THE M&A JOURNAL

THE INDEPENDENT REPORT ON DEALS AND DEALMAKERS Volume 11 Number 1

Services Agreements in M&A Transactions

Services agreements are increasingly important in mergers and acquisitions because companies are relying more and more on external providers and internal "shared service organizations" for critical functions. Early attention to services agreements in M&A planning, due diligence and negotiations can increase deal value for, and mitigate risk to, both buyers and sellers. There are best practices for buyers and sellers in addressing services agreements in connection with M&A transactions.

Changed Business

Intense cost pressures have forced companies to reduce the cost of performing services[1] that support their core businesses, such as information technology, human resources, finance and accounting, procurement and facilities management services. One approach to cutting these types of costs is to centralize functions in a "shared services center" with economies of scale that individual business units lack. Another approach is to outsource traditionally internal functions to outside service providers that can offer both economies of scale and service delivery centers with world-class tools and processes. Because almost all companies now implement one or both of these approaches in their operations, a target[2] in an M&A transaction is increasingly likely to depend on critical services being provided by multiple affiliated and unaffiliated outsiders.

An entire industry of highly sophisticated specialists, along with industry associations, has developed to help companies enter into services agreements and to develop shared services centers. In addition, mid-size and large companies generally have a procurement, sourcing or vendor management group that works with services agreements. Because these services agreements are increasingly complex and mission-critical, companies often use a "center of excellence" in sourcing and outsourcing.

Frantic Rush

M&A practice evolved in an era when "transition services agreements" and "third party services agreements" could generally be ignored until the transaction was nearly finalized. Even today, deal teams often focus on the M&A transaction first, leaving the services agreements and other post-closing operational details to the frantic rush to signing, or sometimes even as a post-signing or post-closing item.[3] In many cases, the deal team excludes the people who know what services are needed and who can provide them until very shortly before, and sometimes even after, the M&A agreement is signed. As a result, deal teams can sometimes miss opportunities to increase value or mitigate risk.

Failing to pay attention to critical services agreements in M&A transactions can

Services Agreements ➔

1 In keeping with current terminology for strategy consultants and technology architects, this article uses the word "services" broadly to include back-office processes, functions and capabilities, including all of the underlying people, systems, technology, facilities and other resources, along with the set-up, operation and disengagement of those services.

2 This article uses the term "target" broadly to mean the entity, division or business being acquired by the buyer in a stock purchase, asset purchase, merger or other M&A transaction.

3 In some cases, leaving service agreements to a later stage in the M&A process is a conscious decision driven by the seller, the buyer or both. Factors such as confidentiality, the buyer's familiarity with the target, limitations on internal resources and cost can drive such a decision.

Services Agreements

continued

impose material risks and significantly affect the expected benefits of M&A transactions from both the buyer's and the seller's perspective. The risks can include:

- Buyers having difficulty integrating and running acquired businesses because they lack critical services.
- Buyers being committed to purchase more services than they actually need or paying more than they needed to pay.
- Sellers taking on obligations they cannot fulfill.
- Sellers unintentionally retaining post-closing risks related to the target's business.
- Buyers or sellers paying unnecessary fees to third parties.

Advance planning by both the buyer and the seller can increase deal value and mitigate risk. Sellers can add value by offering strong commitments to provide the services that buyers will actually need (thus making integration more likely to succeed). Buyers can avoid unexpected human resource requirements and other post-closing costs by detailing their service requirements and related costs prior to agreeing on a purchase price. Both parties can work to preserve the value of existing agreements so as to mitigate the risk of leakage of all or some of the transaction's economic benefits to a third party service provider.

Opportunities

There are opportunities in the following areas:

- Existing third party services agreements used only by the target.
- Existing third party services agreements shared by the target and the seller.
- Transition services agreements.
- "Reverse" transition services agreements.
- Steps that potential sellers can take to prepare for future M&A transactions.
- Steps that potential buyers can take to prepare for future M&A transactions.

If the target is the only business in the seller's corporate group using a services agreement, the easiest approach is likely to have the target continue using the existing agreement (and being bound by the existing agreement) after the buyer acquires the target. However, services agreements often prohibit assignment or change of control. Savvy third party providers can, and often do, use those prohibitions as leverage to exact a price for the ease of continuing the agreement, particularly if the existing pricing is not favorable to the provider or if it is costly to replace the agreement. Depending on the size of an M&A transaction, third party provider consent fees can materially affect the economics of the deal.

Replacing an existing services agreement might also be surprisingly costly. Terminating the target's use of an existing agreement, for example, may mean paying early termination fees or breaching minimum volume or revenue commitments. In addition, transitioning the services to a successor provider may involve cost and operational risk, particularly if the existing services agreement does not require the current provider to assist the target in transitioning to a successor provider. Similarly, adding the target as a service recipient under the buyer's existing arrangements may require lengthy negotiations with the buyer's third party providers.

Replacing an existing agreement also may take surprising amounts of time. Negotiations with third party providers on complex or large-scale services agreements often take far longer than the M&A deal cycle and require the involvement of people beyond the M&A team's "circle of knowledge." Quick negotiations have substantial opportunity costs. Substantially better pricing is available to customers that have the time to identify their true needs, conduct a robust sourcing process, and make long-term commitments. For a large-scale agreement for a critical service, this process can take three to twelve months, start to finish.

The current services provider's leverage will grow as the closing date of the M&A transaction approaches and the buyer's options narrow. The current provider's position will strengthen further if the target breaches the agreement through a prohibited assignment or change of control. As a result, there is a risk that the current provider's demands will grow with its leverage. Potential sellers can mitigate that risk by negotiating away those prohibitions when entering into contracts and being aware of them as part of preparing for M&A activity.

If the seller and the target both depend on one of the seller's third party services agreements, the target may be able to continue receiving services from the provider as a "service recipient" under the existing agreement even after the buyer acquires the target. The seller would then invoice the target or the buyer for its allocable share of the charges under the existing agreement.[4] This has the benefit of preserving the value of the existing agreement, if it works. In considering this option, the parties should address questions such as:

- Does the seller have the right to designate the target or the buyer (as applicable) as a service recipient under the agreement? If so, what are the costs of doing so (e.g., set-up charges or costs for third party consents)?
- Will the terms of the existing agreement meet the buyer's needs? Amendments may be labor-intensive and may delay the M&A deal. However, the buyer may need to make changes, such as requiring the provider to keep the information of the buyer and the target confidential from the seller. What effect will such amendments have on the seller's pricing?
- Does the pricing permit the seller to allocate charges to the target or the buyer? Pricing under services agreements can be complex, with hundreds or thousands of individual prices and no clear way to allocate fixed charges.
- Will the buyer have the right to require the seller to dispute charges or make claims for damages under the existing agreement? If so, will the buyer indemnify the seller against counterclaims that the seller faces as a result of the seller taking such actions?
- Will the buyer have the right to audit the provider? Audit rights may be required to comply with legal obligations or the buyer's policies.
- Who prevails if the buyer and the seller disagree on directions to be given to the provider? For example, they may disagree on how to prioritize projects if some primarily benefit the seller while others primarily benefit the buyer; or they may disagree on changes to be made to shared infrastructure or applications used to support the buyer and the seller.
- Which party will own intellectual property (IP) developed by the provider in the course of providing services to the target or the buyer? The services agreement likely will allocate ownership rights to the seller. What licenses will be granted to the target or the buyer to use the seller's IP in connection with receiving the services?
- Will the seller be liable if the buyer fails to comply with the existing agreement? Non-compliance may take many forms, such as the target's or the buyer's unauthorized use of licensed materials or its failure to pay amounts due under the existing agreement. The risks of adverse consequences to the seller due to buyer non-compliance will be particularly troublesome if the existing agreement is critical to the seller's retained organization.
- Will the seller be liable to the buyer if the services provider fails to perform or if the services are otherwise deficient? In other words, is the seller responsible for its third party provider's services, or is the seller merely managing and passing-through those services to the target or the buyer on an "as is" basis? Depending upon the intent of the parties, it may be appropriate to include express disclaimers of liability of the seller with respect to the services of third party providers and/or to limit the seller's obligations to using "commercially reasonable efforts" or to taking (or not taking) a defined set of actions to cause such third party providers to perform.

Another approach is to negotiate a new contract with the provider to continue the service. This approach provides a much easier separation between the buyer and the seller and allows the buyer to assess the existing third party provider against its competitors to obtain the most favorable pricing and other terms. However, negotiating a new contract may result in the buyer and the seller losing the value of existing services agreements that were negotiated with the combined service volumes and a sourcing process that maximized value. The buyer can lose that value because the new contract covers only its own volume; and the seller can lose value because it may pay higher unit prices under the existing agreement (or even face termination or termination charges) because of the reduced volume. Moreover, it often is not practical to negotiate a new contract before closing an acquisition.

In some cases, there is an easy path to obtaining a new contract with the services provider because the seller has a right to split the existing agreement in a way that preserves its value. The split might be accomplished by duplicating the existing agreement (i.e., "cloning") or by creating two new agreements that divide the ser-

Services Agreements ➔

4 For simplicity, we are assuming that the existing agreement is between the third party provider and the seller. The principles stated here would also apply if the agreement were between the third party provider and the target.

Services Agreements

continued

vice scope, revenue commitments, termination charges and other similar terms of the existing agreement (i.e., "cleaving").

Cloning can have unintended consequences. For example, it might have the effect of doubling minimum revenue commitments or requiring the provider to dedicate a specific person or asset to multiple customers. Thus, cloning is generally used only for simpler services agreements.

"Cleaving" means reducing service volume baselines and minimum charges under both the existing agreement and the new agreement. But it also can mean allocating key personnel, intellectual property rights, rights to dedicated assets upon a termination and other key resources and assets between the existing and new agreements. New projects may also be required to separate service delivery facilities, teams and reporting capabilities for the buyer and the seller; to decouple the seller's confidential information from the buyer's confidential information; and to adapt to the buyer's unique needs or integrate with the buyer's systems.

Cleaving thus typically involves more negotiation than does cloning. The provider has likely scaled its service delivery organization for the combined volume under the existing agreement and sees more economic benefit in providing services under two similar agreements, without the costs of negotiating a new agreement, than in any increase in per-unit charges that may result from the cleaving. At the same time, the services provider may see an opportunity to obtain provider-favorable terms and pricing in return for continuing to provide an essential service, particularly if the buyer has run out of time to find a different provider.

Transition Services Agreements

If the target provides services to or receives services from other parts of the seller's organization, and if both the target and the seller will depend on those services for an interim period after the closing, the parties can enter into a transition services agreement (TSA). Under a traditional TSA, the seller agrees to provide services to the target for a limited period of time following the closing.

A primary risk under a TSA is that the seller is not "in the business" of providing the services. Consequently, the seller generally lacks the tools and processes required to monitor service quality, govern services arrangements with unaffiliated customers, charge accurately for the services and maintain confidentiality among its "customers." In addition, the seller typically lacks the incentives that companies in the business of providing the services would have to perform well to obtain a contract renewal or a favorable reference.

The buyer similarly has limited incentive to invest in the relationship. The seller may face the risk of underestimating the cost of delivering the services and of investing in service delivery capability that goes unused when the TSA ends. On the other hand, the buyer faces the same or greater risk of direct and indirect damages from failure as it would with any other provider of critical services. For these reasons, both buyers and sellers typically are averse to the notion of long-term TSAs (typical terms range from a few weeks to three-six months; rarely do TSAs extend beyond a year).

A well-crafted TSA can increase value and mitigate risks. Key issues include:

Service commitment. The seller often takes the position that its service commitment in a TSA is merely to use commercially reasonable efforts to provide specified services on an "as is" basis. At the other extreme, under some circumstances a buyer might argue that the seller must agree to deliver a well-documented set of services under terms that sophisticated customers would expect from leading providers of mission-critical services.

Ideally, the seller will identify and document in sufficient detail all major services components, excluded services and service limitations. Exclusions and limitations may be driven by the buyer's capabilities, the seller's existing service arrangements, day-to-day demands on the seller's resources, or the buyer's historical consumption of the service.

For example, limits may apply to the seller's hours of operation or the number of supported locations, including ad hoc project hours, monthly data backups and restorations performed, allocated network bandwidth and allocated online storage. Defining and limiting the services early in the deal cycle can allow the seller to make stronger commitments to the remaining functions and can allow the buyer to seek other sources for excluded or limited functions.

Term. The buyer often does not know exactly how long it will need the services at the time the TSA is being negotiated. Thus, a buyer typically would prefer to have reasonable extension rights that provide enough time to build or source long-term services on a comfortable schedule. The seller likely would prefer to shed the exceptional responsibilities imposed by the TSA as quickly as possible, particularly if it has agreed to provide the services at cost or at less than cost. In addition, the seller may be relying on third party agreements that may be used for divested businesses for only a limited period. Depending on the circumstances, limited extension rights with defined notice periods and possibly higher prices during extensions can bridge the differences.

Right to increase or decrease scope or volume or to modify/customize services. The buyer often would prefer a right to grow, shrink or change the services to meet the buyer's changing needs. However, the seller likely has no desire to invest in its service delivery capacity for a single customer that will be disappearing soon and may have difficulty reducing cost until the service commitment ends. Some of the risk can be mitigated with variable pricing as described below. Other risk can be mitigated with clauses requiring the seller to provide fair proposals for providing an increased volume of service, to promptly and fairly respond to change requests, and to pass through the efficiencies, economies and cost savings possible as a result of reductions in volumes. The outsourcing industry has developed a wide variety of effective compromises on these topics.

Commitment of designated key personnel. Employees of the seller or its shared services organization may have critical knowledge about the target's service needs and how services were delivered before the closing. The buyer may view these people as essential to a successful transition. At the same time, those people are unlikely to be as motivated to support a divested business as they are to support the seller's continuing businesses.

The TSA can reduce operational risk by designating these individuals as "key personnel" who must be dedicated for some period of time to providing transition services and who will receive "retention bonuses" if they stay throughout the term of the TSA. If the buyer has a long-term need for the services of these key personnel, the TSA might include a right for the buyer to make offers to hire them when they are no longer needed by the seller to provide the services.

Pricing. TSAs may be priced in a variety of ways, such as cost, cost plus, fixed price or a fixed base price subject to volume and other adjustments. In some cases, transition services are provided to a buyer without additional charge, which is a simple solution but one that fails to provide an incentive to deliver the services. Determining the most appropriate pricing method depends on the type of service in question, how the seller will source the service and the business terms of the overall transaction. Cost is an appealing approach, but sellers often lack ways to measure cost for providing internal services, and allocations of shared fixed costs are inherently arbitrary. Thus, a well-crafted pricing schedule with a list of services and unit prices will provide greater certainty and reduce the risk of disputes.

Companies with an established shared services organization often have pricing established for internal departments that they can use for TSAs. Also, the sourcing industry has market-tested pricing methodologies. For instance, the parties may allow flexibility while matching charges to costs. Appropriate incentives may be maintained by using a combination of fixed prices, unit charges based on service volumes, hourly rates for projects and pass-through pricing for third party charges such as travel, telecommunications and underlying services.

Intellectual property rights. A TSA should, in many cases, allocate rights in intellectual property developed under that TSA. For example, a TSA might provide that the rights in IP developed under the agreement will be allocated so that the parties would have the rights in the newly developed IP that they would have had if that IP had been developed prior to closing. Provisions that have resolved this issue in outsourcing agreements are often helpful in this regard for TSAs. In any event, a TSA should be drafted to include work-made-for-hire and other IP provisions required to secure and appropriately transfer rights in any IP that is developed under the agreement.

Compliance with laws. A buyer typically wants the seller to agree to comply with all laws affecting the services or the buyer. For example, a buyer would not want the risk of becoming liable for actions by the seller, such as disclosing personal data in violation of privacy laws. A seller, on the other hand, would not want responsibility for complying with laws that it is only monitoring because it owns the target. A possible resolution is to have the seller be responsible only for failing to abide by the terms of the contract, including descriptions of specific actions to be taken to comply with those laws that are applicable only to the target or the buyer.

Services Agreements ➔

Services Agreements

continued

Responsibility for third party consents. The seller may require consents from third parties to provide services to the buyer under the TSA. For example, a third party software license may be for "internal use only" by designated companies and prohibit use "as a service bureau." The seller may have clauses in its software license agreement that permit use to serve divested entities. However, absent a license right applicable to the TSA, the seller may need the consent of the third party software licensor in order to use the software to provided services to a divested company.

Depending on the complexity and scope of the transaction, hundreds of consents may be involved, each of which may require negotiations with a third party and the payment of fees. In addition to the payment of fees, consents may also be conditioned on confidentiality obligations, term renewals and minimum volume commitments that might require compliance by both the buyer and the seller. There may be both "front-end" consents that are required to begin to provide the services, "back-end" consents that are required to transfer the services to the buyer at the end of the term, and "middle" consents that are required to expand the services during the term.

The TSA or related M&A agreement should clearly define which party is responsible for identifying, obtaining and paying for each consent (or for each type of consent), and for making alternative arrangements if a consent cannot be obtained. Many outcomes are possible, though aligning incentives by giving each party a financial stake in the consent process is one way to obtain consents and comply with their terms at the lowest possible cost.

Limitation of liability. TSAs often include a waiver of consequential and other indirect damages (e.g., lost profits) and a cap on direct damages, subject to negotiated exclusions. Such exclusions might cover, for example, liability for indemnified claims, gross negligence, willful misconduct, bodily injury, damage to tangible personal property, breach of confidentiality and violation of laws.

Buyers under a TSA would prefer similar terms to back up a strong commitment to providing services. However, because the seller under a TSA often is not "in the business" of providing the services, the seller may have difficulty assessing the risk involved and, therefore, often presses for having liability only where the buyer's damages are the result of the seller's own gross negligence or willful misconduct.

While this limitation may effectively shield the seller from liability for its negligence or deficient services, it provides the buyer with little assurance as to service quality. To maximize value, the parties should align the limitations of liability with both the strength of the seller's commitments for individual services and the allocations of liability for the transaction as a whole.

Termination rights. Like other issues in the TSA, termination rights often are negotiated to reflect a balance between the importance of the services provided to the target or the buyer and the fact that the seller typically is not in the business of providing those services. The buyer would prefer to have broad termination rights (to preserve maximum flexibility) and to limit the seller's rights to terminate (to minimize the risk associated with a termination). The seller, in turn, would prefer to have an easy exit (to address the risk of being over-committed) and to limit the buyer's rights to terminate (to avoid the risk of stranded costs upon a termination).

Several compromises are available to achieve this balance. These include termination notice periods sufficient to allow the parties to make a smooth exit, charges for an early termination, limiting the seller's termination rights to the buyer's failure to pay invoiced charges, and termination due to buyer breach of confidentiality or seller proprietary rights.

In some cases, the target provides critical services to the seller and the seller needs those services to continue for a period after the buyer acquires control of the target. In that case, the parties may enter into a stand-alone "reverse" TSA where the buyer agrees to provide those services to the seller or incorporate "reverse" services provisions into the TSA under which the seller will provide services to the target or the buyer.

While the seller may argue in a TSA negotiation that it is not "in the business" of providing the services, the buyer in a reverse TSA typically has an even stronger argument in that regard. In fact, the buyer may be relying entirely on the seller for the capability to provide the reverse TSA services. A trap for the unwary in this unbalanced situation is to agree in an early term sheet that the TSAs will be mutual, leaving the buyer with an uncomfortable choice between making risky commitments in the reverse TSA or receiving inadequate commitments in the TSA under which the target or the buyer will receive services from the seller.

One key exception is where the buyer is a provider of the types of services to be provided to the seller after the buyer acquires control of the target. For example, a seller might sell its finance and accounting shared services center to a provider such as Accenture, Genpact or IBM. In that case, the seller may elect to enter into a long-term agreement for those services as part of the M&A transaction and require the same strong promises that it would expect if it had outsourced the services to the buyer.

Companies that may be selling businesses can take steps in advance to position themselves to maximize value and mitigate risk. These include:

- Structuring internal shared services centers to act as if they were outside service providers (that is, with unaffiliated customers), including documenting their obligations with statements of work, service levels, services agreements and fixed charges.
- Developing an organization to support divestiture activities, with an "M&A Playbook" and a staff with responsibility for service planning and ongoing support for divested businesses.
- Maintaining a complete database of all third party services agreements and the businesses that they serve.
- Ensuring that outside service providers are committed to (i) taking on work, shedding work, supporting divested businesses, and providing M&A support upon request; and (ii) permitting the seller to clone or cleave existing agreements. This can be accomplished through a combination of amendments to existing agreements and contracting policies for new agreements.
- Ensuring that outside licensors, lessors and similar third parties have agreed to allow their software or assets to provide transition services, at least for a minimum time period.
- Including in the divestiture team, at the earliest stage deemed appropriate under the circumstances, the people who will be responsible for arranging services to be provided by the seller's organization or contractors.
- Analyzing the target's internal servicing capabilities, the services the target needs from shared contracts or from the seller's organization, any services the target provides to the seller's organization, the costs required to provide those services, the effect the divestiture will have on the seller's retained organization (including pricing impacts under existing services contracts), and how best to provide the needed services.
- Identifying projects under third party services agreements that the buyer may not need and that should be put on hold pending a transaction.
- Identifying restrictions on the seller's ability to make commitments to providing post-closing services.
- Including documentation for internal and external services in data rooms.
- Providing potential buyers a form TSA (or a term sheet) containing meaningful service commitments at an early stage in the M&A process to reduce buyer uncertainty and risk, with the expectation that this will increase the value and clarity of offers received.

Companies that may be buying businesses also can take steps in advance to maximize value and mitigate risk. These include:

- Incorporating rights to expand services and obtain acquisition support into third party services agreements, which can often be done by including a right to quickly expand volumes well beyond the original amounts without further negotiations.
- Developing an organization to support acquisition activities, with an "M&A Playbook" and a staff with responsibility for service planning and ongoing support for acquired businesses.
- Identifying in advance any services that will need to be replicated or replaced, as well as the means to mitigate the impact of service failures.
- Documenting services and associated service levels that the buyer's own internal services organizations can perform for acquired businesses, and determining the expected timing needed to bring those services on line for a target.
- Keeping a list of minimum requirements for services agreements.
- Assigning to the acquisition team, at the earliest stage deemed appropriate under the circumstances, the people who the buyer will use to procure the needed services from a third party (including sourcing, business, IT, operations, administration and legal specialists).

Services Agreements ➔

Services Agreements

continued

- Reviewing any documentation provided by the seller on internal and external services, including historical performance levels and problems.
- Under the appropriate circumstances, making any required TSA (or specific terms thereof) part of the buyer's bid.
- Commencing negotiations with third party service providers as promptly as possible.
- Leveraging best practices developed in outsourcing and large-scale agreements for critical services.

Dramatic changes in the ways that companies handle critical core business functions require timely, substantial attention to services agreements in M&A transactions. Leaving these issues to the end of a deal can cause delays, squander value, increase risk and lead to disputes. The best time to begin developing services agreements is well before the target is identified. By integrating the approaches described in this article into your company's contracting policies and overall M&A strategies and approaches, you can help to maximize value and mitigate risk in M&A transactions.

—Brad Peterson, partner;
Paul Chandler, counsel;
Mike Murray, partner
Mayer Brown LLP

MA

Website: www.themandajournal.com

E-mail: info@themandajournal.com

Editorial Office: 914.476.5455

Orders & Subscriptions: For individual subscriptions, discounted multi-copy institutional subscription rates, or additional copies, please call 914.476.5455 or fax 914.476.4111.

THE M&A JOURNAL

the independent report on deals and dealmakers

Editor-in-Chief	**John Close**
Design and Production	**John Boudreau**
Director of Publishing	**Paul Cecere**
Contributing Editor	**Susan Pender**
Senior Writers	**Gay Jervey, R. L. Weiner**
Writing/Research	**Frank Coffee, Jeff Gurner, Terry Lefton**
Circulation	**Dan Matisa**
Printing	**AlphaGraphics**
Web Production	**John Boudreau**

The M&A Journal, 25 Prospect Drive, Yonkers, NY 10705