# Carve-out protections

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## 1. Introduction

This chapter focuses on some of the key contractual protections that a buyer or a seller would look to obtain in a carve-out transaction. While some of the contractual protections would be similar to any other mergers and acquisitions (M&A) transaction, it is common to see additional provisions in a carve-out transaction to deal with issues relating to the separation of the target from the seller's retained group.[1] The specific terms of warranty, indemnity and other protections will also vary depending on the particular business, the structure and the circumstances of the transaction.

A carve-out transaction could take the form of an asset sale, a share sale or a combination of both. Even if the transaction between the seller and the third-party buyer is structured as a share sale, a carve-out transaction will often involve a pre-sale reorganisation within the seller's group and this may involve intra-group asset sales to the target group. This chapter is not intended to comprehensively address all the complexities and nuances that could arise in any carve-out transaction, but seeks to highlight some of the main contractual protections to address some of the risks commonly involved in a carve-out transaction.

## 2. Apportionment of assets

### 2.1 Wrong pockets

One of the key issues in a carve-out transaction is identifying the assets and liabilities which are to form part of the transaction and accordingly providing in the sale and purchase agreement protections for:

1 See also the "Separations – the in-house perspective" chapter.



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- the seller, to ensure it has sold or transferred all the assets and liabilities it is expecting to dispose of and not any other assets that it had wanted to retain; and
- the buyer, to ensure it receives all the assets it is expecting to acquire and related liabilities it is expecting to assume and not any other assets or liabilities.

To address the risk that certain assets have been transferred to the buyer or retained by the seller when it was not intended by either party, a 'wrong pockets' clause is often included in the sale and purchase agreement for a carve-out transaction to reallocate those assets after completion.

A wrong pockets clause will typically provide that if, following completion:

- an asset which should properly be part of the seller's group ends up with the target's or buyer's group then the relevant member of the target's or buyer's group will transfer that asset to the seller's group; or
- an asset which should properly be part of the target's or buyer's group has been left in the seller's group, then the relevant member of the seller's group will transfer that asset to the target's or buyer's group.

One of the key points to be negotiated between the parties will be what assets count as having ended up in the 'wrong' place – should only the assets that were exclusively used in the business of the other group before completion be transferred back or just the assets that were predominantly or primarily used? If, for example, an asset was not used exclusively in the seller's group but is also used in the target group but the wrong pockets clause requires that asset to be transferred back to the seller group, then consideration will also need to be given to whether the seller should also be required to grant a transitional service back to the target group for the use of that asset or whether the risk should be borne entirely by the buyer. The other key consideration is at what price any asset transfers should take place under the wrong pockets clause. To avoid further payments between the parties, it is typical to see that a transfer of assets under the wrong pockets clause is at book value or market value with the amount payable being treated as included in or as an adjustment to the purchase price.



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## 2.2 Sufficiency of assets

Where the target business is being carved out from the seller's group, the buyer will want to ensure that the target business will be able to continue to operate once it has left the seller's group.

In an M&A transaction involving a target that is standalone, a seller will normally resist giving any warranty that the target (in the case of a share sale) or the assets included in the transaction (in the case of an asset sale), together with any transitional services, as applicable, comprise all the assets necessary for the continuation of the target business. However, in a carve-out transaction, the buyer may have a stronger argument for some form of warranty protection relating to the sufficiency of assets in the target group as the seller's group is best placed to take on the risk as to whether it has packaged all the relevant assets for sale that comprise the business.

## 2.3 Stranded assets

If the carve-out transaction is being structured as an asset sale or certain assets need to be transferred to the target company pre-sale, consents may need to be required before such asset can be transferred. For example, landlord consent will most likely be required to transfer any leasehold property or there may be restrictions on assignments under a contract. Further, if any contracts need to be novated, the counterparty to the contract will also need to approve and be party to the novation agreement.

For critical assets or contracts, the parties may agree in the sale and purchase agreement that obtaining any required consents for the transfer of such assets or contracts needs to be a condition to completion of the entire transaction.[2] However, if there are any assets or contracts that are critical to the target business, it would be preferable for all parties to try to deal with those before signing, if possible (otherwise the deal could be held hostage by a key supplier or customer). Alternatively, the parties could consider structuring the transaction in a different way to avoid triggering the relevant consent requirement.

For non-critical assets or contracts, some of the contractual mechanisms that are commonly used to address the risk of required consents not being obtained for the transfer of such assets or contracts to the buyer include:

2 See further the "Conditionality" chapter.



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- an obligation on the seller to use all reasonable endeavours to obtain the consent;
- if consent is still not obtained by a long stop date, for the seller to hold the asset or contract on trust (provided that there is no restriction on this in the relevant contract);
- a back-to-back arrangement with the seller involving the seller sub-contracting its obligations under the relevant contract to the buyer or the buyer acting as the seller's agent, in either case in consideration for the seller passing through any benefits received under the underlying contract (provided that there is no restriction on sub-contracting or agency in the relevant underlying contract);
- a price adjustment mechanism; or
- termination of the contract with an indemnity from the seller for any losses incurred by the buyer relating to such termination.

### 2.4 Group insurance

It is common for business insurance (eg, director's and officer's liability insurance, business interruption insurance, property insurance, etc) to be obtained on a group wide basis. In a carve-out transaction, the seller's group would not typically arrange for the target to obtain separate insurance prior to completion. Instead, it would be left to the buyer to arrange its own insurance cover for the target after completion.

Where the target has an outstanding insurance claim under the seller's group policy, the buyer may wish for such claim to continue after completion. The buyer might require that the seller procure that the relevant policy is maintained and either for the seller to continue to pursue such claims and pass on any insurance proceeds, or if possible, for the target to be able to continue to pursue the claim directly with the insurer.

The buyer may also want protection for the risk of an insured event occurring, which affects the target before completion and is covered under the seller's group policy, but where no claim had yet been made under such policy. There could be a number of reasons that a claim had not yet been made, such as that the relevant claim documents are still being prepared or it is not yet known that a claim could be made. This could be addressed by the buyer or the target obtaining its own insurance relating to past events. This is the common approach for some types of insurance, such as director's



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and officer's liability insurance where run-off cover is generally widely available in the market.

Alternatively, the buyer could seek a provision in the sale and purchase agreement for the seller to maintain its insurance policies and for the target to be able to claim (or for the seller to claim on its behalf) in relation to an insured event that occurred before completion. Even if the seller's group insurance policies permit this, such a provision may be resisted by the seller as it could be administratively burdensome to deal with any target claims, the seller may wish to control the relationship with its insurers or the seller is concerned that the target claim may affect the level of the seller's group insurance premiums in the future. These concerns of the seller can also be dealt with in the sale and purchase agreement, for example, by providing that the seller retains conduct of any claim that the target wishes to make, for the buyer to pay the seller's costs relating to making the claim and for the buyer to reimburse or share the costs of any increase in premiums that result from the target making a claim.

## 3. Apportionment of liabilities

In an asset sale, only those assets and liabilities that are specified to be transferred in the sale and purchase agreement will be transferred to the buyer. Subject to certain limited exceptions,[3] the buyer will have the flexibility to exclude unwanted liabilities from the transaction and leave those behind with the seller. This is one of the major advantages of an asset sale for a buyer (and a disadvantage for the seller). If the buyer can negotiate that certain liabilities are simply not acquired, then it will not need to seek warranty protection relating to the nature or amount of those excluded liabilities. However, typically a buyer will seek an indemnity from the seller with respect to all such excluded liabilities. For any liabilities that are assumed by the buyer, the seller will seek an indemnity from the buyer in respect of any costs or liabilities incurred by the seller after completion relating to the liabilities that the buyer agreed to assume.

In contrast, in a share sale, the buyer will acquire the target company with all its liabilities and obligations. The buyer could seek an indemnity from the seller for liabilities that it did not want as part of the transaction (which could cover both a specific list of

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3 See, eg, the "Employment and pensions aspects of carve-out transactions" chapter.



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liabilities as well as a more general indemnification for liabilities that relate to the retained business of the seller). However, this is a somewhat weaker protection than simply not acquiring the liabilities in the first place and will be of limited value if the seller does not have the financial resources to pay any claim. This risk could be mitigated by negotiating a purchase price reduction, an escrow or retention amount or by obtaining insurance (see section 4 below).

## 4. Warranty and indemnity insurance

Insurance products to cover the risk of a breach of a warranty under the sale and purchase agreement or indemnity under the tax covenant are increasingly available in the market. The most common is warranty and indemnity (W&I) insurance which covers losses arising out of a warranty breach or an indemnity claim under the tax covenant. Insurance could be taken out by the buyer or by the seller and typically would cover only unknown or unforeseen matters. Other common exclusions from coverage include matters like fraud, criminal fines and underfunded pension schemes.

W&I insurance is a useful tool to bridge the gap between the buyer's wish to receive proper deal protection and a seller's aim to achieve a clean exit. It may also make a bid more attractive in an auction scenario if the buyer is willing to use insurance to cover risks rather than obtain recourse from the seller. In some circumstances, the seller's agreed liability cap in a sale and purchase agreement could be as low as £1 so the warranties and indemnities are given by the seller simply for the purposes of facilitating insurance coverage for any breach. A W&I policy is also useful for a buyer if the buyer is concerned about the seller's financial position or the ability to recover damages from the seller in respect of any breaches.

It is becoming more common to employ W&I insurance in transactions, although as at the date of writing, it is still only used in a minority of deals. According to the 2018 Latham & Watkins European Private M&A Market Study (the L&W Study), which surveyed over 210 deals over a two-year period, 32% of the transactions employed some form of W&I insurance, up from 13% and 22% in the 2016 and 2017 editions of the L&W Study.

Other types of insurance products that could be employed to help parties manage their risk include:

- tax or contingent liability insurance to cover known issues in a deal (eg, a known tax issue) where the quantum of the loss is potentially high but the likelihood of the loss arising is low;



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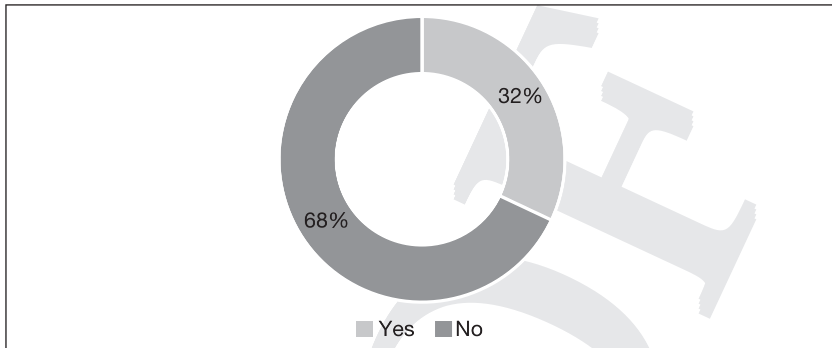
**Figure 1. Use of warranty and indemnity insurance**[4]




- specific insurance to cover existing litigation of the target – eg, if the loss is higher than an estimated amount; and
- specialist environmental risk cover (this could form part of a W&I policy or be a separate stand-alone policy, eg, to back up an environmental indemnity).

## 5. Conclusion

Compared to a typical M&A transaction for a stand-alone target group, a carve-out transaction will involve a number of additional considerations for both the buyer and the seller, which may be addressed through contractual protections in the transaction documents. In particular, there are a number of additional risks that a buyer will not expect to be burdened with, such as those related to the separation of the carve-out business or the moderation of the retained business by the seller. The apportionment of these risks will largely depend on the negotiating strengths of the parties, but given that these risks will not be covered by W&I insurance, the type of seller should also be factored in. While the types of protections and negotiation positions of the parties will clearly be deal-specific, both a buyer and the seller can be better prepared by considering in advance its approach to the common contractual positions taken in a carve-out transaction, as described in this chapter.

4 2018 Latham & Watkins European Private M&A Market Study.



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