

Drafting M&A Transition Services Agreements: Strategies to Maximize Deal Value and Mitigate Risk

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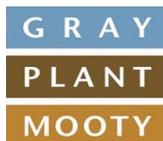
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Transition Services Arrangements: Strategies to Maximize Deal Value and Minimize Risk

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Introduction

This Presentation will:

- Provide an overview of the scenarios which give rise to transition services agreements (TSAs)
- Discuss key provisions to consider in TSAs
- Highlight practical considerations for buyers and sellers
- Discuss select legal and business issues commonly encountered when negotiating transition services agreements
- Review current trends and emerging issues in TSAs

Overview

- What is a transition services agreement?
 - A *temporary* outsourcing or shared service arrangement
 - Between related or formerly related entities, or between buyer and seller
 - Limited duration
 - To provide continuity in operations:
 - While sold business is being integrated with buyer's operations
 - While newly independent company establishes its own capabilities/sources
 - Addresses continuing and/or unfinished service obligations between the parties
 - At arm's length
 - At agreed prices

Overview (cont.)

- Common scenarios in which TSAs arise:
 - Acquisitions and divestitures
 - Spin-off
 - Split-offs
- Nature and scope of services will depend on type of transaction and the parties' respective resources following the closing

Overview (cont.)

- Types of services typically covered by a TSA include:
 - Information technology services/processing services
 - Back office support services (*e.g.*, collections, billing)
 - Insurance administration/claims handling processing
 - Facilities management
 - Human resources (perhaps?)
 - Manufacturing
 - Warehousing/distribution

Overview (cont.)

- Types of services NOT typically covered by a TSA include:
 - Legal
 - Regulatory/compliance
 - Corporate risk management
 - Strategic planning/corporate development
 - Treasury/accounting/banking
 - Human resources (perhaps)
 - Procurement
 - Public relations
 - IP services
 - Investor relations
 - Philanthropy and community outreach

Practical Considerations

- Smooth transition to independence often more important than maintaining higher-than-necessary service levels
 - Value of the underlying transaction depends on a quick and smooth transaction
 - Generally, transition services are a burden on both buyer and seller
 - Often best to allow entities to separate quickly, to focus on their own operations rather than the transition
- Consider ultimate exit strategy post transition services
 - For any given operation, what is service recipient's post transition plan (*e.g.*, outsource, retain in-house, reduce, eliminate)?
 - If the service recipient's plans are to establish a permanent operation in-house, buyer should be more involved during the transition stage

Practical Considerations (cont.)

- Provide specific guidelines regarding the terms, including timeline, cost and level of services to be performed
 - Should understand costs and cost drivers related to the services
 - Reduces likelihood of disagreement or delay during the transition
- Performance metrics
 - Simply stating that transition services should be performed at “existing service levels” may not be sufficient, especially when service provider does not currently measure such standards
 - Use of “true service vendor” style metrics

Practical Considerations (cont.)

- Pre-transaction planning is vital
- Both parties should consider before negotiations begin
 - Consider need for internal confidentiality vs. need for information
- Transaction structure
 - Whole company/stand-alone operation
 - Carve-out
 - Enterprise service model
- Type of buyer will influence scope of services
- Untangling the enterprise structure
 - Assets, contracts and services shared across seller's operations
 - Dedicated "exclusively" to the business
 - Vendor and other contracts
- The issue of stranded costs

Practical Considerations (cont.)

- TSA needs should be first of mind from the beginning of the deal
- Clear communication about how assets outside the business or shared assets will be handled
 - Avoid misunderstandings and negotiating snafus later in process
 - Not always clear or simple
- Vendor and other contracts
 - If not transferred to buyer/target, must the service/asset be provided transitionally?
 - Do the seller's vendor contracts allow a non-affiliate to receive the services?
- Outside counsel can provide coaching and guidance; client legal & business areas have big role

Practical Considerations (cont.)

- Clear guidelines in the TSA are vital to preserve value of the underlying transaction
- TSAs should provide a common understanding of the terms it uses (*e.g.*, what each service means)
 - Often specific services to be performed are contained in exhibits to TSA along with detailed pricing
 - TSAs should specify related services that are not included
- Services exhibit should include *all* services to be performed
- TSAs often include a wide range of operations (*e.g.*, IT, some finance & accounting, etc.), and these operational areas must collaborate to ensure a smooth transition

Practical Considerations (cont.)

- Consider competing interests
 - Acquirer/recipient – heightened interest in more robust transition services from seller
 - Buyer (due to anti-trust concerns) may not have had sufficient access to obtain abundant operational details about the target
 - Will focus on scope of services, service levels, lowest cost
 - Buyer wants smooth, rapid transition and NO interruptions or stoppages

Practical Considerations (cont.)

- Seller/provider – desires to transfer all aspects of divested business to acquirer as quickly as possible with minimal ongoing commitments and liabilities
 - Will be interested in short term agreement, narrow scope, little or no service level commitments
 - Seller wants no distractions from operations it is retaining
 - Anti-trust considerations may have not allowed seller to reveal too much about operations prior to closing
 - Seller is not in the business of delivering services and does not wish to be held responsible as if it were
 - Service transition is part of the “deal” (mindful that any sufficiency representation in the purchase agreement may be qualified by the provision of transition services and carve-out excluded services)

Principal Business Considerations

- Services provided
 - Description of services/statement of work/scope
 - What's delivered?
 - How delivered?
 - When delivered?
 - Knowledge transfer – what is it and how can it be accomplished?
 - The complexity of books and records identification and transfer
 - Personal knowledge of people
 - Data needed to perform
 - Third party providers of services/changes in third party providers/ability to subcontract

Principal Business Considerations

– Subcontracting

- Subcontracting
 - Common Provision: *Each Recipient hereby consents to Provider's continued use of any Subcontractor to perform any Services that such Subcontractor was providing as of the Effective Time. Provider may engage one or more Subcontractors to perform any or all of its obligations under this Agreement; provided that if Provider engages a Subcontractor primarily to perform Services under this Agreement, Provider must obtain Recipient's prior written consent to use such Subcontractor to perform the Services, which consent shall not be unreasonably withheld, delayed or conditioned. Subcontractors engaged by Provider to provide services must go through Provider's standard engagement process, including, to the extent applicable, conducting background checks. Notwithstanding anything to the contrary, Provider shall remain responsible for the performance, in accordance with the service levels, quality and costs set forth herein, of any Service performed by a Subcontractor.*

Principal Business Considerations

– Omitted Services

- Often in the speed/complexity of a transaction potentially applicable services may be omitted
- Look-back period
- Is seller compelled to provide?

Principal Business Considerations – Omitted Services (cont.)

- Drafting can contemplate this eventuality as follows:
 - *If (i) a service, other than an Excluded Service, was provided to the Target Business by Provider, or a third-party service provider prior to the Signing Date, but was inadvertently omitted from Schedule of Services (an "Inadvertently Omitted Service"), and (ii) Recipient desires that Provider or its Subcontractors perform such Inadvertently Omitted Service hereunder, Recipient may request that Provider provide or cause the provision of such Inadvertently Omitted Service. In the event that Provider provides or causes the provision of such Inadvertently Omitted Service, such service shall thereafter become a "Service" hereunder and the Service fee for such Inadvertently Omitted Service, will be calculated consistently with **[the methodologies used to calculate other Service Fees hereunder]**.*
 - Sellers/providers however need to be mindful of the interplay of this type of provision and the "sufficiency" and similar representations in the acquisition agreement.

Principal Business Considerations

– Other Provisions

- Other services – related items
 - Service recipient obligations
 - Reporting/billing
 - Any reverse services required?
- Term
 - End date
 - Incremental termination of services
 - Extension of term (unilateral right or mutual agreement)
 - Disincentives to term extension

Principal Business Considerations – Other Provisions (cont.)

- Performance standards/service levels (SLAs)
 - Metrics/standards applicable to performance (historical performance, best efforts, others?)
 - Measurement regime/computations
 - Financial impacts (possible “credits” for deficient performance)
- TSA governance/transition leaders
 - Not boilerplate provisions
 - Consult clients to document realistic governance (and dispute resolution) processes
 - Balance details with need for flexibility

Principal Business Considerations – Other Provisions (cont.)

- Price
 - Flat fee for all services – more typical of very limited services, limited duration
 - Fee per specified service (often usage driven)
 - Basis for price:
 - Cost-based (disclosure of costs incurred, stranded costs)
 - Fair market value
 - No charges
 - Out-of-pocket/pass through
 - Adjustments to price
- Payment Terms
 - Frequency
 - Accounting
 - Audit right
 - Interest for late payment

Drafting the Fee Provisions

- Drafting the Fee Provisions
 - Common Starting Point:
 - *As consideration for provision of the Services, Recipient shall pay Provider the amount specified for each Service on such Service's respective Service Exhibit. In addition to such amount, in the event that Provider incurs reasonable and documented out-of-pocket expenses in the provision of any Service, Recipient shall reimburse Provider for all such out-of-pocket costs For such time as any employees of Provider are providing the Services to Recipient: (a) such employees will remain employees of Provider and shall not be deemed to be employees of Recipient for any purpose, and (b) Provider shall be solely responsible for the payment and provision of all wages, bonuses and commissions, employee benefits, including severance and worker's compensation, and the withholding and payment of applicable taxes relating to such employment.*

Drafting the Fee Provisions

- Depending on the negotiated deal, the following items may also need to be contemplated (or consciously excluded):
 - Retention bonuses for key personnel, if any
 - Premium rates for outside contractors/sub-contractors, if any
 - Payments in lieu of taxes
 - All taxes (or payments in lieu thereof) exclusive of income and similar taxes
 - All or a portion of administrative, rent or allocated overhead costs (often by reference to historical cost or specific formula)

Drafting the Fee Provisions (cont.)

- Alternative provision:
 - *"Service Fee" means for any Service, collectively (a) the applicable Provider's fully loaded historical cost (as determined by reference to such historical cost in effect immediately prior to the transaction and including but not limited to all wages, bonuses, incentive compensation, employee benefits, workers compensation and other similar types of charges assessed at the employer level, and allocated enterprise overhead and similar expenses) to the Target Business for such Service, and (b) the cost of all retention bonuses or other payments to be paid to any employee or contractor who is being retained by Provider for the sole purpose of performing Services to Recipient (which may be allocated across all of the Services being performed hereunder by such employee or contractor).*

Principal Legal Issues

- Representations and Warranties
 - In TSA or in principal transaction agreement?
- Excused Non-Performance by Provider
 - failure by Recipient to comply with its obligations under the Agreement
 - material defects in the timeliness, completeness, accuracy and quality of applicable information provided by or on behalf of Recipient
 - changes in applicable law
 - performance of any service that would require Provider to violate law
 - system re-configurations or modifications requested by Recipient
 - failure by Recipient to approve certain specified costs—*e.g.*, certain retention bonuses to employees or subcontractors, third party consent costs, etc.
 - failure by Recipient to approve certain subcontractors
 - Force Majeure event

Principal Legal Issues (cont.)

- Liability for contract defaults
- Cap/limits on liability
 - Note relation to principal documents
 - Exclusion of certain damages
 - Offset right
 - Total cap on liabilities
 - Applicable to third party claims
- Possible exclusions from limitations:
 - Breach of confidentiality
 - Intentional refusal to perform
 - Indemnification obligations
 - Performance under TSA
 - Third party damages
- Dispute resolution
 - Escalation
 - Arbitration

Principal Legal Issues (cont.)

- Possible Indemnities
 - Infringement
 - Claims resulting from a breach of confidentiality obligations
 - Information Sharing and Cyberbreach
 - Claims resulting from a breach of the TSA's intellectual property provisions
 - Claims resulting from supplier's intentional refusal to perform
 - Claims by third-party providers arising out of a breach of third party contracts
 - Claims for increase in fees payable to third party providers
- Note relation to principal documents

Limitations on Liability – Drafting Considerations

- Common Provision:
 - *Limitation on Liability. In no event shall Provider have any liability under any provision of this Agreement for any punitive, incidental, consequential, special or indirect damages, including loss of future revenue or income, loss of business reputation or opportunity relating to the breach or alleged breach of this Agreement, or diminution of value or any damages based on any type of multiple, whether based on statute, contract, tort or otherwise, and whether or not arising from the other party's sole, joint, or concurrent negligence, strict liability, criminal liability or other fault.*
 - These limitations might differ from those under the purchase agreement
- Other common exclusions:
 - Matters consented to by the Recipient
 - Limitation provision does not apply to third party claims
 - Total cap on non-third party damages

Indemnification – Drafting Considerations

- Common Provision
 - *Indemnification. Provider shall indemnify, defend and hold harmless Recipient and its Affiliates and each of their respective Representatives (collectively, the "Recipient Indemnified Parties") from and against any and all Losses of the Recipient Indemnified Parties relating to, arising out of or resulting from the gross negligence or willful misconduct of Provider or its Affiliates or any third party that provides a Service to Recipient in connection with the provision of, or failure to provide, any Services to Recipient.*
 - Should indemnification be mutual?
 - Losses “to the extent of”
 - Differing Standards of Conduct (*i.e.*, short of gross negligence)
 - Bifurcation of direct claims versus third party claims
 - Duty to mitigate
 - Sole Remedy
 - Coordination with principal transaction agreement

Emerging Issues

- Cyber-Security/ Information Protection
- Data Backup
- Changing Regulatory Environment

Key Takeaways

- Plan ahead – prior to and during the diligence process
- Identify TSA team
- Not just a lawyer's exercise – must work hand-in-hand with the TSA team
- Be nimble

Speaker Information

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- Mark practices in the areas of business, corporate, and securities law, with a focus on mergers and acquisitions. He serves as Co-Chair of the firm's Mergers & Acquisition Team. He has experience representing both public and private companies and private equity funds in various corporate transactions, including mergers, acquisitions, public and private offerings, tender offers, and debt financings.

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