectly, loss of turnover and liquidity, and reduced purchasing power vis-à-vis suppliers once the divested business enters into direct supply agreements, assuming the same source of supply. A cross-functionally operating project management office (PMO) will help in identifying those separation issues along the entire value chain at an

early stage, such that these can find their way into transaction structuring and the transaction documentation.

Ulmer: Structuring a spin off or a carve out is a complex exercise. The transaction needs to produce two entities, each of which is able to operate more or less independently from the other. Assets and liabilities need to be allocated, contracts separated and IP rights transferred. Employees need to find a new home. Over the last couple of years an additional element has been added to this complexity: foreign investment regulation. Depending on the proposed new ownership structure and the nature of the business, the transaction could be subject to intense scrutiny by authorities, and ultimately face strict limitations. Security interests may play an important role in deciding how a transaction is structured, influencing, for example, how critical contracts or IP are allocated.

“DEFINING THE PERIMETER OF THE BUSINESS THAT WILL BE CARVED OUT OR SPUN OFF IS ONE OF THE MOST IMPORTANT TASKS THAT THE TRANSACTION PLANNERS WILL FACE.”

STEPHEN I. GLOVER
Gibson, Dunn & Crutcher

FW: Could you provide an insight into some of the common deal breakers that surface in carve out and spin off deals, and how such problems can be overcome?

Greenberg: In the current environment, differences in valuation perspectives can be a deal breaker in carve out sales. To preserve optionality in case bids are not attractive, we sometimes see sellers pursue a ‘dual track’ process involving preparing for a spin off at the same time as a sale process. We also sometimes see earnouts and contingent consideration used to bridge valuation gaps. Another common issue relates to the allocation of liabilities in a carve out sale. Sellers typically seek to limit their retention of pre-closing liabilities, while buyers typically want to limit their exposure. These differences can be overcome through indemnification provisions with caps, baskets and other limitations and through the use of representations and warranties (R&W) insurance, which is increasingly used in carve out sales. In spin offs, the parent has greater flexibility to shift liabilities to SpinCo, subject to it remaining solvent. In carve out sales, the allocation of regulatory risk to complete the deal can be a deal breaker when there are significant business overlaps. This can be addressed through limits on the buyer’s obligations to accept regulatory remedies and through reverse termination fees payable by the buyer if it fails to obtain the approvals.

Glover: The biggest deal breaker relates to value. If a parent company that wants to sell a business in a carve out concludes that it will not receive an acceptable price, it will likely choose not to proceed with the transaction. If a parent company that is planning a spin off concludes that the market will not value the newly spun off company’s stock at an attractive level, it will likely change its plans. A closely related problem relates to the development of a satisfactory perimeter definition. If the parent and a third-party buyer cannot agree on the scope of the business being sold, the deal is likely to fall apart. It may be possible to solve value and perimeter problems by redefining the scope of the business to be spun off or sold. Time can also be an effective cure. When market conditions improve, the deal may begin to look attractive again. Regulatory problems sometimes become deal breakers as well. The buyer and seller in a carve out transaction may abandon a transaction if they conclude that the antitrust authorities will not grant clearance. Alternatively, they may seek to increase the likelihood of regulatory approval by refining the scope of the transaction or proposing the divestiture of certain assets. Because the antitrust authorities in the US, Europe and the rest of the world are taking aggressive positions, reaching agreement on appropriate adjustments can be quite difficult.

Kühnle: Structuring the deal, creating the target operating model, disentanglement, day one-readiness and in parallel running the divestment in an ambitious timeline – these challenges represent the complexity of carve out and spin off deals, but even more demand an increased level of transaction certainty. Dealmakers should be prepared for deal breakers such as insufficient internal resources to support the PMO, lack of meaningful risk mapping at the outset, an insufficient target operating model, weak and short sighted business planning, financial data that does not fit to the perimeter, lack of reliable data and poor housekeeping relative to the divested business, non-transparent carve out and spin off actions taken under control of the company, brain-drain of key employees and management, any kind of value detracting arguments by buyers and investors, and, most seriously, absence of a ‘plan b’ scenario. Getting the deal done means identifying risks early, anticipating their

respective magnitude, and managing them effectively.

Ulmer: Often, separating a business can lead to major challenges. What looks great on paper can be hard to implement. This mainly depends on how integrated the respective parts of the business are. And even if these parts are run relatively independently, they may nevertheless rely on the same infrastructure, technology or permits. For practical reasons, the transition period for effecting the separation may need to be extended as the carved-out business relies on services or supplies provided by the remaining business, which gives rise to many questions, including allocation of costs. Some of these issues have been deal breakers in the past. Discussions around the possible separation of the economically-challenged Thyssenkrupp steel business show that corporate history can be a critical element when assessing what is deemed feasible.

Bonnie: Spin off transactions present management with a variety of challenges. These are transactions that require substantial time and management focus, diverting attention away from operating a company's core businesses, and they involve substantial one-time costs. Carve outs and spin offs both require the functional and operational separation of a business that has been embedded in a larger enterprise. Operational entanglements and shared services, such as IT, accounting, legal and HR, must be identified and addressed. Legal entanglements, such as contractual relationships, licences, IP and branding, shared liabilities and credit support, must similarly be worked out. In addition to untangling and separation challenges, a spin off also involves the issues inherent in an IPO. The SpinCo must gain the ability to operate independently as a standalone public company, with its own senior leadership and board and its own public company corporate functions, including accounting, financial planning and analysis, investor relations and Securities and Exchange Commission (SEC) reporting.

FW: What advice would you offer on structuring the deal in a tax-efficient manner, to address actual or potential liabilities?

Bonnie: A primary driver of spin offs is their tax efficiency. Unlike a carve out sale, a spin off represents the opportunity for a parent company to divest a business in a transaction that is tax-free to the parent company and its stockholders. The rules in the US tax code that govern tax-free spin offs are exceedingly complicated and the preconditions for tax-free treatment can limit the candidate businesses for a spin off, as opposed to a sale. The parent in a spin off may ask the US Internal Revenue Service (IRS) to provide either a transactional or a significant issue private letter ruling that supports the desired tax-free treatment of the transaction based on its particular facts and plan for separation. Even if such a ruling is received, the parent almost universally receives an opinion of counsel confirming certain requirements for tax-free treatment. Achieving the desired tax outcome in a spin off depends not only on how the separation is effected, but also on the actions of both the parent and SpinCo before and after separation.

Kühnle: Carve outs and spin offs require diligent tax structuring from the outset. The legal separation steps will regularly follow the tax structuring and usually include reverse carve outs, asset and share transfers, transfer of real estate and IP. Each of those transfers may trigger different tax risks which become more complicated with the number of entities, jurisdictions, cross-border transfers and, possibly, tax groups, concerned. Income tax, taxation of capital gains as well as transfer and withholding taxes, such as on real estate or shares, are the key areas to watch out for. Sellers will need to indemnify the buyer from unknown tax risks for the pre-effective date periods. As far as spin offs are concerned, where shareholders held their shares in the parent company as private assets, the spin off basically does not constitute a disposal of their shares for tax purposes, and no taxable gain is being realised.

Ulmer: Tax is a key element of transaction structuring. Each situation is unique, involving different assets, jurisdictions and tax regimes, resulting in different issues. Consequently, the best advice is to involve tax experts as early as possible. Often, it is tax specialists who decide on transaction structure, or even whether the envisaged transaction is feasible. While their early involvement might not always be in the interest of all team members, ultimately, no-one wants to hit the wall later in the process.

> "WITHOUT UNDERSTANDING THE SCOPE OF A CARVE OUT OR SPIN OFF, IT IS IMPOSSIBLE TO ASSESS WHETHER A TRANSACTION WILL CREATE VALUE."
>
> MICHAEL J. ULMER
> Cleary Gottlieb Steen & Hamilton LLP

Glover: Packaging the assets and liabilities of the business to be divested often requires significant tax planning, especially when the business operates in several different jurisdictions and its assets and liabilities are housed in different subsidiaries. In addition to the tax issues associated with the packaging exercise, the carve out and spin off transactions themselves give rise to tax savings opportunities. Carve out proceeds are generally taxable to the seller, but the parties may be able to structure the deal so that the buyer receives a step up in the basis of the target's assets. Planners will ordinarily structure spin offs to ensure that the spin off distribution qualifies as tax-free to both the parent and its stockholders under section 355 of the Internal Revenue Code (IRC). In addition, if the parent plans to couple the spin off with a cash-generating event, it may be able to engage in planning that puts cash in the hands of the parent company on a tax-free basis. If the proposed acquirer of a business is about the same size as the target business, tax experts can evaluate the feasibility of a tax-free reverse 'Morris Trust' transaction, in which the parent spins off the target business and the spun off company combines with the third-party acquirer.

Greenberg: Tax considerations can play a critical role in how the transaction is structured and valued by the parties. In a carve out sale, sellers typically seek to structure these transactions in the most tax-efficient manner possible consistent with business objectives, while buyers may place a value on acquiring the business in a manner that provides a step-up in basis of the assets acquired. Spin offs can be structured to be tax-free to the divesting party, subject to meeting certain tax requirements. In either case, careful planning with outside advisers at an early stage of the transaction planning is key to obtaining a tax-optimising result. Advisers can help develop the step plan for the transaction, identify the tax implications and interdependencies of different steps and avoid unnecessary tax costs. The tax requirements for effecting these types of transactions are often complex and may require an assessment of the need for tax rulings or tax opinions at an early stage.

FW: Looking ahead, do you expect to see more of these transactions in the M&A market? What underlying deal drivers are in play?

Kühnle: We anticipate an increase in carve outs and spin offs over the next 12 to 36 months. Traditional drivers will still be focusing on the core business, protecting target profitability across the group of companies, and generating funds to invest into new technologies and growth. More recent drivers such as sustainability regulation – the EU Green Deal, environmental, social and governance (ESG) and the Taxonomy Regulation – increasingly force decision makers across industries to decarbonise existing business models and result in substantive changes to the industrial landscape. Disruption adds another layer, be it attached to artificial intelligence, digitalisation, geopolitical risk, supply chain, inflation, fears of recession, changing customer preferences or new models of working. Shareholder activism comes on top. More than ever, decision makers will need to actively manage their portfolio of group companies to cope with this mix of deal drivers. Obviously, this will fuel increased carve out and spin off activity.

Ulmer: We should expect to see more of these transactions. The transformation that many sectors are undergoing on their journey toward less energy consumption and more environmentally friendly production will lead to businesses being set free. The return of activist campaigns pushing in this direction also contributes to keeping up the number of spin offs and carve outs. Financial investors may be less proactive in approaching a group and offering to acquire a carve out, as borrowing costs have become a limiting factor in this context. However, strategic investors following long term strategic goals like insourcing production or other elements of the value chain could step up as potential acquirers of these assets. Finally, carving out a business can create value for existing shareholders even in a challenging market environment.

Glover: Notwithstanding near-term uncertainties, spin offs and carve outs will continue to be a prominent part of the dealmaking environment. Volumes will go up and down, tracking the M&A market generally. But when the markets are hot, carve outs and spin offs will proliferate. In a rapidly changing world, the pressure to respond to evolving conditions through divestitures is likely to grow more, rather than less, intense.

Greenberg: We expect to see spin offs and carve outs continue to be an important part of the M&A landscape in the year ahead, although increased market volatility and macroeconomic uncertainty in 2023 could present some headwinds for carve out sale levels. The fundamental drivers for companies with diversified businesses to pursue these transactions – unlocking value, improving liquidity and reducing debt, and enabling growth through greater focus on core businesses and strategies – remain in place. I also expect that investors and shareholder activists will continue to be supportive of companies pursuing these transactions where they make sense as a way to improve shareholder returns. At the same time, financial and strategic buyers sitting on undeployed cash resources may see attractive buying opportunities for carve out businesses as valuations come down from where they were at the height of the market.

Bonnie: If US corporate tax rates return to levels closer to where they were before the tax reform in 2018, the tax drag of carve outs and other strategic options will increase. This may lead to companies utilising spin offs more frequently as the potential comparative tax advantage associated therewith will increase. In addition, a more restrictive posture by antitrust and other regulators may reduce the number of viable strategic buyers in carve out M&A. Both carve outs and spin offs will continue to remain options that companies will consider when evaluating which potential strategic alternative can deliver the most value in each specific circumstance. ■