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"Extraordinary Events" in an Outsourcing Relationship: Managing Acquisitions and Divestitures

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One of the keys to a successful outsourcing relationship is flexibility—in the contract terms and in the relationship. Flexibility is required to meet ever-changing business needs through the life of the deal. This flexibility is put to the test when a customer experiences an "extraordinary event" such as a merger, acquisition or divestiture. The occurrence of such an event, which is not as unusual as its name would suggest, may require extensive adaptations to the outsourcing arrangement. This article examines the portions of an outsourcing relationship that will require review, modification and flexibility when a customer who is already in an outsourcing relationship is about to experience an acquisition or divestiture. This article also points out areas that a customer should consider before entering into an outsourcing agreement so that the customer has the required flexibility in its outsourcing agreement to handle these changes.

Engage the Supplier

As soon as the customer can publicly discuss its plans, the customer governance team should discuss the acquisition or divestiture plans with the supplier. The supplier may be called upon to perform analyses and provide other support relative to the closing of the extraordinary event. For example, in a divestiture, the supplier may need to provide transition services to the buyer of the business for a period of time. The outsourcing agreement should provide that the supplier will provide some level of service and support to a customer in planning for and handling extraordinary events, particularly where the same types of support functions were provided by customer staff prior to outsourcing that function to the supplier. In some cases, services that are

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required in connection with an extraordinary event may constitute "new services" under the outsourcing agreement, which may me an additional charges for those services.

Examine Transition Events

Sometimes companies change so rapidly that they face an extraordinary event even before the transition to the supplier under the outsourcing agreement is complete. Where a customer is still in transition to the supplier, the customer must immediately review transition plans and milestones under the outsourcing agreement. Transition events may have to be suspended or stopped entirely. Interruptions to transition events and milestones may impact the supplier's ability to deliver on other transition events and milestones. For that reason, it is important to view the changes in the context of the whole impact to the outsourcing transition, not just the transition events and milestones that are specific to the divested or the acquired business.

Evaluate How Services Will Be Provided

Many outsourcing agreements permit a customer to provide services through the agreement to a broad variety of affiliates and other related entities. A customer facing a divestiture should always first check these provisions. It is possible that if a customer is divesting only part ownership in a division or business, that division or business may still be able to receive services directly under the outsourcing agreement if it continues to meet the definition for eligibility. Where ownership of a business or division is changing completely, usually the divestiture clauses of an outsourcing agreement are triggered. In that case, the divested entity may be entitled to receive services for a temporary period of time, typically a year or so, until it can make its own arrangements. Often, the divested entity will also be entitled to transition services for an additional period of time tacked onto the temporary service period, so a divested entity may enjoy services for an extended period of time, in some cases as long as two years or slightly more.

With an acquisition, the customer must check the same terms to determine if the customer is acquiring enough of an interest to fold the acquired entity into an existing services agreement. In some cases where the acquired entity has its own service arrangements, it may be desirable to leave those in place until a later time. Where the acquired entity will have separate service arrangements from those of the customer, the customer must check its own outsourcing arrangements to ensure that the customer will not violate any exclusivity, preferred supplier or other similar commitment clauses. There are many other issues to consider when folding in an acquired entity into an existing outsourcing relationship. Many of these are addressed below.

Review Entire Contract, Including Schedules

With any extraordinary event, it will be necessary to examine the entire agreement, and particularly the schedules, to determine how they may need to change to accommodate the event. The event may require amendments to statements of work and service level agreements. Schedules that list items such as locations, equipment, managed agreements, licenses and other similar matters may require updating, and additions or deletions. The governance model may change to accommodate additional roles, or roles that are no longer needed after a divested entity departs. Many of these schedule changes will require the supplier's approval, particularly as those schedule changes may increase the supplier's obligations under the outsourcing agreement.

Meeting Minimum Commitments

Some outsourcing arrangements have minimum revenue or other financial commitments in place that the customer must honor, often on an annual basis. While an acquisition may not present any problems in this area, a divestiture may affect a customer’s ability to meet its minimum commitments. In this case, the customer will need to negotiate with the supplier to make adjustments to the commitment levels that appropriately reflect the change that occurs through the divestiture. There are some contract clauses that a customer may consider when entering into the outsourcing agreement that can provide the customer with necessary relief when these events occur. The first is an extraordinary events clause, discussed below. The second is a clause that allows the volume, revenue or other measurable units consumed by the divested entity under a new or replacement agreement with the supplier to continue to partially satisfy or count toward any minimum commitments of the customer. This clause is justified where the supplier enters into a new agreement with the divested entity, and the supplier is not at a loss of business because of this replacement agreement. Customers may not be able to capture the full benefit of the volume under the new agreement, however, where the new supply relationship produces additional costs to the supplier that were not reflected in the original deal pricing. This could happen, for example, when the supplier has to support two different systems under the two different agreements, instead of one original system on which the original pricing was based. Customers should also note that combining volumes under two different agreements may create complexities in the future if the minimum volume commitments are not met, and the supplier and the two customers must then allocate the consequences of any shortfall.

Review and Adjust Pricing Terms

An extraordinary event will probably require the customer and supplier to mutually examine the pricing structure and terms to ensure that they will still achieve their original purpose after the event. Most outsourcing deals rely on the concept of “baselines” or expected volumes of particular services based loosely on the customer’s prior experience of consumption of those services. For example, one baseline might be the annual number of travel expense reports processed for reimbursement each year by the customer . The customer and supplier should review service baselines, any permitted “fluctuation” zone around baselines, and additional resource charges (ARCs) and reduced resource charges (RRCs), and the impact on all of these given an extraordinary event. In the example above, for an acquisition, the number of travel expense reports processed might double once the acquisition is complete and the services are folded into the existing outsourcing relationship. The customer will need to carefully evaluate whether the event will cause the customer to go outside of agreed-upon fluctuation bands around baselines or pricing. The customer will also need to evaluate whether the additional volume justifies a new lower price, where, for example, the supplier will benefit from the increased volume without having to make significant additional investment to absorb that volume.

Again using the example above, where a divestiture by the customer causes the number of travel expense reports processed by the supplier to fall to half the original volume, this type of reduction may bring about a pricing review. This pricing review may result in a resetting of baselines at a lower level, with a new fluctuation band. It may also bring about a slight-

ly higher per-unit price, when appropriate, to reflect the lost volumes that the supplier will have once a divestiture is complete. A divestiture or acquisition may also affect a supplier's ability to meet other pricing terms and conditions, such as savings commitments, consolidation efforts for efficiencies or process improvements, and other similar terms that all may be affected, positively or negatively, by an acquisition or divestiture.

Include an Extradordinary Events Clause

Whenever possible, it is best to anticipate corporate change, and to include an extraordinary events clause that permits a customer to make these changes without having to renegotiate a new deal with the supplier. These clauses are usually called extraordinary events clauses. They permit corporate change within certain agreed-upon "bands" of fluctuation, and in some cases, can prevent the re-pricing scenario discussed in the paragraph above. If a corporate change occurs that causes or will cause service consumption to go outside of the permitted band of fluctuation, either higher or lower, then the customer may call for a pricing review to assess the impact. Often the clauses allow the customer to call for a pricing review even if a significant event does not cause the customer's consumption of resources to go outside of the fluctuation bands. For example, where a customer alters a business process or technology, and that change is an extraordinary event affecting the services, the customer may call for a pricing review and adjustment.

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The pricing review may result in lower per unit prices (for example, when volume increases through an acquisition), or lowered service baselines with or without changes in unit prices (for example, when a divestiture causes a large reduction in overall usage of a particular service). These clauses usually provide that only the customer may call for the review and adjustments, unless some other rights of the supplier are triggered. Occassionally, these clauses permit the customer to engage a third-party auditor to confirm that the new pricing proposed by the supplier adequately reflects the supplier's reduction in costs as a result of the extraordinary event.

Finally, at some point when the customer changes affect the fundamental financial assumptions of the deal, the supplier will have rights to re-open pricing discussions, and possibly receive unwinding charges. The numerical triggers for these clauses—that is the amount of change that may occur before prices are impacted—are usually the subject of intense negotiation between the supplier and customer during agreement negotiations.

Revisit Required Consents

In most outsourcing transactions, the customer and supplier must obtain the consents of third parties under agreements for products, services and licenses so that the supplier may take assignment of those agreements, or alternatively, use them on behalf of the customer. In an acquisition, additional rights may be required to permit the supplier to use the third-party products, services or licenses on behalf of the acquired entity. In a divestiture, the supplier is often obligated to provide services to the divested entity for some transitional period. At the point where the customer no longer has a majority interest in, or is no longer under common control with, the divested entity, the consents and rights to use that the supplier may have obtained at the outset of the deal may no longer cover the divested entity. In that case, the supplier and customer may need to acquire additional consents and rights to use for the

divested entity. Obtaining required consents and additional rights to use may cost money. In that case, the customer and the supplier will have to determine who is responsible for payment of those additional costs. In cases where the supplier has the opportunity to increase revenue through provision of services to an acquired entity, or to keep revenue through continuing to provide services to a divested entity, it may be appropriate for the supplier to bear the cost of obtaining the additional required consents. The analysis of who should pay will turn on a variety of facts surrounding the circumstances, including the contract provisions regarding the required consents.

Analyze Assets

The customer and supplier must analyze the assets involved in an acquisition or divestiture as they relate to the outsourcing relationship. For example, an acquired entity may have assets that should transfer to the supplier because they are similar in nature to those that the supplier took at the outset of the transaction. In a divestiture, the divested entity may want to buy back the assets that are used to serve that business. In those cases, the outsourcing agreement must provide the necessary rights for the customer to cause a transfer of the dedicated assets and third party agreements from the supplier to the divested entity. When a deal is international in scope, undoing the asset transfers in various countries can add complexity.

Evaluate Employees

Similar to the physical assets, extraordinary business changes require an assessment of the affected "in-scope" employees. With an acquisition, the customer must determine if there are "in-scope" employees who should transfer to the supplier. With a divestiture, the customer must determine whether the divested entity will want to hire back any employees who have transferred to the supplier. In that case, the customer needs to determine whether that hiring back of employees will affect any rights of the customer with respect to the customer's rights to hire back its employees in the future. For example, many outsourcing agreements place some numerical or percentage- based limit on the number of dedicated personnel available for hire at any unwinding of the relationship. If a divested entity hires some of those people, the customer may have a lower available number of people to hire back or transfer to another provider at the customer's unwinding of the relationship.

Plan for Termination Issues

The termination issues in an outsourcing relationship for an acquisition, or merger, are different from those in a divestiture. In an acquisition or merger situation, the customer may desire to move its services to the outsourcing provider used by the acquired or acquiring entity. In that case, the customer will need to evaluate the termination clauses, and its ability to leave the outsourcing agreement for those reasons. Many outsourcing agreements permit the customer to exit the relationship if the customer has a change of control or other similarly large organic change. Often, there is some amount of termination charges associated with that exit right, but usually it is a lesser amount than the charges that would apply in a termination for convenience.

For a divestiture, the termination issues are more complex. If there are pricing and other fluctuation bands, as discussed above, that permit a certain amount of change and fluctuation in the

consumption of services, then it is possible that the divestiture will not cause the customer to exceed these bands, and the customer may continue to enjoy the same services and pricing after the divestiture. If the divestiture is a large one, with a large impact on the services consumed, then at some point the exit of the business may cause a termination for convenience in one or more service areas, and termination charges may be triggered. It is important that the outsourcing agreement be clear about the amount of services that may be removed from the supplier’s scope without incurring termination charges.

Consider Flexibility at the Start

It is important for customers entering into long-term outsourcing relationships to build in flexibility and protections to allow for significant and inevitable corporate changes. Some of these protections include rights to reduce the scope of services without penalties, rights to reduce service consumption down to a negotiated level without a penalty, extraordinary events clauses that permit change without causing price increases, and an understanding of when termination charges will apply.