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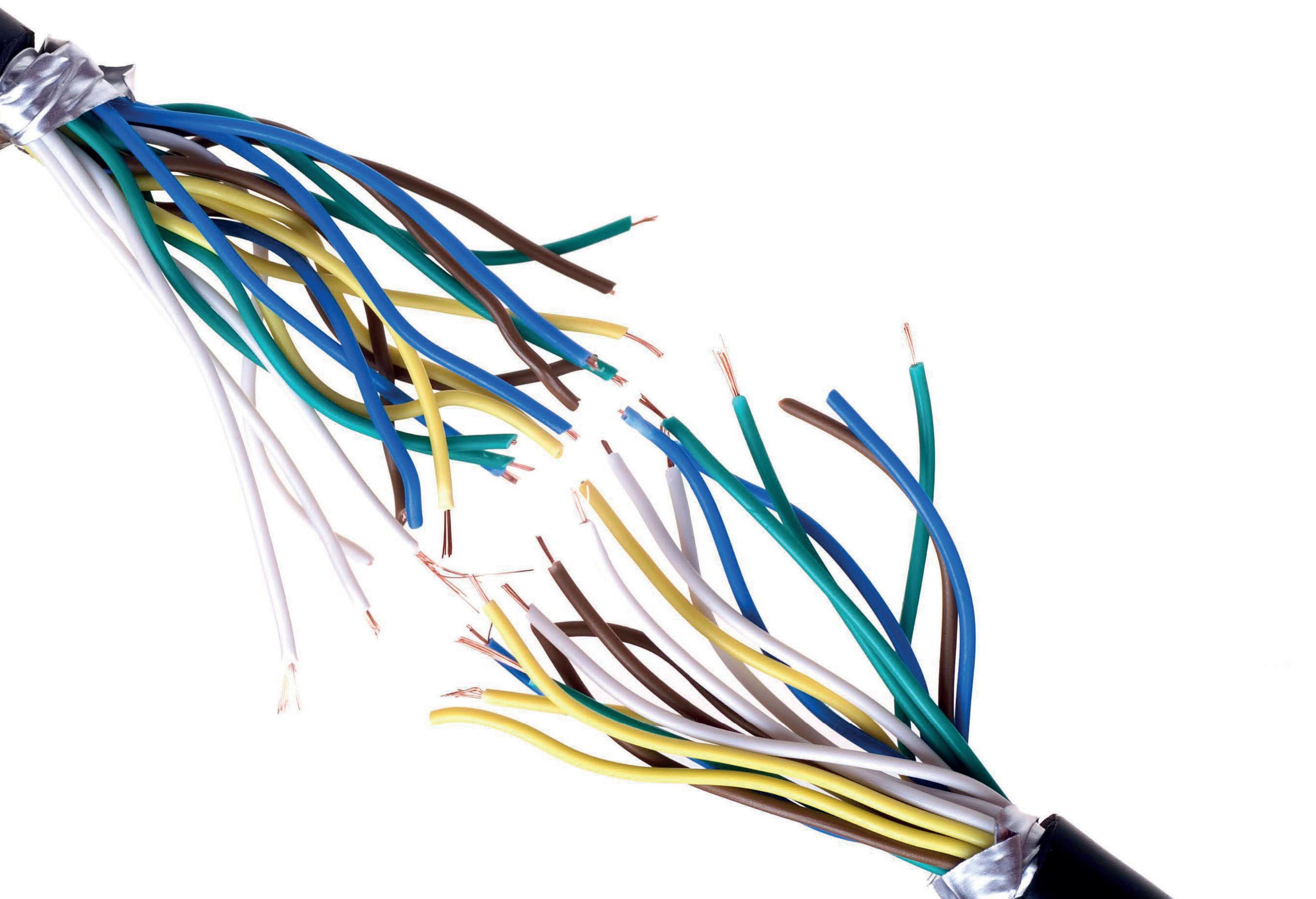
M&A-driven technology contract separation: A strategic approach

Part of the *Wired for Winning* series on M&A technology topics



Contract separation is a critical part of an M&A carve-out transaction, be it a divestiture, asset sale, or spin-off. Information Technology (IT) contracts are among the largest, most costly, and most complex contracts to separate because they can encompass both software licenses and physical assets such as servers and telecom equipment. Without sufficient preparation and a strategic approach to technology contract separation, both seller and buyer run the risk of incurring significant costs and violating contractual agreements. Sellers may not realize that vendor permission is almost always required to allow the carve-out unit to continue using established vendor contracts after the transaction closes. Buyers, in turn, may incorrectly rely on the seller to separate the contracts sufficiently to allow the carve-out unit to operate in the near term and long term.

Contract separation: Frequently used terms

Assignment: Contract is transferred to carve-out entity. Only done if the seller will not use this contract in the future (and likely did not do so prior to the transaction)

Clone: Exact copy of the contract is created for the seller, with vendor agreement. May exclude commercial terms (i.e., pricing, pay term)

Stand up: New contract is negotiated for carve-out entity

Rights to use: Seller obtains consent from the vendor to provide the products and services purchased under the contract as part of a transition services agreement (TSA) to the carve-out entity

What should M&A participants do to prepare for contract separation?

Although most of the responsibility and work in a technology contract separation typically falls to the seller, there is benefit for the buyer to monitor and/or participate in the process and urge the seller, if necessary, to structure an agreement with the vendor that benefits all parties. Following these suggested steps can help M&A participants execute an effective and strategic technology contract separation.

1. Identify vendors and define requirements

The first step to executing a contract separation is identifying the vendors and associated products and services that are applicable to the carve-out unit. This typically requires a top-down and bottom-up effort:

- *Top-down*—The centralized procurement team queries vendor spend databases or manual data repositories to identify a list of vendors/products applicable to the carve-out
- *Bottom-up*—Business and functional-level subject matter experts develop a business-critical vendor list

The next step is determining whether the carve-out will continue to require the vendor/product after the M&A deal closes—also referred to as defining the business intent. Often, defining the business intent can be a challenge, as the buyer's decision-makers may not yet be engaged or choices about the target state are farther down the planning path and have not yet been made. At this point, an effective practice is to compose a set of broad assumptions and obtain alignment from senior executives on both sides of the transaction.

2. Obtain the contract documentation

It is common for companies to underestimate the effort needed to locate all contract documents, especially during the time crunch of an M&A transaction. In a best-case scenario, the seller utilizes a contract management system that contains the majority of contracts. In a worst-case scenario, no such centralized solution exists and contracts are dispersed across geographies on shared server drives, in file cabinets, and on employee hard drives. It is essential to search for contracts as early as possible in the M&A process. Also, companies and their technology and procurement teams can cast the net broadly, even if the M&A team has not yet confirmed whether a specific contract is relevant or required. One important category to remember is contracts purchased from technology resellers. In this case, the company may need to request a data inventory of all purchase contracts from the reseller and then reclassify this information by each original vendor.

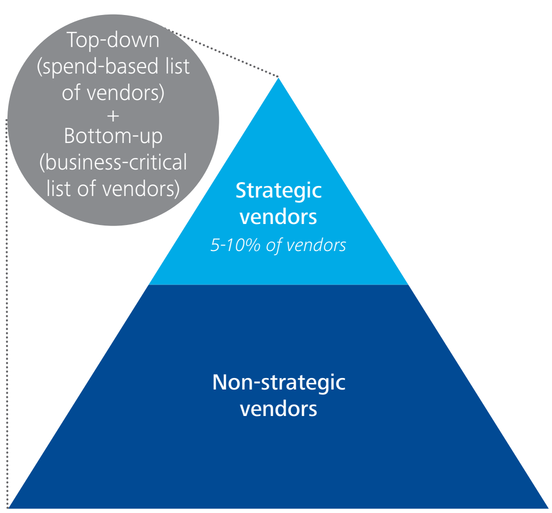
Once contracts are located, they should be stored in a centralized, secure repository and catalogued in a contracts database that is developed specifically for the M&A transaction.

3. Reach agreement with strategic vendors: Specific vendors and the associated contracts may be considered critical to the carve-out entity and are labeled as strategic because of their:

- *Financial impact*—Vendor has a material component of the carve-out's cost base
- *Level of criticality to operations*—Vendor products/services are customer-facing or integrated into core processing
- *Complexity of transactions*—Vendor arrangement with the seller includes a number of ongoing, complex purchasing arrangements

Working with strategic vendors (see Figure 1) on contract separation is likely to take significantly longer than for other contracts. In fact, the rule of thumb is that strategic vendors are "the first and the last ones you talk to." Reaching an agreement with certain strategic vendors is generally a requirement for the seller; it may be incorporated into the sales agreement governing the transaction or listed as a dependency for deal closing. It is not uncommon for a buyer to insist on the seller being responsible for costs associated with their "rights to use" the software during the transition period and to cap the potential cost for the buyer's continued use of the agreement.

Figure 1: Working with strategic vendors



4. Budget for one-time and ongoing contract separation costs

One-time contract separation costs—consent fees or repurchasing costs—are an often overlooked component of an M&A transaction budget. The objective of contract separation is to minimize one-time costs; however, it is important for seller and buyer to agree on which party will be responsible for the costs before and after deal close.

In addition, the seller and buyer may incur ongoing costs driven by contract separation. The seller may be left with stranded costs for products and services that were previously borne by the carve-out but are not transferred as part of the transaction. In this case, the seller may incur costs for more licenses than are actually required for the remaining business. The buyer, in turn, may have to repurchase licenses. Additionally, both seller and buyer may be subject to pricing increases if the original contract pricing included volume-based discounts. To prepare for worst-case scenarios, a high-level cost estimate should be included in the transaction budget to cover for these potential cost overruns.

5. Understand the potential risks

IT vendors are aware that changing software and hardware solutions can take extensive time and effort, both of which are at a premium during an M&A transaction. Some vendors will try to hold companies "hostage" and not agree to a contract assignment or a clone without a one-time payment, a rate increase, or both. Discussions with certain vendors may extend until the buyer is unable to seek an alternative solution and is left with little negotiating power. Vendors are even less inclined to be agreeable if they know that the buyer purchases the same product or service from a different vendor and, therefore, there is little likelihood for a longer-term relationship.

6. Select and execute the contract separation approach

Most contracts, including software license agreements and data subscriptions, restrict use to the original licensee and its affiliates. Therefore, the first priority when designing and executing a contract separation approach is to determine that the carve-out entity has a contract to operate on Day 1. The second priority is to minimize one-time and ongoing costs to the seller and the carve-out business unit.

A traditional contract separation approach might include the following components:

a. Conduct legal review of contracts and record attributes

b. Assign contracts wherever possible; otherwise, negotiate transfer terms and fees

c. Repurchase licenses and negotiate new contracts, where transfer is not allowed

This approach can be time-consuming, costly, and present risks to meeting the Day 1 timeline. It opens the door for vendors to start contract negotiations—driving increased one-time transfer costs and

ongoing stranded costs to the seller. Additionally, it may overlook the need to obtain necessary "rights to use" permission to authorize transition services agreements between seller and buyer.

Deloitte's approach helps enable Day 1 business readiness and mitigates compliance risk. The primary components of this approach (which can be customized to meet each transaction's specific requirements) are:

a. Establish vendor communication strategy

b. Obtain "rights to use" for transition period

c. Clone (i.e., duplicate) contracts for the carve-out entity

d. Gain approval for license transfers

This approach frames M&A-driven contract separation as a business event rather than a negotiation. By doing so, it seeks to limit/reduce one-time transfer costs and mitigates for both seller and buyer cost increases resulting from license repurchases or stranded costs. No detailed review of contract terms is required, as this approach is founded on the assumption that both short-term and long-term rights are required by the carve-out. Re-contracting also reduces the need for detailed up-front analysis and reduces concerns that the future intent is not yet known by the business and functional experts. Re-contracting also benefits vendors, as it provides a reason for the carve-out to remain a customer rather than seek an alternative product or service provider. Additional business is likely to follow, as two separate companies will require technology solutions to maintain and grow each business.

Technology assets are worth millions of dollars; protecting that value during and after an M&A transaction should be a primary goal for all parties. By working proactively, fostering a collaborative approach, and treating

M&A-driven contract separation as a business event rather than a standard negotiation, seller, buyer, and vendors can craft a re-contracting agreement that's a win-win-win.

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