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Divestitures: Typical Negotiated Issues

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Spin-off vs. Divestiture

- A spin-off involves distribution of a business to stockholders (sometimes in connection with an IPO of the spun out business unit ("Spinco")); a divestiture involves a sale to a third party buyer
- The key to a spin-off is to ensure that the stock distribution is not taxable, and that requires compliance with IRS rules, which drives the structure.
- IRC §355 requires parent own 80% of Spinco, parent distribute a controlling interest in Spinco, Spinco have been engaged in an active business for 5 years, business continuity and a spin-off that has a business purpose and is not an earnings pass through device
 - So, e.g., pre-spin IPO must be for less than 20%.

Spin-off vs. Divestiture

- A spin-off is more of an internal negotiation:
 - How much cash/liabilities Spinco should receive/assume
 - IP split; fields of use; mutual non-competes
- Constraints
 - Must ensure successful Spinco IPO, if IPO is contemplated
 - Must ensure that Spinco has right amount of net operating capital, so spin is tax free
- Spinco must decide on its own branding/identity and whether to implement cultural change or keep what works
- Issues in both Spin-Offs and Divestitures
 - what assets to spin/keep/license/jointly own (especially patents)
 - issues regarding splitting up contracts that apply to both businesses
 - loss of volume discounts and other parent-level negotiated benefits

Divestitures

Recent Examples

- Verisign/Symantec (authentication services)
- P&G/Diamond (Pringles)
- eBay/Silver Lake (Skype)
- HP/Polycom (video collaboration business)

Many Tough Divestiture Issues

- Many tough issues that matter, with no “right” answer:
- Scope of liabilities assumed (HR/IP-see below)
 - Treated as a sale of a business or a sale of assets?
 - Who has more negotiating leverage? Maximize via market check?
 - What is each party’s tolerance for “deal risk”?
- Scope of and process of identifying tangible assets transferred
- Splitting “shared contracts”? (parent volume discounts?)
- IP split-see below
- Transition support (term/economics/liability cap)-see below
- Strategic partnering (exclusivity/non-competes/minimum commitments)-see below
- HR –see below

Negotiating Environment

- Difficult to untangle a highly interconnected, global businesses/assets/people/network without business interruption
- Above can be made even more difficult by the need for a fast closing
- Risk aversion and “attachment” to particular rights or assets can derail any deal
- Mutual trust, “leap of faith”, good communications and executive sponsorship are key to resolving roadblocks
- Shared goal of continued joint customer satisfaction, if applicable, helps

IP Scope

- Where assignment of IP is impractical; license is only solution
- Many complex issues with such IP licenses including:
- Scope of any exclusive vs. non-exclusive rights:
 - exclusions from exclusivity: patent cross-licenses, litigation settlements, existing (immaterial?) uses within the divesting company
 - Field of use restrictions/non-competes
 - Addressing current vs. anticipated uses
 - Assignability/sublicensing rights (e.g., where Buyer sells Spinco?)
- Understand limitations imposed by Seller's longstanding IP policies (e.g., restrictions on assigning patents)
- Any natural allocation of who should bear various IP risks?
 - e.g., mature business, so no "need" for IP indemnity?

Scope of Assets Transferred

- Limit representations only to “Transferred Assets” or to area covered by the exclusive IP license, or apply to entire historical Business?
- Impossible to give detailed, accurate representations, in a short negotiating period, when businesses are long standing and intermixed with Seller’s other business units on many levels?
- “Asset sufficiency” representations:
 - hard for Seller
 - important to Buyer
- Knowledge and materiality qualifiers and indemnity caps, deductibles and/or baskets are critical to fair risk allocation
- Post-closing true up if assets missing?
- Customized dispute resolution process?

Closing Conditions

- Deal certainty critical because:
 - Separating one group of employees from another; RIFs?
 - Shared customer anxiety about continued product support and migration plans
- Seller will insist on eliminating closing conditions that may result in a broken deal, such as:
 - Obtaining (vs. exercising reasonable efforts to obtain) third party consents to assign contracts (or “split” shared contracts)
 - Delivering some minimum level of Target employees
 - Giving Buyer a right to terminate based on an MAE
 - Maximum level of customer “attrition”
- Such concessions require Buyer “leap of faith”/trust

HR/Employment

- ARD Process/Timing Impact
- Retention/Motivation/Alignment of Interests
- Decisiveness Reduces Employee Stress
- Effect of Employees' Changing Allegiances on Negotiations and Integration
- Who bears RIF/retention/bonus costs?
- Other international aspects

Transition Agreement

- IT, facilities, operations, parts sourcing, inventory management, international invoicing and temporary access to employees
- Buyer may need temporary IP sublicense while it negotiates its own license or does R&D work around
- Typically, transition services provided on a cost-plus basis, so Seller wants this obligation to terminate ASAP, whereas Buyer wants the term to be sufficient to ensure a smooth transition
- Seller will want Buyer to agree to exercise commercially reasonable efforts to effect the transition ASAP, so losses/risks minimized
- Seller will want to disclaim any service warranties and limit its liability to a modest figure overall and by service type; Buyer wants Seller to have “skin in the game” to ensure smooth transition
- These issues may have a major impact on deal economics, so critical to address at term sheet stage, if possible

Strategic Partnering Agreements

- Examples: sole-source/ preferred provider/most favored nations (MFN) purchase, supply or re-seller agreements; development or joint development agreements
- Issues include how to define “exclusivity”, “preferred provider” and “MFN”, the scope, definition and term of minimum purchase obligations, exceptions to such obligations and the dollar cap on the remedy for breach of any such obligations
- Requirement of preferred or exclusive status in particular areas on a company-wide basis may have significant unintended consequences, especially as technology or markets evolve
- Customer reaction may put pressure on obligations the divesting company needs to maintain or obligations the buying company needs to pick up