Cross-Border Carve-Out Transactions: Due Diligence and Purchase & Sale

This article is Part 2 of a series of 3

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In our first article in this series, we provided several initial, planning stage-level considerations for companies and counsel evaluating a cross-border carve-out M&A transaction. As deal teams advance from the planning stage toward transaction execution and implementation, additional care must be taken to successfully effectuate this type of complex transaction.

Our second installment will discuss important concepts in crossborder carve-out deal process related to transaction preparation and pre-closing matters, due diligence, and the mechanics of the purchase and sale of the target business.

Identifying and Defining the Target Business

As in any single-jurisdiction carve-out deal, it remains critical for the parties to identify and clearly define the target business (which may involve defining that which is *not* part of the target business) in a manner that is clearly expressed and consistently applied throughout all of the transaction documents. This may sound simple but often can be difficult in a cross-border context; it is the product of many conversations between the parties and a precise, thoughtful due diligence effort.

Failure to reach a clear, thematic understanding on which parts of the business should flow to the acquiror and which should remain with the seller can greatly increase transaction costs and instances of frustration, as well as the likelihood of a dispute among the parties. In an age where the rapidity of transaction execution has seemingly become paramount for sophisticated parties, acquirors and sellers in cross-border carve-out situations should equally prioritize sound process. In that context, the value of meaningful pre-deal conversations and discussions across multiple layers of each party's organization cannot be overstated in a cross-border transaction involving many jurisdictions.

Beyond conceptual agreement upon the business that is the subject of the transaction, it is also important to carefully and properly describe the business in the transaction documents. A thorough and neatly-tailored defined term for the "Business" will have important ramifications throughout the primary transaction agreement and ancillary documents.

Carve-out transaction agreements reference the transfers of assets, liabilities, contracts, real property, employees, and intellectual property that relates to the target's Business. The definition of the Business should then, from an acquiror's perspective, be appropriately broad so as to ensure that the acquiror indeed receives the entire suite of assets and equity that it expects. From a seller's point of view, an overbroad definition of the Business could imply that the seller must carve out a larger amount of its operations and deliver more of its assets than expected.

Furthermore, non-competition covenants in cross-border carve-out agreements, which are becoming increasingly common, will almost always key off of the definition of the Business for purposes of determining the universe of restricted activities during the non-competition period. Therefore, even where the definition of the Business is not directly used to specifically describe the assets and consideration to be delivered to an acquiror at closing (as may be the case when a "Transferred Assets" and "Transferred Equity" definitional construct is used, or where target assets are set forth on an appended schedule), a seller should nevertheless be attuned to the risk of an overbroad "Business" definition that has restrictive covenant implications.

It is also common for the definition of the Business to liberally flow through the target's representations and warranties, and an unwary seller could thus become indemnifiably responsible for inaccuracies relating to retained parts of its operations that are not actually being transferred, but that may nonetheless be encapsulated by an overlooked and overbroad Business definition.

Further to the point of constructing these definitions, in the context of multinational target companies with international presences, it is important for acquirors to make sure to include both the appropriate verbs that describe the operations of the Business, as well as the appropriate nouns that capture all of the products and offerings of the Business. To illustrate, consider the following two drafting examples and the potential ripple effects through a hypothetical transaction created by each:

> "Business" means the business of Seller as conducted as of the date hereof, including the sale of products.
>
> "Business" means the global consumer products business and operations of Seller as conducted as of the date hereof and as of the Closing Date, including the design, manufacture, marketing, distribution and sale of products that include household cleaning solutions, adhesive products, batteries, lighting products, light bulbs and other products that may be delivered, transported, installed or otherwise placed in the stream of commerce by Seller or any of its Subsidiaries, or any of their respective predecessors in interest. For the avoidance of doubt, the Business shall not be deemed to include any "Retained Businesses" of Seller.

Asset Separation

In many cases, a global business unit that is the target of a cross-border carve-out transaction is not neatly packaged in separate subsidiaries, unconnected offices, or independent information systems that correspond to the division of the seller that is up for sale. Assets comprising a global business unit that is to be carved out from a parent and sold are frequently highly commingled, co-owned, co-located and possibly co-encumbered.

Contracts and equipment, especially for overhead or other shared services, may be shared between the target business and another retained business. Sometimes, to-be-acquired assets are titled in the name of a seller entity that is not part of the transaction and whose stock would not otherwise be transferred to an acquiror-owned entity at closing. Physical space can be shared by employees that perform work for a retained business of the seller.

In such cases, shared assets should be migrated, by conveyance or otherwise, to a seller entity that is to be acquired, since the failure to do so would deprive the acquiror of a portion of the business for which the acquiror is paying the purchase price. There can nonetheless be substantial breakage costs and lead time involved in this decoupling of the component parts that sum to comprise the target business.

Preferred methods for detaching these assets from the seller's ownership and preparing them for acquisition and integration by the acquiror again depend on the length of the anticipated timing between signing and closing. Where asset commingling is heavy and not neatly divided among separate subsidiaries, a long interim period can provide an opportunity to complete a comprehensive series of detailed pre-closing reorganization transactions. A pre-closing reorganization is typically comprised of equity purchase transactions (to transfer ownership of seller's subsidiaries that hold assets of the target business to acquiror) or asset purchase transactions (together with any related consents or approvals) that repackage the commingled target assets into a new or existing transaction subsidiary for purchase by the acquiror.

Sellers should take care to ensure that pre-closing reorganization documentation (i) is precisely drafted to include the appropriate descriptions of transferred assets and liabilities and (ii) does not purport to transfer a universe of assets and liabilities that extends *beyond* those used or held for use in the target business. Preclosing reorganization transactions should be duly authorized by the governing bodies of the subsidiary entities involved, typically by written consent.

In certain cases, asset and liability transfer transactions can create unintended tax consequences—either by creating tax liabilities or by altering tax benefits formerly available to the entities involved. Any tax consequences of a pre-closing reorganization should be not be deemed to constitute an adverse effect on the subsidiary entities involved, and sellers would be wise to include an acknowledgment in the transaction agreement to this effect.

The completion of a pre-closing reorganization also presents several areas to monitor from the acquiror's perspective. Since the seller is responsible for preparing the delivery of the target business to the acquiror during the time which it continues to own that business, acquirors may wish to have some level visibility (*i.e.*, review rights or notice rights), if not control over (*i.e.*, consent rights), the integrity of the seller's preclosing reorganization paperwork.

Acquirors often contend for a fulsome sufficiency of assets representation and warranty in the transaction agreement, sometimes with an extended survival period, and they sometimes insist that satisfactory completion of the pre-closing reorganization to complete the asset separation process should be an express condition precedent to the closing of the larger transaction.

Unique Considerations in Cross-Border Carve-Out Diligence

Once there is thematic understanding between the parties as to which parts of the target business are to be purchased and sold, due diligence efforts with respect to the target business can be meaningfully undertaken. Performing due diligence in the context of a cross-border carve-out transaction can be as much an art as it is a science. In a perfect world, acquirors would have complete and timely access to a target business, its management, its books and records, and facilities. In a cross-border carve-out transaction, full and perfect access is rarely available for a number of reasons, and if not carefully planned, a due diligence investigation of a global business can quickly become chaotic. In our experience, we have observed that the due diligence exercise in a cross-border carve-out deal can be complicated by a number of factors:

- Scope: The amount of diligence and investigation needed to effectuate a cross-border carve-out deal is much more expansive than a garden-variety domestic merger. Since the target business exists across multiple and disparate countries, product markets, regulatory environments, financial reporting regimes and professional and interpersonal cultures, an acquiror and its deal team must accordingly examine the target business through each such lens.

- Geography: Target assets may be scattered across the world. It is impossible for an acquiror to conduct an identical due diligence process at all times and in all places where target assets are housed. Local consultants or advisors may need to be engaged for remote site visits. Management interviews may not be capable of being conducted by the same team due to language differences. Time zone differences may complicate work that references a specific time or date, such as inventory counts.

- Separability: Target assets, such as leases, contracts and licenses, may be utilized by the target business as well as a retained portion of the business that is not part of the transaction. In such instances, analyzing the relevant contract provisions for assignability will require additional effort.

  When assets are "shared", the parties must decide whether to separate the shared asset (such as terminate an existing lease for a shared office in order to establish two office locations—one that stays with the seller and another that goes with the acquiror), or to continue a shared arrangement (such as a sublease in favor of the seller of the existing leased location). When shared assets cannot be permissibly shared, however, such as a key permit or governmental authorization, the acquiror must form a plan for obtaining or replacing the shared asset so that it may operate the business after the closing in the same manner it was operated prior to the closing.

- Access: In U.S. practice, advisors often take for granted the near-immediate availability of business information. Securities exchange filings, state-level annual reports, tax assessor documents and appraisals, Uniform Commercial Code lien search results, PACER litigation filings, registrations and qualifications to do business, good standing certificates and other tools are commonly deployed (many times electronically and at low cost) to understand a target's business and operations at a high-level.

  In other jurisdictions, however, obtaining information about security interests and encumbrances, for example, can take substantially more time to obtain and sometimes require an in-person presence at a municipal office. Some countries may not have a centralized recordkeeping function or data infrastructure with respect to certain types of business information. In these types of situations, the lack of full and timely access to a suite of due diligence information can impair an acquiror's ability to assess holistic transaction risk *ex ante*.

- Regulatory: It is critical to identify jurisdiction-specific approvals from regulatory authorities at the outset of a transaction process. At a high-level, key antitrust approvals and merger control clearances, without which the acquisition does not make sense, should be identified and agreed early in the process. As will be discussed in our final article, applying a sensible closing conditionality will undoubtedly involve the study of all such approvals needed (and the likelihood of timely attainment) in order for the acquiror to operate the target business after the closing.

- Timing: Finally, in today's market, no deal process for a desirable target business is afforded an unlimited "shot clock". The pressure to negotiate and sign a definitive agreement as promptly as possible has only increased over recent years. Strategic interlopers, private equity funds, and activist factions can and do intervene in ways that may be highly disruptive to transaction execution. Therefore, acquirors must get comfortable with the reality that *full* and perfect diligence in the cross-border carve-out context remains a luxury. Determining the appropriate level of investigation that constitutes *due* diligence is paramount when seeking to timely execute on an M&A carve-out opportunity. Below, we offer a conceptual framework for thinking about the appropriate amount of due diligence for your situation.

Determining the Appropriate Level of Diligence

There is a clear, logical relationship between the amount of time that parties are afforded to negotiate and close a cross-border carve-out deal, on the one hand, and several other due diligence-related transaction variables, on the other hand. Where the deal timeline is extremely accelerated, the due diligence exercise will necessarily be truncated in a way that creates ripple effects through the acquisition agreement. With the parties unable to complete a customarily thorough inspection of the target company, a compromise that is based on what's feasible must be reached.

Timing Available for Diligence Investigation:	Potential Scope of Legal Due Diligence Work Plan:	Potential Legal Due Diligence Deliverable:	Risk Allocation and Representations and Warranties ("R&Ws"):	Extent of Target's Disclosures Against R&Ws:
Extremely Limited	Reliance solely on public information, audited financial statements and securities filings, disclosure schedules to publicly-filed debt documentation.	Limited to summary recitation of known liabilities of the type required to be disclosed by law or on an audited balance sheet.	Buyer-Preferred: Extremely limited qualifiers and expansive R&Ws. Rationale: Buyer has not been afforded meaningful opportunity to investigate the target, and must therefore allocate risk through fulsome R&Ws. Seller-Preferred: "Material Adverse Effect"; knowledge qualifiers Rationale: Seller has not been afforded meaningful opportunity to perform internal diligence, verify its representations and warranties and fully populate its disclosure schedules.	General, narrative disclosures; limited references to agreements, documents and factual circumstances.
Limited	Due diligence request list Q&A; lien searches; litigation searches; intellectual property searches; entity-level incorporation/registry searches; limited virtual data room population.	Limited to summary recitation of known liabilities and issues expressly identified by target pre-signing.	Potential Compromise: Materiality qualifiers; chronological "look-back" qualifiers.	Disclosure of material items; limited specific disclosures.

Timing Available for Diligence Investigation:	Potential Scope of Legal Due Diligence Work Plan:	Potential Legal Due Diligence Deliverable:	Risk Allocation and Representations and Warranties ("R&Ws"):	Extent of Target's Disclosures Against R&Ws:
Moderate	Management interview teleconferences; supplemental and follow-up due diligence request list Q&A; substantially full virtual data room population.	High-level "red flag" summaries of known material issues and potential unknown liabilities; short-form due diligence reports in key areas.	Potential Compromise: Tailored materiality qualifiers.	Moderate specificity.
Substantial	In-person site visits; stakeholder/customer/ supplier interviews; third-party consultant engagement; facility-specific due diligence; environmental sampling/Phase I reports; etc.; full virtual data room population.	Comprehensive, long-form due diligence reports; third-party studies; etc.	Buyer-Preferred: Extremely limited qualifiers and expansive R&Ws. Rationale: Even where buyer has had sufficient time to fully investigate the target, comprehensive contractual R&Ws are necessary to preserve buyer's access to indemnification. Seller-Preferred: Limited, tailored materiality qualifiers Rationale: Seller may require qualifications to R&Ws in order to reduce its scheduling burden and preserve deal timeline.	Fulsome disclosure; full specificity.

Key Cross-Border Diligence Areas in 2019

Understanding the complications of a proper due diligence investigation, as well as having developed an appropriate work plan for finalizing the due diligence effort, parties must then identify the universe of key diligence issues that could pose risks to closing or create leakage in value after closing. In today's market, we believe the following due diligence areas are of critical importance in cross-border carve-out deal execution.

These highlighted diligence areas are, of course, not exhaustive and should be studied in addition to all of the other customary subject matter areas that may be implicated by each individual situation.

– Tax & Structuring: Understanding the tax implications of an acquisition target with global operations and historical liabilities is a key first step in developing a reliable valuation premise. Tax-advantaged transaction structures previously thought exotic (such as reverse Morris trusts and other Section 355 spin-offs) are becoming more common.

  In addition to developing a tax-efficient transaction structure and separation methodology, there can exist either tax liabilities (transfer taxes, stamp duties, VATs, unresolved contingent tax liabilities or controversies) or assets (net operating losses, incentives, other credits) in the target business that flow through to the acquiror after closing.

– Anti-Corruption, Trade and Sanctions: As FCPA enforcement and anti-bribery scrutiny intensifies, a global business with global customers must be carefully examined, as anti-bribery liability can be inherited by an unwitting acquiror. Does the target do business with "blocked" countries? How does the target ensure reliable compliance with applicable anti-bribery frameworks? In today's political climate with heightened risk of economic sanctions and tariffs ongoing among major markets, parties should think proactively about an appropriate risk allocation should an adverse trade event occur.

– National Security & Data: President Donald Trump has enlivened the focus on regulatory approval of transactions that involve aerospace, defense, infrastructure and technology (including semiconductor technology). Being aware of the likelihood of such review (whether by Committee on Foreign Investment in the United States or otherwise), and implementing a sensible risk allocation tailored to such likelihood is a key task for parties operating in these industries.

Further, the broad reach of the E.U.'s General Data Protection Regulation has already begun to reshape the manner in which parties think about information technology integration and data migration from target to acquiror. This is especially impactful for target businesses whose core operations are large in scale and involve regular collection of customer personal information. We anticipate that regulatory approval of M&A transactions could one day include data aggregation considerations, in addition to traditional antitrust considerations such as market share and economic competition.

– Pension, Labor and Employment Matters: Where deal valuation depends on achievement of synergies, acquirors should be acutely aware of the many potential regulatory impediments to synergy achievement, such as the rights and influence of works councils, labor unions pension trustees and other employee factions. Funding of "underwater" pension liabilities may be required in order to absorb a workforce in European jurisdictions.

  These factions often exhibit considerable elements of bureaucracy, and it can be difficult for parties to achieve these kinds of approvals on an expedited basis. Delivering advance notices and developing a proactive communication strategy can be an effective way to overcome such roadblocks.

Mechanics of Purchase and Sale & Acquisition

At the closing, the target business is delivered to an acquiror by two mechanisms that are described in detail in a cross-border carve-out acquisition agreement: (i) the purchase and sale of target business assets (in an asset purchase fashion) and (ii) the purchase and sale of equity interests (in a stock or equity purchase fashion) of subsidiary entities of the seller where the operations of such entities relate to the target business. The usual considerations follow.

For the asset transfer, assignment and assumption documentation, intellectual property transfer documents, and a bill of sale are the primary ancillary documents involved. For the stock transfer, stock power agreements or transfer of physical stock certificates of the purchased subsidiaries will be involved.

The asset purchase and sale mechanism will bring the usual suite of considerations for counsel to document with respect to third parties. Where third-party consents are required, an analysis should be undertaken to find out which consents are critical, versus merely desirable or preferred. Should attainment of critical consents be a condition to closing?

Target assets that, for whatever reason, cannot be transferred at closing are often referred to as "non-assignable assets". In the case of non-assignable assets, the customary provision regarding further assurances and efforts on the part of the seller to make future conveyances can be helpful, but several intricate variations on the seller's obligation to effectuate future conveyances are creeping into market practice.

For example, are "efforts"-based standards relevant in a post-*Akorn v. Fresenius* world? Should there be a chronological or monetary threshold put in place that would dictate when sellers are not obligated to use such efforts? If sellers cannot ultimately deliver clean title to assets that the acquiror believes it has purchased under the language of the transaction agreement, how do the parties ensure that the acquiror receives the benefit of those assets after the closing?

Where the revenue attributable to non-assignable assets (such as leases for manufacturing facilities or customer contracts) could be material, do sophisticated parties really want to be relegated to reliance on broadly-drafted concepts in a terminable transition services agreement or opaque legalese concepts like "constructive trust"?

Further, part of the post-closing complexity for acquirors is arranging the assets and equity it just bought into its existing corporate body. Purchased assets will need a purchasing entity to take ownership of them, and the transfer process is more straight-forward when an acquiror's asset-purchasing entity is domiciled in the same jurisdiction as the seller's asset-selling entity.

If the acquiror does not have local operating subsidiaries that are primed to absorb these transferred assets and assume any transferred liabilities, the acquiror should use the interim period to establish its own local wholly owned subsidiaries that are prepared to receive those transferred assets at the ultimate closing. While this approach is more effective when time permits, it is also more costly, and it will require a separate workstream and a miniature checklist to track.

Generally, an acquiror will want to ensure that, among other things, all of the assets it is expecting to receive are subject to transfer and continue as part of the target business post-closing. Acquirors should also ensure a mechanism exists for all encumbrances to be removed (such as any under a seller parent's blanket credit agreement). Finally, the acquiror should ensure that all such equity purchases and asset transfer transactions should be effectuated and documented in accordance with local laws.

Any pre-closing reorganization documentation should be kept simple and thematically consistent with the master acquisition agreement. Typically, where permissible under local law, this local transfer documentation utilizes heavy incorporation by reference to the master purchase agreement and is not subject to separate substantive negotiation or conflicting substantive terms. Therefore, it should not be surprising or discomforting for local transfer documentation to assume a substantially abbreviated form.

Although the preparation of this documentation is not conceptually difficult, it can be very time-consuming to implement and finalize. By way of example, we caution that we have seen local asset transfers require voluminous ancillary documentation, requiring use of forms unavailable in English, multiple witness signatures and apostilled oaths, and even mandatory in-person appearances at foreign offices that maintain irregular hours of operation or poor recordkeeping.

Further, some jurisdictions may require that the purchase price (or a portion thereof), denominated in a local currency and sometimes non-nominal in amount, must actually be paid between the parties in exchange for the transferred assets. Examples and considerations in deal execution such as these illustrate the attention to detail required and the value-add of experienced transaction advisors in the context of high-stakes transformative global M&A events.

Shareholder Activism: Nine Lessons Learned

By Greg Taxin, Adrian Kingshott, Damien Park and Gavin Solotar, Managing Directors of Spotlight Advisors

Our boutique advisory firm—one of the only independent firms that advises companies in activist situations—had the opportunity to work on 19 live activist situations during 2018, involving 23 different activist investors. Our role in these engagements was typically to help our client analyze the activist's claims, assess the chances of winning, act in response, engage and negotiate with the activist and communicate with the shareholder base. Our backgrounds as investment bankers, lawyers, proxy advisors, institutional investors and activists ourselves help to shape the advice that we provide.

The companies involved in our assignments this year ranged in size from $100 million in market cap to $21 billion. Seven of our engagements went the full distance, to a final proxy vote. We worked with 13 different law firms, six proxy solicitors and five communications firms during the year. Three of our situations involved M&A deals facing opposition.

Here is some of what we learned from our 2018 assignments:

1. We still find that many companies have not adequately reviewed their **Bylaws and governance provisions** in peacetime with an eye on shareholder activism. In the last several months, we worked with counsel in reviewing the Bylaws of three separate clients—unfortunately, after an activist emerged in each instance—to consider patchwork fixes to ensure the company