Making the Transition – Key Legal Issues and Risks in IT Transition Services Agreements

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Introduction

Transition service agreements are an accepted and well used solution to the practical and challenging realities faced by companies who have just completed an M & A transaction and who need to separate their IT systems, data and business processes from each other. However, reaching for the transition service agreement will not always be the best or the only solution for a company facing post deal separation issues. In fact, there are many legal risks and operational constraints inherent in the transition service agreement route. Early strategic thinking about the various options available to a company in the post deal environment will help highlight alternative approaches which in some cases may prove to be easier and less risky than a transition services arrangement.

The Transition Service Agreement

The drive to constantly improve efficiency and reduce costs means that in many cases, group companies will have centralised a number of their core business processes. These may be centralised into multi service "shared service" centres or centralised according to function but not necessarily in the one location (e.g. IT services provided from Melbourne whereas HR support across the group companies provided from Sydney). These services may also be outsourced entirely to a third party provider, partly outsourced (such as in a payroll bureau arrangement) or provided entirely using in-house resources – this article focuses solely on the latter with the previous two scenarios having their own particular complexities in the event of an M & A transaction, which is the subject of a separate article in itself.

Typical examples of such centralised processes include payroll and HR, finance and accounting, procurement and the broad category of IT services. Once an M & A deal is complete the vendor and the purchaser may find themselves in a situation where a service which they previously took for granted is no longer available due to changes brought about to a company's operations post completion. For instance as part of a business/asset sale an entire IT department may be sold as part of the transaction, leaving a company devoid of essential IT services. Or, a purchaser may acquire an entire IT department and IT estate as a result of a share acquisition without necessarily acquiring core business processes such as finance and accounting functions or payroll which may remain with the vendor and the retained companies. The transition service agreement attempts to fill this gap by providing a temporary "business as usual" solution.

A transition services agreement is a contract between the purchaser and the vendor for the provision of a range of services on a temporary or transitional basis. The chief aims of this arrangement are to maintain a business as usual environment post completion and to provide a structured framework for the parties to disentangle and separate systems, data, people and processes in an orderly fashion. At the end of the transition services arrangement, all having gone to plan, the parties can safely go their separate ways and each will be able to operate independently of the other. Sometimes a transition arrangement will involve a one way flow of services but in other cases it can involve a mutual or two way flow of services. In each case this will depend upon the unique features of a particular M & A transaction and also upon the way a company is organised and equipped post completion to provide these services to itself. Fees are charged by the provider of transition services but almost always on a cost recovery basis and not with a view to making any profit out of the arrangement.

The temptation for the lawyer faced with the task of drafting a TSA, is to grab a standard IT services/ outsourcing template and use that as a base. Fine, provided it's understood that many of the provisions will not be applicable or appropriate in the context of transition services and will require adjustment. On the one hand the party providing the transition services will take the position that it is not a commercial IT service provider and it is providing the transition services as a kind of favour to the other party. On the other hand, the party receiving the transition services will often try to seek some of the comforts customers normally seek in traditional outsourcing arrangements, such as prescriptive levels of service and attendant financial remedies such as service credits if such levels of service are not met. After all they argue, they are paying for a service. This is the tension which needs to be balanced and worked through in the TSA negotiations.

In reality there are many reasons why transition services arrangements cannot be approached in the same way as a conventional IT services delivery arrangement. Firstly it is true to say that the service provider is usually not in the business of providing the transition services on a commercial basis. The service provider's only experience of providing the transition services will have been confined to providing these services to related group companies and business units. Secondly the services will usually be provided on an "as is where is" basis with no promise of enhancement or no road map for change or innovation. This principle is usually essential to the service provider who has more than likely pursued a strategy of moving toward greater operational efficiencies and who does not want to be obliged to upgrade technologies, employ more staff or purchase more resources. Thirdly, this is not intended to be a long term relationship as is the case with many IT and business process outsourcing transactions. In the majority of cases a TSA will be in place for no greater than 12 months but the usual length is around 6 months.

Key Legal Issues and Risks

This is not to say that TSAs are straightforward arrangements without risk or even potential legal liability. When dealing with complex and dynamic IT infrastructure, systems and confidential data, the level of risk can escalate particularly in transactions which may have one or more of the following features:

- the transaction is cross border and multi-jurisdictional with transition services being provided from or to dispersed geographical sites throughout the world;
- the transaction involves a break-up sale scenario, where multiple parts of a company are being sold and there are multiple purchasers;
- where IT systems across business units are very tightly integrated and data is held in common databases;
- where existing third party IT and telecoms contracts provide for significant break costs or the charging structure is based upon volume bands which could "penalise" a customer if volumes suddenly decrease;
- where staff attrition rates for a particular service are high and there is a risk that the transition service provider's resource pool may need to be augmented by temporary backfill labour which may be costly. This can often be the case with high demand IT skill sets.

The issues and risks which typically arise in TSA negotiations include the following:

- **Term of the agreement** – tensions can arise here between the operational needs and goals of the vendor and the purchaser. The transition services recipient will likely want the term of the TSA to be relatively flexible with an ability to extend, whereas a transition service provider with a committed strategy to either scale back or reduce its commitments to providing transition services (consistent with its own internal drive towards increased operational efficiencies) will want to know there is a definite end date. The key risk from the transition service provider's perspective is that the longer the TSA is permitted to run the less motivation a recipient will have to throw all its energies and resources behind a swift disengagement.
- **Costing model** – given the short term and temporary nature of transition service arrangements, a service provider will want to keep the charging mechanism and any associated reporting or administrative obligations in the transition services agreement as simple as possible. In contrast, the recipient of the transition services will usually want a bit more granularity in the charges particularly where the charges being paid are not insignificant, or where there are time and materials or pass-through components. Additionally, a recipient may not be content to be locked into an "all or nothing" pricing model when they anticipate being able to cease use of all or significant parts of a service prior to the end of the transition service agreement. In such cases they will tend to argue for a reduction in the charges commensurate to a reduction in their consumption of the services. This may be a sore point of contention for the service provider who may validly argue that the only reason they have maintained a particular sized resource pool (people, equipment and contracts) is to provide the transition services and meet its contractual commitments under the transition service agreement. Although the service recipient may scale back its use of the transition services it does not always follow that the provider can turn off resources like a tap and so may be left with costs it has to absorb itself.
- **Changes to systems and services** – how much freedom should the service provider have to make changes to the method of delivery of the services? In conventional outsourcing arrangements there are usually constraints around a provider's ability to change key personnel, systems and processes with a robust change control procedure and service level and service credit regime providing the ultimate financial stick for performance suffering as a result of any provider initiated changes. The same principles do not work in TSA arrangements (see the comment on service levels below) and once again there is a fine balance to be struck between a service provider's ability to fulfil its loyalties to its own group companies' strategic directions (which might include downsizing the very resources used to provide the transition services) versus a service recipient's desire to keep the services in as steady a state as

possible as it makes the transition towards independence.

- **Personnel issues** - most M & A transactions will bring with them a degree of uncertainty amongst personnel of the vendor and purchaser regarding future staffing issues and changes. For the provider of the transition services, staff instability or attrition may pose a risk to it being able to deliver according to its contractual commitments under the TSA. This is especially exacerbated if transition services personnel feel that they are only fulfilling a temporary function and could face redundancy once the transition services arrangement comes to an end. In such cases the temptation to look elsewhere for more stable employment could leave the transition service provider with no other choice but to backfill using temporary and potentially expensive contract staff. Early thought around designing appropriate retention incentive schemes and early engagement with relevant staff may help reduce the impact of this risk.
- **Service levels** – in conventional services and outsourcing contracts it is common for a customer to commit the service provider to perform the services to contractually binding service levels and to attach service credits (payable to the customer) in the event of the provider's failure to meet the service level. Although it is possible to have some provisions in a TSA regarding the level of service to be provided to the recipient, it will not be appropriate to have a detailed service level and service credit regime. Firstly, a service credit regime is a device used to incentivise good performance from a service provider because it will affect their revenues and ultimately their profit. Given that a transition service arrangement is not a typical commercial transaction entered into with a view to making profit, a service provider will have no incentive to provide the transition services if full recovery of its costs is in some way jeopardised. Secondly, a detailed service level and service credit regime is difficult to work up, takes time to negotiate and involves significant administrative resources and time to administer and report against. None of this sits comfortably within an arrangement which is meant to be swift and short term.
- **Data security** – the storage and processing of confidential and other company data in a shared service arrangement which is wholly within a company group does not pose the same risks and challenges as the storage and processing of data which occurs between two non-related entities. Whereas a commercial outsource service provider will have the experience and technologies to physically or virtually keep separate and secure the data it stores and processes on behalf of its many customers, this will not always be the case with a provider of transition services. The situation becomes even more complex in the event of a "break up" sale where there are multiple purchasers of different parts of the sale companies. In such a case, these purchaser will rightly want assurance that there are robust systems and mechanisms in place to ensure the separation and confidentiality of highly sensitive business data.
- **Third party consents**– compliance with existing licensing and telecoms terms and conditions is sometimes a legal risk which is overlooked or worse, ignored in the provision of transition services. Although there may be a well intentioned temptation to allow the service recipient access and rights of use in relation to certain business applications and use of IT and telecoms infrastructure this will often be in breach of those terms and conditions given that the original rights of use will have been confined to companies within the group and non-related entities. Many large software vendors are vigilant about policing licence compliance and more often than not will be aware of the M & A transaction and therefore more likely to be looking out for licence transgressions. The consequences of non-compliance can be costly for the service provider so it is essential to be upfront in the TSA about the constraints around what applications and infrastructure can be made available to the recipient as part of the transition services.
- **Cross-border complexities** – the complexity and risk around all of the above issues can be intensified if the provision of transition services takes place across multiple geographies throughout the world. Take for instance the issue of compliance with data protection laws. If a particular service is to be provided to an entity from an offshore location then it follows that this could (and in the case of HR and payroll services it almost always will) involve the transfer of personal data for processing to a transition service provider in the offshore location. Depending on the offshore location and the adequacy of local data protection laws, the processing of such personal data at the offshore location could result in a non-compliance with applicable data protection laws. Currency and local taxation issues may also need to be treated on a country by country basis with the result that transition services may be charged for in several different currencies.

Outsourcing – An Alternative Approach

A TSA is not the only, nor necessarily the best way, to deal with the complex issues of separating the businesses of the vendor and purchaser following completion of an M & A transaction. One alternative approach is for the potential transition service provider to consider outsourcing a function rather than making it the subject of a transition services arrangement. For instance, if a vendor in an M & A transaction anticipates that it may be asked by a purchaser to provide IT and finance and accounting functions on a transition basis from completion, then it could consider outsourcing these functions to an outsourced service provider prior to the completion of the corporate transaction. This approach has the potential to reduce or even eliminate a number of the risks identified above and some of the advantages of taking this route include:

- the need for a transition services arrangement and a migration and disengagement strategy between the vendor and the purchaser is removed because post completion, the separated entities simply become customers of the same outsource provider. Migration of a function to the outsource provider will take place before the M & A transaction is complete and this will involve the transfer of assets and staff to the outsource provider. The outsourcing agreement will of course need to make provision for what happens in the event of a sale (as indeed in an acquisition) but such provisions are now an accepted part of outsourcing practice; and
- an outsource provider brings a core expertise and track record in providing IT and business process services which will heavily outweigh that of the potential transition service provider whose core expertise and experience will not necessarily be in such areas.

Outsourcing may not be a route which automatically appeals to all companies facing the prospect of an M & A transaction. After all, the preparation of a business case, engagement of relevant stakeholders and the procurement process itself may not follow smooth and uncomplicated paths. However, provided there has been a rigorous examination of a business case for both options (transition services or outsourcing) then a company is in a better position to analyse the relative costs and risks of both approaches and will be best placed to make an informed choice rather than just automatically opting for the transition service approach.