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VALUE LEAKAGE

Mitigate the Risk of Value Leakage: Choosing the Best Path Forward in a Divested ITO Relationship

ISG

INTRODUCTION

The proactive CIO can plan ahead as sourcing relationships are undertaken.

One of the challenges facing many CIOs is managing services contracts when parts of their organization are split off because of a merger, acquisition, divestiture, or joint venture activity.

When faced with this kind of major organizational change, the CIO will likely need to decide the appropriate action for the outsourcing contracts in place. This paper explores some of the questions that may arise when a majority share of some part of the organization is "spun off" to a third party, such as the sale of an operating division or subsidiary. In addition to having to react to these events as they occur, the proactive CIO can also plan ahead as sourcing relationships are undertaken, so they will be better positioned to retain the value of these relationships in the face of future equity events.

BACKGROUND

Many IT contracts now are structured as global agreements, with commitment and pricing based on volumes across regions and business units in place at contract signing. This situation may increase the risk for value leakage when a sector or division is split off. Let's look at examples:

1. Loss of client volumes attributed to the divested entity may expose the client to re-pricing or loss of leverage.

2. Breaking free of the host, the divested en¬tity may no longer be party to the contract and may lose any benefits attributed to it.

3. One or both parties may be subject to claims of increased cost from their service provider(s).

Thus, the question arises as to how to retain maximum value of the original outsourcing agreement, as well as the value of the division being sold.

When a global client of ISG's agreed to sell a majority stake in its financial services division to a private equity firm in 2006, more than a dozen different global service contracts required some sort of action in relation to the "new organization." These actions took the following forms:

1. **Assignment** – Rights were assigned to the new organization as a separate contracting entity.

2. **Participation** – The new organization remained an "arm's-length" customer of the original parent.

3. **Termination** – The new organization had no interest in the services involved.

4. **No action** – The contract went "in whole" to the new organization with the original parent retaining no service relationship with the service provider.

In order to consider contractual options and execute separation, two virtual teams were established — one within the "host" and one within the new organization. These teams were charged with dealing with the other party, as well as collectively dealing with the service providers, while presenting a "single face." This illustrates a "cooperative adversaries" strategy where the host and the new organization naturally have diverging interests at times, yet both must cooperate in order to protect the value of the sourcing contracts and complete the transaction and the subsequent separation.

The acquiring entity — whoever ends up the owner of the separated unit — has an interest in ensuring the viability of the acquired organization, and it may have recourse back to the original parent if the operational integrity of the new unit is compromised as a result of problems with IT service contracts.

Considering how the outsourcing contract language deals with rights of assignability is imperative.

CONSIDERING THE OPTIONS

As the CIO prepares for a pending divestiture, considering how the outsourcing contract language deals with rights of assignability is imperative. In general, ISG considers it a best practice to include rights of assignability (to affiliates) in a services contract. This enables the contract to be extended to an "affiliate," whether it is one that split off from the host organization or a new division coming in by way of acquisition.

Another critical element of contracting is defining what constitutes an affiliate. The resulting definition should be structured to provide for the most likely scenarios the client will face. (Note: ISG encourages clients to seek legal counsel to ensure these contractual rights are included when preparing a new agreement or in evaluating current agreements).

Depending on how the service contracts were structured, a number of different scenarios may result:

1. The contract is perfectly aligned and goes along with the split-off portion in a clean break. (No action is necessary).
2. The divested entity is not a functional party to the services contract; the contract may need to be terminated. (This is another area requiring special legal review).
3. The divested entity constitutes some portion of the user base and hence, the statement of work (SOW). Therefore, the divested entity can be clearly and distinctly defined as a new contracting entity. (The contract is "partially" assigned to the new and separate entity, with a portion being retained by the original parent).
4. The divested entity constitutes some portion of the user base, but ***cannot*** be clearly and distinctly defined. (The contract is assigned, with scope partition to follow).

Entity relationship to host	Likely contractual remedy
Contract owned by divested entity →	Minimal or no action necessary
Divested entity not a party →	Minimal or no action necessary
Divested entity a clearly defined portion →	Partial assignment
Divested entity a party, but without clear delineation →	Partial assignment, with disintegration

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In the latter two situations, a secondary decision must be made concerning whether to "assign" the contract or to "participate" in the contract. Without venturing into the finer legal points of distinction, participation means "business as usual." The host organization remains the sole contracting entity, and the divested entity simply constitutes a segment of the user base, possibly sharing costs with the host.

"Assignment," on the other hand, means the divested entity becomes a second, independent contracting entity. The divested entity has its own version of the service contract, which excludes the scope that is no longer relevant, such as a "partial" assignment.

EFFECTING THE CHANGE

Notification

It is highly recommended that the relevant service providers be notified of the possible assignment as early as possible. Legal review should be sought on the notification letter, which should refer to the following:

1. Any assignment rights in the existing contract
2. Any conditions (e.g., "conditional on the expected sale of division XYZ . . . ")
3. The expected effective date of assignment

At the same time, however, the notification letter should allow for flexibility in changing that date or in dispensing the assignment altogether if the situation should change.

Change in Scope

Someone very familiar with the existing contract documents should examine them for possible scope separation, when the parent retains certain scope and other scope goes with the separated entity. For shared resources or services, this may require substantial negotiation between the parent and the separated entity to ensure that all requirements are met and to ensure that costs and resources are shared equitably.

Once the separation event is a certainty, a second letter should be sent to the service providers, laying out the detailed changes to the contracts and seeking service provider input. This will almost certainly result in the need to arrange service provider meetings, in which it is essential to deal with any legal issues quickly and decisively. After that has been achieved, meetings also can be very helpful in focusing precisely on the scope of the service contract and how that scope should be separated.

Change Controls

The agreed-upon scope changes should be made by a series of change controls, with one set to remove separated entity scope from the parent's documents and the other set to remove parent scope from the separated entity's documents. The complexity of this effort should not be underestimated; however, after the legal framework for assignment has been established, it should not be necessary to use legal staff to do this work.

The client has considerable work to do to precisely define respective changes in scope in the various contracting documents.

Assigning the contract essentially means "cloning" the contract onto the split-off entity, whereby the split-off entity becomes a distinct contracting entity. At the instant of assignment, the two contracts are virtually identical (except for their respective scopes). The client has considerable work to do to precisely define respective changes in scope in the various contracting documents (such as site list, user list, reports, applications list, etc.).

A strategy of "ring-fencing" (or "cordoning off" in a contractual manner) any additional changes to the contract for some period of time generally reduces the risk of additional cost demands by the service provider, who may otherwise presume significant duplication (or divergence) of effort.

RISKS OF CHANGING THE SCOPE OF SERVICES

When the decision has been made to assign a services contract to the "outgoing" affiliate, communication to the service provider is critical. Service providers may naturally tend to view this event as a cost driver, fearing they will now have "two of everything" (change process, gold build, review board, account liaison, etc.). One way to mitigate this exposure is to clearly position the assignment in terms of "as is, where is." In other words, the scope of services of the statement of work now literally comprises two segments. In fact, there are now two contracting entities, but the sum of the two parts is precisely the same as the original.

Clearly, it may be necessary to make some changes, such as service-level reporting for the distinct entities or the approval of change controls. Yet, these can be handled through change controls — which enable a very deliberate and measured response from both parties— with a transparent discussion on the possible cost impact of each change, one at a time.

GOVERNANCE AND REPORTING

Depending on whether the transaction is a partial or a full divestiture, either a supplementary governance model or a whole new process will be required. In the former case, the divested entity (and its majority owner) must ensure that their interests are represented in such matters as service level management. Both the host and the divested entity must also determine what items of governance will be separately managed and what items will be dealt with "behind the scenes" (with a single point of service provider interface and no obvious impact on cost).

Several of the more meaningful Service Management & Governance issues that must be dealt with are as follows:

Critical Service Levels (CSLs) – Ideally, the original contract dealt with assignability to the extent that critical service levels are automatically carried over to the new segments. In many recent engagements, however, the contract is vague at best on this point, or the divested entity was not previously called out as a unit of measure for purposes of service-level reporting. The best-case scenario is that the new entity was clearly defined, with service levels in place as a standalone business unit. In most cases, however, a client will face at least negotiating additional reporting and the associated costs.

Small sample sizes can occasionally pose another hurdle. For example, before divestiture, a CSL may be assigned to resolve a percentage of certain events (e.g., 99.5 percent) within "x" amount of hours. The service provider, however, may be faced with a situation where the new entity experiences so few events that a single failure places them in default — a level of exposure generally not considered best practice. One way to deal with this is to negotiate a rolling accumulation of events over several months, so that a single failure would not constitute default.

The major objective is for the client to have the same level of service assurance "as a separate entity" that the original contract provided.

Additionally, with a new mix of CSLs in place, the allocation (weightings) of particular CSLs (and categories) should be examined to ensure that the appropriate amount of revenue is at risk. The major objective is for the client to have the same level of service assurance "as a separate entity" that the original contract provided.

One-Time Deliverables – So-called "critical deliverables" are more a point of negotiation between the host and the new owner of the split-off entity. Often, this is a fairly simple exercise since certain deliverables are clearly either "owned" by the host or by the business segment. Failing that, an allocation of the credit based on relative makeup of the contract (percent of seats, ratio of users, contract value) usually provides a satisfactory solution.

A documented agreement should be reached to determine who is responsible for confirming satisfactory deliverables completion, with time frames, escalation protocol, and reporting of results.

Aside from allocation of credits, a documented agreement should be reached to determine who is responsible for confirming satisfactory deliverables completion, with time frames, escalation protocol, and reporting of results.

Other Reporting – The typical information technology outsourcing (ITO) contract contains a host of particular reporting requirements. Pursuant to the divestiture, the client is advised to conduct an examination to determine the relevant reports and the incremental reporting requirements that may be imposed. A default position for the client may be "all same," which is when all the operational, financial, or performance reporting as originally called out is expected for the new entity "of and by itself." Service providers can reasonably expect some compensation if the event was not otherwise anticipated in the contract. This expense can be mitigated by not allowing users to take advantage of the event by asking for everything on their wish list.

LAYING THE GROUNDWORK FOR FUTURE DIVESTITURE

A divestiture will be much easier to accomplish if preparations are made beforehand. The following are some suggestions:

1. Are there any divisions or business units that you could imagine separating from the parent company for any reason? (This question should be asked to senior executives only).

2. When gathering scope information for outsourcing activities, preparations may be needed to have assets assigned to the appropriate business unit or division (e.g., for physical locations, applications, equipment, or software; and pull-down menus may be needed that include division title).

3. The same groundwork may be needed with geography as the data key. This makes it possible to extract Division A in Europe from Division A in North America, for example.

4. Assignment rights should be clearly and explicitly spelled out, including the right to "partially assign" where a single IT services contract may be split between two or more subsidiaries, or between the parent and the subsidiary being spun off.

5. Additional resource charges (ARCs) and/or reduced resource credits (RRCs) should be negotiated from a position of knowledge. What happens if a particular unit's volumes are suddenly removed?

6. Software rights should be spelled out, with maximum flexibility (e.g., assignable to all subsidiaries, including minority ownership, and fully transferable licenses). Service providers are generally unwilling to grant these rights after the fact.

American Express (AMEX) provides a good example of when preparations for mergers, acquisitions, and divestitures were made beforehand. AMEX outsourced IT for American Express Bank (AEB) in the 1990s to EDS to facilitate a sale of the bank. EDS' task included moving all the AEB systems out of AMEX data centers. As a result, the contract with EDS was itself fully assignable to a third party who might purchase the bank. Additional considerations in laying the groundwork include integration versus facilitation of separation, geography versus business unit as a driver for system architecture, and establishing a clear baseline of integration.

Common purchasing systems, HR systems and financial systems make sense even if the core businesses are somewhat different.

The Big Tradeoff: Integration vs. Facilitation of Separation – Efficiencies are available from integrating common processes, systems, databases, and so forth. For example, common purchasing systems, HR systems and financial systems make sense even if the core businesses are somewhat different, such as a holding company that owns a retail banking business as well as a life insurance business. With higher levels of integration, it can sometimes be harder to separate a business unit. The following steps, however, can be taken to mitigate the challenges of separation:

1. Employ industry standard commercial off-the-shelf (COTS) systems, such as SAP or PeopleSoft/Oracle.

2. Retain division indicators in the database.

3. Spell out the right to separate in contracts with the COTS vendors.

Geography vs. Business Unit as a Driver for System Architecture – Given that a company is big enough to need multiple instances of enterprise resource planning systems, should the separate instances be based on geography (time zones or geographic regions) or on a business unit? Occasionally, geography motivates the spinoff, causing an organization to — for example — sell off all its European assets.

Establishing a Clear Baseline of Integration – First, note that the need for "all new" governance mechanisms, as well as the opportunity to continue leveraging support processes already in place, will be largely determined by the type of transaction. If the host continues to own substantial equity in the new entity, both parties may be inclined to leverage support resources and processes. In this case, the client can mitigate service providers' efforts to increase cost by clearly stating a position such as "all old unless otherwise stated." In other words, they could state on the contract, "We will continue use the same gold build, continue to use a single service desk and so forth, until such time as a change request is submitted." Service providers may have a tendency to assume they will be forced to install redundant support mechanisms by default, whereas the client may be happy to leave things intact.

It is not unusual today for long-term contracts to undergo at least one major restructuring.

CONCLUSION

The divestiture of a business unit or segment presents a significant milestone in the life cycle of an ITO contract. It is not unusual today for long-term contracts to undergo at least one major restructuring, with divestiture considered as a reason for restructuring. Otherwise, value leakage is likely for both the host and the divested entity. Deliberately "parsing" the contract and examining what can be held intact and what must be renegotiated is necessary to ensure that both parties continue to enjoy the benefits that were originally envisioned.

As the divestiture begins, it is critical to set the parameters of the agreement to ensure that CSLs as well as less regular deliverables are consistently met. Going forward, your organization should strive toward implementing processes for future divestitures as well. ISG strongly recommends seeking professional legal advice to assist with assigning service contracts.

ABOUT ISG

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