Doing a Deal from the Inside Out

Selected Negotiating Points for Transition Services Agreements

Fourth in a Series

By B. Scott Burton

The previous article in this series discussed many of the key "pre-deal" items a seller should consider with respect to potential transition services a buyer may continue to need from the seller following the purchase of a subsidiary or business unit. The seller's knowledge of the potential inventory of transition services is an important element that should be used during negotiations with the buyer. Likewise, the buyer's diligence should cover as much as possible with respect to potential services. With such preparation as background, the parties will be in the best position to successfully navigate the issues that will arise in negotiations.

Transition services agreements traditionally have been underappreciated agreements between the parties in a purchase and sale transaction. However, they fill an important need assisting the buyer in preserving the value of the business just purchased and assisting the seller in making a particular target attractive. While simple in construct, the items addressed by a transition services agreement must be taken extremely seriously as they provide a buyer with important value protection and could expose the seller to potential liability following the closing. As with many other documents in a large-scale transaction, the keys for both parties lie in preparation for negotiation and appreciation for the risks assumed. Discussed below are some common issues associated with transition services agreements.

Services to Be Provided

Typically, the body of a transition services agreement will reference exhibits setting forth the specific details—description of service, terms of provision and fee. The technical precision of such descriptions necessitates exhibits to avoid burdening the body of the transition services agreement. Often, depending in part on when the form of the transition services agreement is agreed upon (prior to signing or between signing and closing), there may be a "catch all" provision that is designed to supply the buyer with other services that were historically provided but for some reason not identified. The seller's willingness to agree to such a provision will be a function of self-assessment and resources following the closing.

Third-Party Service Providers

In many situations, the seller will have existing relationships with third parties who provide services to the businesses being sold. In such cases, the seller often will want to have the services flow through to the buyer. It is an important item in the seller's due diligence to ensure that those services can in fact be provided through a third party. If not, the parties should negotiate to determine how best to provide those services and, to the extent any additional costs are necessary to obtain those third-party services, who should bear those costs.

Types of Transition Services

At the risk of over generalizing, the types of services covered under a transition services agreement include:

- Information technology services/processing services,
- Back office support,
- Facilities management,
- Human resources,
- Risk management/insurance,
- Accounting support, and
- Litigation/legal support.

Service Standards

Although a buyer often objects, it is common for a seller to agree only that the services shall be provided in good faith and in a manner consistent with the historical provision of such services and with a like standard of care. Likewise, the seller may wish to disclaim all other representations and warranties with respect to the services. These positions are common when the seller is not in the business of providing third-party services. Buyers wishing to negotiate an alternate service standard may wish to (1) isolate a different standard for certain critical services on the services schedule and (2) seek to negotiate reimbursement rights in the context of indemnification.

Compensation

Compensation for transition services can be one of the more tricky items in the transition services agreement. In part, such a calculation is complicated because it is difficult for the seller to determine what the costs of those services should be in a shared services environment. The buyer wants an accurate assessment of what those services (and corresponding costs) should be to properly account for the cost of such services in the company's financial statements. In addition, the parties need to determine whether the services will be provided at "seller's cost" (usually plus out-of-pocket expenses) or with some sort of markup component. Often this issue becomes less critical over time because, as the need for specific services ends, the associated cost item ceases.

Termination and Extension of Services

If there is one item that is true for virtually all transition services arrangements, it is that the time estimate for the completion of the transition is almost always wrong and usually too short. Thus, the buyer typically will try to negotiate for a right to extend the transition services for a period of time. Meanwhile, the seller wants to terminate the transition services as soon as possible and has little taste for such an extension. Often a compromise is reached wherein the buyer, for a short period, can ask for and receive an extension (perhaps at an enhanced cost) subject to an ultimate drop-dead date, the extension of which would be totally within the discretion of the seller.

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Dispute Resolution

Again, given the short nature of most transition services agreements, the dispute resolution process is usually very summary. However, the nature of transition services and the general need for immediate day-to-day performance usually require some sort of rapid resolution structure. A transition services agreement may have an escalation clause that escalates any dispute to key decision makers of the parties. Alternatively, it may refer to a dispute resolution process that is contained in the definitive purchase agreement or, as a final resort, a submission of the dispute to an arbitration panel.

Limitation of Liability

With respect to limitations on liability, the purchase agreement might allow the buyer to recover consequential or other indirect damages or might otherwise stay silent on that matter. However, most transition services agreements expressly exclude these categories of damages from the buyer's potential recovery under the agreement. This result, like with other matters addressed above, is consistent with the recognition that the seller is not in the business of providing the services that are the subject of the agreement. Please note that a transition services agreement limitation of liability only addresses claims between the buyer and the seller and typically does not address (and may specifically exclude) indemnification for third-party damages.

Indemnification

It is common for the seller to indemnify the buyer from losses incurred by the buyer as a result of third-party claims regarding the seller's performance (or lack thereof) under the transition services agreement. Additionally, some transition services agreements include a limited indemnity that entitles the buyer to a contractual remedy from the seller in instances of the seller's gross negligence or willful misconduct. In the case of some services, the buyer may be successful in negotiating a reimbursement for the cost of a particular service in the event that it is not being provided satisfactorily. Typically, such a provision limits the seller's compensation to the buyer to the greater of the following:

- A refund of the fee paid by the buyer for that particular service;
- The buyer's incremental cost of performing the service itself; or
- The buyer's incremental cost of obtaining the service from a third party.

Negotiation Dynamics

As alluded to in the previous issue, there is a natural tension that permeates a transition services agreement negotiation.

From the buyer's perspective:

- The buyer wants as much support from the seller as possible to aid integration and prevent interruption;
- If there is a short time between signing and closing, the buyer may not have had sufficient time to contemplate and plan integration; and/or
- Antitrust or similar concerns may have prevented the sharing of operational details.

In contrast, the seller has the following concerns:

- The seller wants to "get out" of the business sold and focus on other business;
- The seller may not be in the business of providing support services and likely does not want the potential for corresponding liability; and/or
- Pricing such services may be difficult, and the seller does not want to lose money on services (this item is directly proportional to the seller's self-evaluation).

In response, a seller often tries to limit this provision to provide that this reimbursement is the seller's maximum liability to the buyer and is the buyer's sole and exclusive remedy with respect to the selected service. The seller may insist that the buyer agrees to exercise commercially reasonable efforts to minimize the cost of any alternatives to the provision of the service by the seller.

Ultimately, a well-conceived and well-drafted transition services agreement serves the needs of all parties in a transaction. A good transition services agreement helps the buyer to preserve the hoped-for value and helps the seller in realizing the maximum value for the property. When contemplated by all parties from the beginning, a transition services agreement will serve as a tool to smoothly convey a business from seller to buyer, resulting in a win-win situation.

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auditors are not satisfied with the remedial actions taken by the company. Finally, if the company does not report the situation to the SEC within the one-business-day period provided by Section 10A, the auditors are required to independently report their findings to the SEC and may choose to resign from the auditing engagement. On the other hand, if the company takes appropriate remedial measures that satisfy the auditors, neither the company nor the auditors have any SEC reporting obligations.

Consider (New) Outside Counsel for the Investigation

Upon receiving notice of a Section 10A issue, the company should consider engaging outside counsel to conduct an unbiased investigation regarding the alleged, potential illegal act. There are several advantages to having outside counsel perform the investigation.

- First, until waived, any findings or conclusions reached by outside counsel and communicated to the company are protected by the attorney-client privilege.
- Second, depending on the nature of the alleged, potential illegal act, outside counsel will likely have experience and specialized expertise in analyzing whether the behavior at issue constitutes "an act or omission that violates any law, or any rule or regulation having the force of law."
- Third, having an unbiased external person or organization conduct the investigation provides for an objective analysis of the situation.

On this last point, Howard A. Scheck, Chief Accountant for the Enforcement Division of the SEC, recently noted (albeit speaking on his own behalf rather than on behalf of the SEC) that one of the factors the SEC considers in its evaluation of the company's response to a Section 10A notification is whether the outside counsel engaged by the company to conduct the investigation is truly objective. Thus, if outside counsel engaged to conduct the investigation routinely handles a large number of matters for the company or is somehow already tied to the acts or omissions being investigated, the company should consider engaging another firm or attorney to provide the analysis.

Make Sure Nothing Is Destroyed

Should a Section 10A matter be disclosed to the government at a later time, the SEC will almost always inquire into what the company did to preserve evidence. This early step, if handled inadequately, can forever change the government's perception of

So What Is an Illegal Act?

The SEC has taken an expansive view of the term "illegal act" as used in Section 10A. That view does not necessarily require fraudulent intent. Illegal acts may thus include:

- Activities directly intended to defraud investors by dissemination of false or misleading financial statements;
- Misappropriations of assets;
- Other types of illegal acts that are not directed at the financial statements per se but may have a direct effect and are likely a form of fraud;
- Unusual situations in which other types of misconduct are discovered, such as significant violations of tax, environmental, antitrust or other laws which could materially impact the financial statements and, if not properly disclosed, might also constitute fraud; and
- An intentional misstatement of immaterial items in a registrant's financial statements that violates Section 13(b)(2) (the books and records provision).*

Even "intentional" can have a different meaning than its common interpretation. For example, the SEC has maintained that an intentional misstatement of an immaterial item requires only a knowing act of making a particular inaccurate book entry without knowledge at the time that the entry was in fact incorrect.

*Section 13 of the Securities Exchange Act of 1934 sets out the requirements for filings with the SEC. This section generally requires issuers to make and keep their books and records in "reasonable detail" to accurately reflect transactions and dispositions of assets. This section further requires issuers to maintain an internal accounting control system that provides reasonable assurance that;

a. Management authorizes transactions;
b. Transactions are recorded in such a way as to prepare financial statements in accordance with generally accepted accounting principles;
c. Management authorizes access to assets; and
d. Recorded and actual assets are compared on a reasonably frequent basis.

Neither materiality nor scienter is a necessary element of a violation of Section 13(b)(2), although Section 13 itself states that no criminal liability will be imposed for a violation of Section 13(b)(2), the key books and records provision, absent knowing misconduct.

the good faith and competence of the subsequent investigation. Electronic evidence, particularly e-mail, is a significant concern, given that it can routinely be destroyed as part of the company's normal electronic information storage policies. Mr. Scheck similarly noted that the SEC considers actions taken to preserve such evidence in its evaluation of the company's response to a Section 10A notification.

Expect an "Audited" Investigation

> The goal in many of these situations is to fairly and rapidly respond to the concerns identified by the auditors and, all things being equal, to do everything reasonably possible to satisfy the auditors' concerns in order to allow the auditors to continue their engagement.

As one might expect, if the auditors' concerns have escalated to the degree that they are formally reporting a Section 10A issue, the auditors may be concerned about fulfilling their own professional obligations and avoiding exposure. The auditors will evaluate every phase of how the company and the audit committee respond to the concerns. And, the larger firms often task their own forensic and litigation support units to perform a shadow "audit" of the investigation conducted by the company. When the auditors' concerns involve issues of management integrity or the ability of the auditors to rely on a management letter of representation, the auditors will closely examine how issues of key internal controls are evaluated and resolved to determine whether the auditors can continue to rely on the company's representation or whether they should resign from the representation, which significantly complicates the situation.

Stay Focused on the Goal

In times of crisis and confusion, staying focused on the goal is often difficult. A calm, objective assessment of the situation is critical, particularly if everyone else appears to be losing perspective and objectivity. The goal in many of these situations is to fairly and rapidly respond to the concerns identified by the auditors and, all things being equal, to do everything reasonably possible to satisfy the auditors' concerns in order to allow the auditors to continue their engagement. Changing auditors, particularly in the midst of audit season, is unpleasant at best. Unfortunate timing and circumstances, such as a crisis late in the fiscal year after the auditors' fieldwork is underway, may put the company in a situation where other auditing firms are unwilling or unable to assist, new engagement notwithstanding. Maintaining objectivity and responding appropriately, yet calmly, will help to ultimately resolve the Section 10A issue presented and assure the auditors that the company takes its securities obligations seriously.

Scott Sorrels, a member of Sutherland's Litigation Practice Group, has practiced in the securities regulatory and enforcement area for more than 25 years. His practice involves representing public and private companies, their officers and directors, along with financial institutions, accounting and law firms and their principals, in SEC and bank regulatory enforcement actions, Department of Justice investigations and criminal prosecutions, and complex civil litigation. Laurance Warco, a member of Sutherland's Litigation Practice Group, has more than ten years of litigation experience, including the defense of all Big Four accounting firms, law firms, corporations and individuals in numerous federal and state courts.