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Outsourcing and the Economic Crisis, Part III: Post-Merger Technology Integration

March 2009
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Outsourcing and the Economic Crisis, Part III: Post-Merger Technology Integration

In our previous updates, we discussed outsourcing as a tool for significantly reducing costs (*"Outsourcing Services in the Face of an Economic Downturn"*) and possible strategies for restructuring existing outsourcing deals as we head into a long-term global recession (*"Restructuring Existing Outsourcings"*). Whilst the current economic climate has resulted in less merger activity than in recent years, there has been an increase in the number of distressed acquisitions, which themselves result in the immediate need to find synergies between the two organizations' technology systems and processes in order to achieve cost savings and efficiencies. Existing IT systems and processes and existing outsourcing arrangements are central to this. This update discusses some different strategies for IT, outsourcing and process integration and examines the legal constraints or drivers which may impact such strategies.

IT and process integration options

There are five main strategies that merging entities could use to tackle IT and process integration. Each of these could be adopted exclusively or in conjunction with one or more of the other strategies.

- *Absorption*. Under this strategy, one entity will migrate its data and processes to the other entity's systems and processes. This is more likely in the case of a larger entity acquiring, or "absorbing", a smaller one. This strategy would result in the smaller entity's systems and processes being retired over time. Significant cost reductions can be obtained by rationalising the infrastructure and processes in this way, although this is not always straightforward – there can be significant data migration issues, particularly where the two entities' business processes are not aligned.

- *Cherry pick*. The merged entity will need to review carefully the entire IT infrastructure and processes to cherry pick the best from the two entities. This best-of-breed approach may seem attractive but is not necessarily a straightforward option – it is likely to require complex and expensive integration activities at a time when what may be best for the future business may be unclear.

- *Co-existence*. The merged entity can, of course, choose to do little in the way of integration and simply maintain existing IT systems and processes – leaving the two organisations functioning largely independently of each other. This may be a low risk option but it achieves little in the way of synergies or cost savings. Even if this strategy is adopted, there can be some common administration functions that are good candidates for integration, such as human resources or finance. Also, a common e-mail system or desktop set-up can be a highly visible, and relatively easy to achieve, indicator of the new, merged world.

- *Transformation*. The merger can be an opportunity for transformation change, particularly if the current systems and processes of both organisations are considered outdated or no longer "fit-for-purpose". If integration is too difficult or expensive and co-existence does not achieve the necessary synergies, transforming to completely new infrastructure and processes designed from the bottom up to meet the needs of the new organisation can be an attractive alternative. The initial costs of this strategy will, of course, be high, but the new, streamlined systems and processes can deliver long-term value. This strategy does not avoid, however, the difficulties of data migration.

- *Outsource*. Outsourcing the IT and processes of the merged organisation to a third party provider is not strictly a different strategy, but it can be used to achieve one, or a combination, of the strategies described above. A specialist service provider may be best placed to implement the chosen strategy, particularly where it involves a large element of integration or transformation.

Impact of current arrangements

The existing legal and commercial arrangements of the two merging entities will, inevitably, influence the chosen technology and outsourcing strategy for the merged entity. These contractual arrangements will need to be reviewed as early as possible in the merger process to establish how they will affect the future strategy. This update highlights some of the constraints or drivers that will need to be considered, particularly when deciding between suppliers to the merging entities of similar products or services.

- *Performance*. The first point may seem obvious, but a key consideration will be to compare the suppliers' performance – whether performance against service levels or performance of the underlying IT products – and whether the suppliers' performance can be maintained given the increased volume or scale of the merged organization.

- *Commercial terms*. The merged organization will need to determine quickly which supplier contract has the more favourable commercial terms, for example in relation to pricing, service levels and service credits, and especially future flexibility (*e.g.*., as to volumes)? In the current market, this may well be even more important than performance.

- *New service recipients*. Does the supplier contract permit a new entity to be brought within the scope of the agreement as a new service recipient without the need for the supplier's consent? Can this new service recipient benefit from the same terms and conditions as the existing service recipients?

- *Volume growth*. If a new service recipient can be brought within scope, does the supplier contract allow and cater for the volume growth that will be an inevitable consequence of the merger? Does the unit price decrease automatically according to pre-agreed volume price bands or is this left open for negotiation? In any event, are the volumes such that it would benefit the merged organisation to seek to re-negotiate anyway, perhaps as the *quid pro quo* for bringing the additional volumes and displacing the other incumbent supplier?

- *Early termination penalties*. If one supplier's relationship needs to be terminated in favour of another, the consequences of early termination must be considered. Does the customer have the freedom to terminate without cost or are termination fees payable on early termination? Perhaps there will be other termination rights in existence (*e.g.*, existing breaches or even a right for change of control of the customer) that could be used to avoid the payment of termination fees.

- *Cherry pick terms*. It is not an unusual situation for the same supplier to be providing the same or similar services to each of the merging entities. If this is the case, what opportunities are there for merging the two contracts? Can the customer take advantage of this situation by cherry picking the best commercial and legal terms from each of the separate contracts, using them to form a consolidated contract? It may be impractical to get the supplier to agree to such cherry picking unless the merged entity is, or could become, a key customer of the supplier.

In short, there is little doubt that significant cost savings and efficiencies can be achieved by rationalising the technology systems, processes, and supplier contracts of the two merging entities. But it requires a clear strategy together with clarity of the existing contract base to establish the “art of the possible”. And even then, organisations must not under-estimate the resource that will be required to carry out the due diligence activities and then negotiate with the chosen suppliers and, where necessary, those that are being displaced.