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Corporate Carve-Outs

Throwing the baby out with the bathwater or being left holding the baby and how to avoid both!

Corporate carve-outs are becoming increasingly popular for private equity funds in a market where finding a good asset at a reasonable price is proving more difficult. A buyer who is willing to take on a corporate carve-out opens the door to a plethora of new potential assets, as it is able to identify and bid for non-core assets of large nationals and multi-nationals who are looking to concentrate on core businesses or looking to raise capital with any such divestment.

However corporate carve-outs come with a health warning; they can be very difficult transactions to get right. If not done properly a buyer can be left without the rights and/or assets that it needs to operate its new business or can be left with responsibility for liabilities and obligations that relate to a business which the buyer does not own.

In this note we explore some of the principal matters with which a buyer should be concerned if it is considering a corporate carve-out.

What is a corporate carve-out?

A corporate carve-out is the acquisition/disposal of a part only of an existing business and can be a sale of assets, shares or both. For a strategic buyer the acquisition may very well be made to compliment an existing business, but for a financial buyer, like a private equity house, such an acquisition may be of a stand-alone business and, as such, it is key that all of the assets required to run the business are either transferred, or remain accessible, to the transferred business post completion, for example by way of a transitional services arrangement.

Determining the assets to be acquired

As alluded to already, what is often key to a corporate carve-out is understanding the business being acquired, how it currently operates within the existing wider business and how it is to function once it divorced from the Group and acquired by the new buyer. Depending on the nature of the business, it will be necessary to consider the transfer of plant and machinery, stock, intellectual property, know-how and confidential information, licenses, goodwill, information technology, underlying contracts and debtors and creditors.

In many cases it will not be clear whether the assets belong to the business being retained, the business being sold or both, and it may be necessary to "split" or "share" contracts, to licence intellectual property between businesses or to share premises and employees.

The Transitional Services Agreement

It may be necessary for the buyer and the seller to enter into a Transitional Services Agreement whereby one or both businesses agree to provide services to the other post completion for a set period of time, allowing the benefiting business continuity of service whilst it puts in place the necessary standalone infrastructure for itself. Again, it will be necessary for the buyer to have a clear understanding of the services that the business requires post completion and how long it will realistically take to replace them. In the interim the parties should be clear about the services that are to be provided and the level of service expected.

Employment factors to consider

Unlike a share purchase when all employees of the target group will generally transfer with the target group itself, thought needs to be given to who the employees of the business are in a corporate carve-out. In the EU the Transfer of Undertakings (Protection of Employment) Regulations apply and may automatically transfer employees with a business to the buyer, irrespective of what the parties agree. Careful analysis will need to be undertaken to ascertain which employees would, or should, transfer with the business and also to agree between the parties any employees that are specifically required or excluded. Robust procedures for dealing with employees as regards their transfer will need to be agreed and, depending on the allocation of risk between the seller and the buyer, indemnities given in respect of claims by employees relating to their transfer or non-transfer.

Will restrictive covenants come into play?

It will be important to ensure that post completion the business transferred is not detrimentally affected by competition with the business from which it was carved out. By it's very nature a corporate carve-out is likely to result in some overlap between the retained and the transferred businesses and so significant thought must be given to making sure that the retained and transferred businesses can co-exist in an appropriate and acceptable way for both parties. Competition advice will also need to be sought so that the reciprocal protections do not fall foul of the prohibitions on cartels and similar arrangements.

Tax implications of the sale

The tax implications of a corporate carve out depend on whether it is structured as a sale of assets or a sale of shares. If it is structured as an asset sale, an important consideration for the parties will be whether it is a transfer of a business as a going concern ("TOGC") for VAT purposes. A TOGC is outside the scope of VAT. It is worth noting that the TOGC rules are not an optional relief; if the conditions are met they must be applied and as such, the requirements should be considered at the early stages of the transaction. Several conditions must be satisfied for a TOGC, one of which - particularly relevant to corporate carve outs - is that there must be a transfer of a business or part of a business as a going concern and, if part of the business is being sold, this part must be "capable of separate operation". The assets in question do not need to have actually been used by the seller as a separate operation, this merely needs to be possible.

If the parties structure the carve out as a share sale, both seller and buyer will want to understand whether any tax charges may arise on moving unwanted assets out of the target pre-sale, or whether any degrouping type charges could arise on the sale, following a transfer of assets into the share in target pre-sale. Buyers will also want to ensure that they have tax warranties and/or a tax indemnity to cover any historic tax liabilities they inherit when they acquire the shares in target.

Conclusion

As many UK groups, and non-UK groups with UK assets, continue to grapple with the likely impact of Brexit, and as those same people look to take on the brave new world which follows negotiations, it seems likely that business rationalisations and sales of non-core assets will become more prevalent. As practitioners and active participants in this area we hope that this will drive the number of corporate carve outs in the UK through 2017 and beyond.

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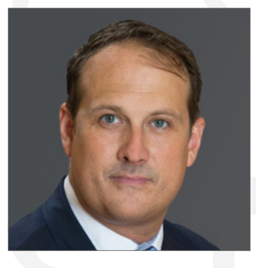

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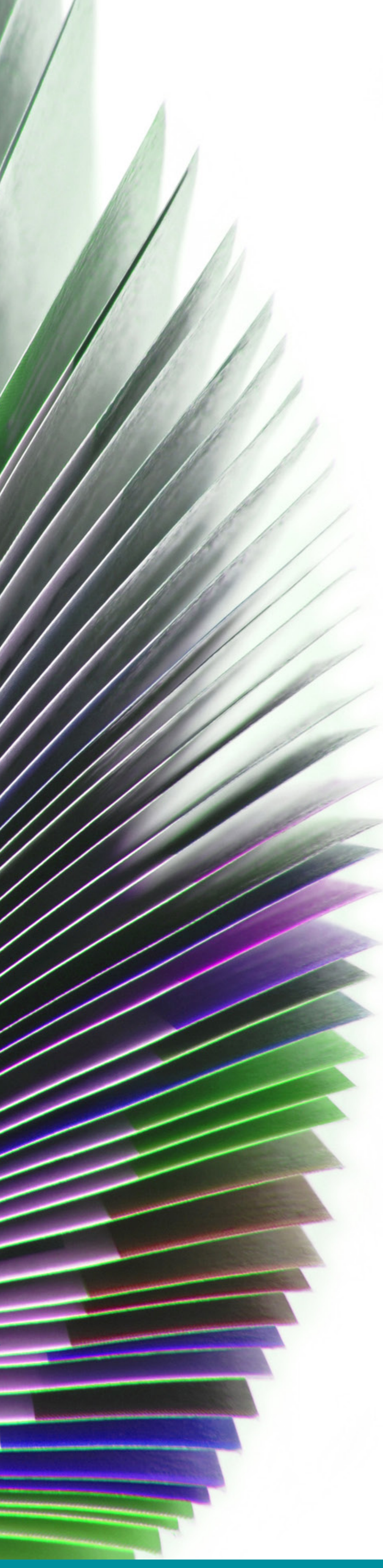

Offshore Structures

For many years the benefits of setting up offshore structures were clearly defined and throughout the last 20 years the offshore funds and SPV administration industries have thrived.

More recently however, the offshore financial centres have faced a number of headwinds and in fact it is not uncommon for onshore based managers to contemplate whether it is now worth the time and effort to go offshore at all.

Why move?

Initially, the domiciliation of funds in offshore jurisdictions such as Cayman became popular due to the relatively light regulatory regime and the beneficial tax rates available to investors. This included the ability to transfer units without paying stamp duty land tax and for onshore managers to charge fund management fees without the application of VAT. For these reasons there was a significant push to domicile funds offshore irrespective of the underlying assets, investment strategy or total funds being raised.

It quickly came to light that not all offshore jurisdictions were fully equipped to service these funds from a technical understanding and operational perspective. Further, some jurisdictions did not have the necessary infrastructure to provide the fund domiciliation, administration and accounting services required by these funds.

In some instances, especially in the case of smaller funds, the costs of running offshore structures outweighed the tax benefits available. This was particularly visible where subsequent deals required new entities to be set up in an established structure. Furthermore, if deals spanned several jurisdictions thought had to be given to tax harmonisation and whether the tax benefits could be rolled up ultimately to the Fund rather than being blocked lower down the structure.

Current state of the industry

As one would expect, with the industry maturing, there has been increased scrutiny from the regulators. Offshore presence is no longer a rubber stamping exercise but requires an understanding of the ultimate beneficial owners, involvement in day to day running of the fund and knowledge of the underlying asset classes as well as adherence to various anti-money laundering, compliance and regulatory filing requirements.

Involvement from regulators

Certain jurisdictions have been more open to fund structures than others. For example, they provide different platforms involving different levels of regulatory scrutiny to establish smaller funds vs. larger funds.

Certain regulators have been more intrusive in their involvement in the funds industry relative to others. Such measures have included the exertion of pressure on Fund Managers and service providers to demonstrate "actual substance" in the offshore jurisdiction. This requires a detailed understanding of where the effective central management and control of the structure lies and whether the Fund Manager is actually involved in the day-to-day running of the fund. This requires a distinction to be made between how much investment advice is being provided onshore vs. offshore. Base Erosion and Profit Shifting ("BEPS") planning has accelerated this trend.

This in turn requires a determination of the split of services underpinning the fund structure and ultimately if it will be subject to onshore taxation rules and classed as an offshore shell structure. Transfer pricing soon becomes important, especially to determine services being provided on and offshore.

In addition, not all investors are comfortable with all off shore jurisdictions, although some investors acknowledge that the presence of a regulator gives additional comfort to certain investors (such as institutional investors) that the Fund Mangers are being held accountable and responsible to regular scrutiny.

Current Trends

So today sees many fund managers questioning whether going offshore is really right for them. Whilst those with existing offshore infrastructure are likely to continue using that model to maintain the status quo, new promoters may consider the benefits to be marginal and may be just as likely opt for simplifying their structure by keeping it onshore.

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