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When Seller Contracts For IT On Behalf Of Acquisition

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Last year was a record year for mergers and acquisitions activity as 2015 generated $4.7 trillion worth of deals driven by inexpensive debt and the pressure to become more efficient in a low-growth economy.[1] To help achieve the expected benefits of an acquisition, the information technology infrastructure and back office services of the acquisition must be integrated into the buyer's environment or stood up independently. However, the integration approach is time-consuming and prone to failure; it is estimated that 50-80 percent of acquisitions fail due to lack of proper integration.[2] Given this high rate of failure, an acquisition that has its own independent IT and back office environment is more likely to be successful.

Nevertheless, it is not uncommon for an acquisition to be integrated into the seller's IT and back office environment, thereby making it difficult to parse these services from the seller. To overcome this obstacle, there is an emerging trend for the acquisition to contract for these services before the M&A deal is finalized, thereby establishing an independent environment that eliminates integration problems that often plague acquisitions. This contracting approach commonly involves the seller negotiating on behalf of the acquisition with a service provider before the sale of the acquisition is complete to allow the implementation of services prior to or close to the anticipated sale date. Those agreements would then be assigned or novated to the buyer after closing. This unusual contracting relationship produces a myriad of issues that the seller, service provider, and buyer must navigate. Some of the more significant issues are discussed below.

Loss of Bargaining Power

Perhaps the most significant obstacle faced by a seller negotiating agreements on behalf of an acquisition will be the loss of bargaining power. Oftentimes, a seller will engage current service providers to create new service agreements for the provision of services to the acquisition. While a service provider may have been willing to make contract concessions when negotiating an agreement to provide services to the seller's entire organization, service providers are much less willing to extend the same terms and conditions in an agreement for the acquisition due to a smaller scope of work. As a result, the seller's negotiation team should prioritize the terms needed for the acquisition and recognize that the service provider will not be as flexible as it had been in prior negotiations with the seller.

Cloud-Based Technology

The emergence of cloud-based technologies allows the acquisition to implement and stand up services much faster than a siloed approach. As with any cloud agreement though, there are trade-offs between the ability to negotiate customized terms versus the speed to deploy the solution using the service provider's standard terms. In particular, areas where cloud agreements typically diverge from customized IT deals that may be important for the acquisition include service level credits as a sole and exclusive remedy, scaled-back audit rights, the ability to store and process client data anywhere, and minimal disengagement services. The economics of a cloud solution dictate that the service provider is not able to offer more robust terms that the acquisition benefited from under the seller's master agreement. Consequently, the seller's negotiation team needs to evaluate these reduced terms and decide whether or not the proposed solution will meet the requirements of the acquisition.

Lack of Historical Data

It is common for performance data associated with the acquisition to be comingled with the seller's other lines of business, thereby making it difficult to develop volume projections and associated pricing for the acquisition due to this lack of historical data. For example, if the seller is negotiating an agreement for back office accounting functions, it may not be possible to discretely identify invoice volumes. As a result, service providers will often push for a baselining period to allow both sides the opportunity to ascertain realistic volumes for the acquisition, usually followed up by a one-time true-up. A typical baselining period will last six months and the seller should push to include contractual provisions that describe a formulaic method to set the new volume baseline for the acquisition. To the extent that the new volume baseline deviates significantly from the initial assumption in either direction, the service provider's solution may not be appropriately sized and the parties will need to engage in further contract negotiations which may result in an increase to absolute price or an increase to the cost per unit. If the new volume baseline is significantly higher, the buyer may be faced with a large invoice at true-up.

Hypercare

IT and back office functions are often shared services in many organizations, so it is unlikely that many seller personnel from these areas will move with the acquisition. As a result, buyer personnel will be thrust into the role of managing the relationship with the service provider, and seller personnel who move with the acquisition may encounter new escalation procedures for problem resolution. To mitigate these issues, the seller should contract for a period of "hypercare" during which the service provider provides extra resources (usually for an additional fee) to help ensure that the services are successfully implemented. A typical hypercare period lasts three months and is important in any transition to a new provider, but it is even more critical in M&A transactions given the number of new faces.

Soliciting Buyer Input

The buyer will want to have some input into the negotiation process to ensure that its legal and operational concerns are addressed. However, the buyer does not have any contractual standing to negotiate terms until the new agreement is assigned or novated to it. During the negotiation process, the seller should solicit input from the buyer on key legal, commercial, and operational/technical terms. From a solution perspective, subject matter experts of the buyer should have the opportunity to vet the statements of work, service levels and pricing since operational ownership will transfer to them after

the purchase of the acquisition. Likewise, the buyer's legal team should be consulted to provide input on items such as liability caps, termination rights, and intellectual property rights. Service providers are more than willing to accommodate changes after assignment or novation, but bargaining power may be reduced at that point in time so it is more advantageous to address key concerns during the initial negotiation.

Ask for an Escape Clause

The seller's negotiation team should strive to include a clause that would allow the seller to cancel the new services agreement should the acquisition fail to close. If the service provider is amenable to including such a clause, it is common for the service provider to look to recover business development costs incurred during the negotiation process. Some, but not all, service providers are open to including such a clause. Those that oppose including this type of clause typically argue that the seller will most likely want to find another buyer for the acquisition target and therefore would still need to contract for the services. These service providers also cite that the seller can terminate the agreement for convenience (with payment of termination charges), although this method is usually more expensive than reimbursement of business development costs under an escape clause.

Leverage Existing Agreements

If all else fails and a new services agreement for the acquisition cannot be reached in time, a well-negotiated master agreement between the seller and service provider typically includes the right for the acquisition to still receive services as an eligible recipient of the seller. While this approach does not fully achieve the independence gained with a new services agreement specifically for the acquisition, this fallback option allows the acquisition to continue to receive services while the parties can continue to work on a new agreement.

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[1] Maureen Farrell, 2015 Becomes the Biggest M&A Year Ever, Wall St. J., Dec. 3, 2015 available at http://www.wsj.com/articles/2015-becomes-the-biggest-m-a-year-ever-1449187101?mod=djemCFO_h&mod=djemCIO_h (last visited Jan. 23, 2016).

[2] http://www.themiddlemarket.com/video/seamless-integration-of-new-acquisitions-258423-1.html?page=3

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