Outsourcing & Demerging

Traps & Opportunities

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Introduction

A divested entity is either a business unit, department, division or wholly owned subsidiary that is "gotten rid of" by its parent organisation. The "getting rid of" may entail selling (in its many forms including Management Buy-Out), forming a new subsidiary and moving some or all of the assets of existing entities into the new entity, restructuring the business, insolvency or just a simple case of ceasing to trade.

"Demerging" – the new buzz word

The new buzz word is "demerger" and the Treasury and the ATO have agreed to more than 50 changes to the new demerger legislation making corporate restructures tax effective. Apparently many of Australia's top groups are looking to restructure under the new tax rules. There are still issues to resolve such as the treatment of employee shareholders, however, we should expect to see even more industry restructures occurring before too long.

Outsourcing contracts and divested entities

And before those of you in Government think that this is purely a commercial issue – think again. Just recently we were talking to inmates of a State Government Department who were bemoaning the fact that they couldn't really consider technological rationalisation as, the minute the Government changed, the group would go back to being a number of individual departments with their own specific requirements. In other words, the group would demerge.

Now why should we be concerned about this? On three separate occasions in the last year we have been presented with problems relating to the deconstruction of outsourcing agreements upon corporate restructure. In most instances the contractual wording was woefully inadequate to protect either party and in one particular instance (dealing with a supplier) we just shook our heads and asked them why they signed the contract. We were told that they did their risk analysis and didn't think that the customer would restructure – they were doing so well! Just goes to show – you never can tell and, with the Government making it attractive to demerge, its probably wise to ensure that there is adequate protection in any contract.

Divested entities – what are customers trying to achieve in contracts

Having spent the time and cost of going out to tender, selecting a preferred supplier and negotiating the final agreement, most customers want to protect the benefits they believe their agreements with suppliers give them. This will invariably include negotiated fees (usually at a preferential rate based upon economies of scale), administrative and relationship services. What we have seen them try to do is to attempt to tie the supplier to delivering services to any future divested entity at the same advantageous rates and benefits as agreed to in the existing contract. Sometimes its used as an enticement for future purchasers – the administrative services are already being provided and the cost is known.

What's wrong with that we hear you say. Well experience has shown us that there's nothing wrong with the intent but there's plenty wrong with the way we have seen contracts structured to cater for this. In order to help you with this issue we thought it would probably be most effective if we took some actual words from an actual contract and discussed the issues in each clause. So that is what we have done below – with apologies for the legalese but that's how lawyers draft things.

PS – we would normally recognise copyright by quoting the lawyers that drafted any clause we use but in this instance we do not think they will thank us so we haven't.
PPS – we'd like to hear from any of you who have stories to tell relating to this phenomenon.

Divestitures: Clause 1(a)

If Customer divests any Customer entity or if Customer or a Customer entity divests itself of any business unit during the Term and requests that Supplier continue to provide any specified Services under this Agreement to the divested Customer entity or business unit (or successor in interest thereto), then Supplier shall provide the divested Customer entity or business unit (or successor in interest thereto) with those Services designated by Customer for up to 24 months following the date of divestiture at the Fees then in effect under this Agreement.

What's wrong with this?

1. A divested entity may become an entity separate to the parent entity. This clause does not recognise the legal implications of that event. Should the supplier agree to this with no changes then which entity will be liable for payment of fees? Will the supplier continue to bill the original entity or the new one? And if the supplier bills the new one – under what agreement will the services and fees be covered?
2. 24 months is a long time – especially in this day and age when many outsourcing agreements have terms of only 3 years (some as little as the 24 month extension requested here).
3. There is no time limit up to when this clause may be invoked. The parent entity may have, for example a four year agreement and may divest in the last year of that agreement. According to this clause the supplier has got to provide services for 2 years some of which time will be beyond the original term of the agreement. Thus the agreement has expired - there is no agreement in force to protect either party!
4. This clause does not recognise that divestment destroys economies of scale. The supplier could well be left with a number of small uneconomic deals. Whilst the customers may think they have "got one over the supplier" experience shows that whenever a supplier is forced to deliver services at a loss or at an uneconomic rate then service quality suffers.
5. Following from the "*same fees*" issue – this clause does not recognise that there will be costs to the supplier: two sets (or more) of reports, management meetings, analysis, customer satisfaction surveys, etc. The theory that if you don't alter the underlying numbers of people and infrastructure being supported then the costs should remain the same doesn't hold true in practice. Administration takes time and resources and costs money and the new entity should shoulder that additional cost.

How to fix the clause

- Insert wording to the effect that the customer will work with the supplier and the new entity to negotiate a satisfactory agreement between the supplier and the new entity based upon the terms and conditions of the existing agreement.
- Provide for the original entity to remain liable for all fees for a shorter period of time to accommodate contract negotiation.
- If the request is for a short period of time e.g. up to 6 months (no more) and the original entity remains liable for the fees then it should be OK to ask for the fees to remain the same as those currently in force.
- The new entity may have to accept that if new infrastructure needs to be put in place to facilitate the delivery of services e.g. new comms lines, then the new entity will have to pay for this.

There is no satisfactory argument to attempt to force the supplier to assist with the funding for a customer's restructuring – the cost of delivering support services to the new entity should be factored into the strategic planning and decision-making processes relative to the demerger.

Divestitures: Clause 1(b)

Upon notice from Customer that the Services shall be terminated with respect to the divested Customer entity or business unit, Supplier shall provide the Termination Assistance Services requested by Customer in accordance with Clause ??. There shall not be, and neither Customer, any Customer entity nor the divested Customer entity or business unit shall be liable for, any charge or fee relating to the termination of the Services previously provided the divested Customer entity or business unit.

What's wrong with this?

1. On the surface this looks OK. However, this clause does not identify who will be liable for the costs incurred in delivering the Termination Assistance Services. One could assume that it is the original entity but assumptions are dangerous when dealing with contracts and money. There is no reason why the supplier wouldn't provide these services if the supplier is paid to do so. Unfortunately the contract clauses referred to above were also a bit vague on the "who pays for what" situation. With contracts its best to clearly state what you want as any ambiguity may be used against you as well as in your favour.
2. Also, the hooky at the end of the clause about no liability for charges or fees relating to termination of services is directly contrary to the provisions in the contract for Early Termination. What the lawyers are trying to do here is say that a divestment is different to an Early Termination for no cause. We don't see it that way. An unscrupulous customer (and there are some) could well restructure their organisation and move assets from one business unit to another terminating services for the new business units. Essentially this clause, taken to its extremes, allows for constructive termination and the avoidance of Early Termination for no cause fees. We are sure that most organisations would not want to restructure just to avoid termination fees. However, one such deal we were asked to assist with recently involved the customer performing a number of shareholder-enforced corporate divestments in rapid succession. In that instance the result was virtually a constructive termination forced upon both supplier and customer by the shareholders (and it wasn't anything to do with the quality of services – it was a strategic issue).
3. A partial termination of a contract will affect supplier profitability and the supplier should be given the ability to renegotiate remaining services so that they remain at least profitable.

How to fix the clause

- Clarify who pays for the Termination Assistance Services.
- Make provision for the supplier to renegotiate remaining service fees if the divestment results in a reduction from the baseline of users and infrastructure supported of a nominated percentage (we have seen anything from 10-30% - its your choice). In fact, clause (c) below does allow for that in the last sentence – but the wording belongs in this clause not in that one which relates to transfer or assignment of rights and licences.
- Pay the supplier early termination for no cause fees if the divestment results in a reduction from the baseline of users and infrastructure supported of a nominated percentage.
- Make some provision that if divestments in aggregate over the life of the contract reduce the baseline to a nominated percentage then the supplier may request that the contract be terminated early for no cause. This recognises the ability of the customer to constructively terminate via divestments and partially recompenses the supplier. (Early Termination for no cause fees usually end up being about 6 months costs.)

Summary

The lessons to be learned from this are that, before you enter into any form of outsourcing agreement, make sure you have all the alternatives covered. The one thing to be learned from the past is that the future won't necessarily be like the past. Scenario planning can help here, playing "what if" scenarios to see what might happen in the future. This sort of planning is important for both organisations and vendors, yet we see many of them assuming the future will be a repeat of the past. Recent history has shown this to be wrong.