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# SURVIVING INTERCOMPANY ARRANGEMENTS IN CARVE-OUT TRANSACTIONS

BY JOSEPH CASTELLUCCIO

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**A COMPANY SEEKING** to sell a part of its business via a carve-out transaction must contend with a complicated series of separation issues in order for the business to be sold—the “carve-out business”—to stand on its own. The carve-out business is likely to be intertwined with, and dependent on, its parent and sister companies and most of the carve-out business’s intercompany arrangements with these affiliates will need to be terminated prior to the closing of the carve-out transaction.

However, it may be necessary or desirable to keep some of the intercompany arrangements in place following the closing. For example, after the transaction the carve-out business may remain an important customer of, or supplier to, its former parent/sister companies. In these situations, both sides will need to tailor and adapt these arrangements to the post-closing relationship among the parties—that is, the status of the newly separate carve-out business as a third-party to its former parent/sister companies.

Below is a brief description of some of the key issues in intercompany agreements that require attention in a carve-out transaction. The monetary and other costs required to address these issues should be factored into the overall cost-benefit analysis of the transaction.

## 1. Interdependent Systems

Information technology (IT) systems are typically leveraged across a parent organization and among its various businesses. Even businesses operated as subsidiaries by a common parent will likely have interdependent IT systems that cannot easily be separated. In fact, enterprise systems are frequently the most intertwined and difficult to separate components in a carve-out transaction.

### Divide, Transfer or Replace?

Initially, a seller company will need to determine which systems can be divided and/or transferred in the transaction. These components include software applications, data, physical assets (including servers) and employees responsible for maintaining and operating these systems and assets. Likewise, a buyer company will need to determine whether any of its existing IT systems, assets and employees can be used to support the carve-out business during the transition period and/or afterward.

For system components of the seller that cannot or will not transfer as part of the carve-out, the parties should determine which services the seller will continue to provide to the divested business during the transition period using the same leveraged systems that the seller

was previously using to support the business prior to its carve-out. The seller typically must create logical separations in its systems to segregate data and limit access by the carve-out business's personnel to only the carve-out business's data. For example, if servers that house information and applications for several different businesses of the seller (including the carve-out business) are not transferred with the carve-out business, significant work may be needed by the buyer and carve-out business to replicate server infrastructure for use following the transition period. In addition, the selling parent company may have master license agreements for critical third-party software that cover all of its businesses and subsidiaries. These master agreements will not cover the carve-out business following the closing and will need to be replaced.

### Shared Systems and Support

If the carve-out business continues to rely on the leveraged systems of its former parent/sister companies during the transition period, the parties will need to determine the extent to which technical and operational support will continue to be provided by each side. For example, the party responsible for maintaining the IT may be willing to provide support for the existing technology, but not rights to use and support for improvements or upgrades to the systems. In addition, the seller will be reluctant to enter into long-term support arrangements because it could be distracting from its core businesses (especially if each party is not primarily in the business of developing IT and providing related support).

### Compliance with Competition and Data Security Laws

To the extent there are any shared systems after the closing of the carve-out transaction, the parties will need appropriate safeguards for access to, and handling of, employee, customer, and other sensitive data and information. This is particularly important when employees have access to information from each side, whether in the course of providing transition services or other ongoing support. These safeguards include separating databases, limiting access rights to a small group of critical employees and only data that relates to the carve-out business, confidentiality agreements

and relevant training for employees. These safeguards are necessary to ensure compliance with antitrust and competition regulations and data privacy and security regimes. In both cases, regulations and requirements may differ across jurisdictions and cross-border sharing of information—even among affiliates—can easily run afoul of relevant laws.

### 2. Supply Agreements

If a carve-out business is dependent on its parent/ sister companies for raw materials to manufacture its products, the carve-out business must ensure that its supply of these materials is not interrupted by the closing of the transaction. If the carve-out business intends to continue to obtain them from its parent/sister companies—or if the carve-out business cannot secure alternate suppliers prior to closing—it must enter into arms-length supply agreements with its parent/sister companies prior to closing. Especially if the carve-out business has not historically been operated as a separate subsidiary, there may be no existing intercompany agreements with its parent/sister companies for these materials or, if there are, they are likely not on arms length terms.

Two important terms for carve-out businesses in these supply agreements are the permitted uses of the raw materials and the initial term of the agreement. The carve-out business must have the right to use any raw materials it receives under these supply agreements to qualify new suppliers of these raw materials and the initial term of raw material supply agreements must be long enough to allow the carve-out to find alternative suppliers before it is forced to renegotiate with its former parent/sister companies. If a critical supply agreement terminates before a carve-out business is able to find an alternate supplier, the carve-out business may be forced to accept off-market or burdensome terms from its former parent/sister companies in order to continue to operate its business.

### 3. Shared Intellectual Property

If the carve-out business relies on IP owned by its parent and/or sister companies to operate its business, the carve-out business will need to secure the rights to continue to use, develop and commercialize this IP after the closing. In the same way as raw material supplies may not be subject to existing formal intercompany agreements, the



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carve-out business may rely on informal or undocumented arrangements for the use of parent/sister company IP that will no longer be valid following the closing of the carve-out transaction, particularly with respect to unregistered copyrights and knowhow.

Even if there are formal arrangements in place for the carve-out business to use IP that it does not own, the carve-out business should secure a full complement of rights needed to operate and grow its business after the closing. These rights included the rights to improve the IP (and the right to use these improvements) and the right to commercialize the IP and related improvements. In certain circumstances, the carve-out business may also seek the right to prosecute and defend the IP—for example, if the parent company fails to do so itself. The carve-out business must also be comfortable with any rights the parent/sister companies retain to terminate its IP rights.

In addition, it is important for a carve-out business to secure IP rights needed to execute on all its current and future plans and forecasts—even aspirational ones. This is especially true for any IP that is critical to new products or businesses, which in some cases serve as the basis for the business thesis of the transaction.

#### **4. Creditworthiness of Counterparties**

When contractual counterparties are affiliates—especially as part of a large, creditworthy parent group—credit risks may be less important than they would be with unaffiliated counterparties. Following a carve-out transaction, however, each side will need to assess the creditworthiness of the other side as a separate,

unaffiliated counterparty in any ongoing business relationships. These risks must also be assessed by any applicable regulators and ratings agencies.

In order to address these types of risks, one or both sides may seek additional credit support, guarantees or other assurances in connection with ongoing performance and payment obligations. For example, a newly independent carve-out business may need to provide additional collateral or affiliate guarantees to maintain its credit rating or to obtain the necessary regulatory approvals for the transaction. However, even if certain types of support are theoretically available, they should be thoroughly vetted by all internal stakeholders to ensure that they comply with relevant company policies.

#### **5. Shared Environmental Permits**

To the extent that environmental permits applicable to a carve-out business cannot be transferred as part of the transaction, new permits may be needed for the carve-out business to operate without interruption. Since new environmental permits can take months or years to be approved by relevant agencies and regulators, a carve-out business may need to temporarily operate under its former parent's permits until it can obtain its own permits so that the carve-out transaction to close in a reasonable period of time. These arrangements between buyer and seller should contain agreements by both sides to comply with the terms of the permits and allocate responsibility for breaches of the permits.

In addition, any shared permit arrangement must be negotiated with and approved by the relevant regulators, which can take a significant amount of time and may involve simultaneous negotiations with multiple agencies. Therefore, the arrangement should obligate the buyer and seller to cooperate as needed for the carve-out business to obtain the new permits and to address any concerns raised by the relevant regulators. As a result, any potential shared permit situations should be identified as early as possible in the carve-out transaction. ■

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