



Taking Stock of Your Service Provider

By Robert M. Finkel

Equity ownership or joint venture creation can sweeten a deal with a vendor. But it's essential to look before you leap.

When your service provider courts your business by suggesting that it sweeten your transaction with an equity ownership stake, warrants, or creation of a joint venture, the proposal will often seem too tempting to be refused. In fact, including an equity component in a services transaction can create attractive benefits—as well as additional risks—to both customer and vendor alike.

The prime motivating factor of any services vendor for including an equity component will be to increase the likelihood that the provider will land your business. If structured properly, a services transaction with an equity kicker can also create positive financial returns for each of the parties. At a time when certain segments of the services industry, such as business process outsourcing, are expanding rapidly, an equity arrangement may provide customers

with an opportunity to make a relatively low-cost investment in an industry that, by all accounts, will continue on its recent path of impressive growth. For the service provider, offering a potential customer an equity stake can be a significant negotiating advantage to gain new accounts in what is an increasingly competitive global sourcing marketplace. And, for both parties, a direct customer investment or joint venture can provide a means to combine resources, or to market products jointly, enabling the vendor to position itself better to penetrate a market.

For the customer, access to new processes or technologies may be a compelling reason to pursue an equity transaction, as an equity-based arrangement could create a forum for the parties to share their know-how, or collaborate in the creation of new IP, in a manner that might not otherwise be possible.

In the services context, taking an equity stake can also be a critical part of an overall risk mitigation strategy. The enhanced rights that typically come with equity ownership, such as board representation or other management rights, may enable a customer to monitor more effectively the performance of its service provider. Creating a joint venture may also lessen a customer's perceived risk of turning over completely any outsourced operations to a third party, a risk that may be especially of concern if the services are critical, highly proprietary in nature, or involve work being performed in an offshore location. And finally, from the service provider's perspective, an equity-based transaction can create a means to develop a stronger, more durable relationship with its customer.

As is the case with any strategic relationship or joint venture, there can never be any guarantee that the venture will ultimately succeed; the failure rate for joint ventures and strategic alliances generally remains high, and it is probably greater than most perceive. And no matter how well the parties structure the investment piece of the transaction, the arrangement will almost certainly fall apart if the vendor fails to perform adequately under the services side of the deal. In addition, in the case of an outsourcing transaction, an equity-type arrangement may result in the customer retaining, at least in part through its equity ownership, the risk of certain operations that it desired to transfer to a third party, as well as taking on the additional risk associated with being a minority owner of an ongoing business venture with what are typically limited control, exit, and other corporate rights.

KEY ISSUES IN EQUITY DEALS WITH VENDORS

While hybrid-type arrangements may offer clear benefits to the parties, they will also layer on additional complexity to an already complex business transaction. Certainly, the customer should not lose sight of the fact that, in most cases, the services agreement should remain the central part of the transaction. While the equity component may enhance the attractiveness of the deal, the services side should be able to stand on its own. Second, a customer should bear in mind that equity-based services transactions usually have

inherent conflicts of interest that need to be addressed and resolved in the negotiations phase.

HANDLING THE SERVICES AGREEMENT

Any customer negotiating a hybrid equity/services arrangement needs a services agreement that contains arms-length, market terms. They should not rely upon their rights as a shareholder since, as a minority owner, the customer will not ordinarily have the ability to control the quality of the services.

In structuring the overall arrangement, the parties should pay particular attention to the areas within the contractual arrangements that may generate potential conflicts between the shareholder relationship, on the one hand, and the services agreement on the other.

- **Termination:** Perhaps the most complex issue in negotiating hybrid transactions will be the interplay of the termination rights among the various agreements. Most services agreements will grant the customer a right to terminate the agreement in the event of material breach and prolonged force majeure outages, among other events. Another fairly common feature of a long-term service arrangement is the right to terminate, for convenience, the arrangement at any time for any reason, which will often be conditioned upon the payment of a pre-determined fee. The issue the parties to the arrangement will have to consider is the implication to the venture if one party has the right to terminate and the appropriate cross-termination triggers. From the customer's perspective, in the event the vendor commits a material breach of either the services or other transaction documents, it will usually be the case that the customer will want the option to trigger some kind of a liquidity right.

- **Exit Rights:** Another complex area that may well require significant negotiation and advance planning is termination assistance. Service agreements frequently provide that the vendor will continue to provide services to its customer following the expiration or termination of the agreement. The customer may also have the right to acquire or license from the service provider key assets or software. The issue the parties will need to address is how to balance the interests of the vendor, on the one hand, in retaining any assets and employees that are essential to its continued operation, with, on the other hand, the customer's interest in continuing to receive the benefit of the services post-termination.

- **Non-Competition:** In these types of hybrid transactions, the parties will need to address the geographic and business scope of the venture and the appropriate non-competes. The parties should exercise caution, however, in granting the joint venture a mandate that is too broad as this too could create potential conflicts of interest.

- **Dispute Mechanisms:** Parties to any services agreement should consider the appropriate forum to resolve disputes over service delivery and other matters, since disagreements, particularly

over operational matters, arise in just about every transaction. Whatever mechanism the parties adopt in the services agreement should be consistent with the dispute resolution mechanisms in the joint venture documents, since any serious dispute will likely involve issues under all of the major transaction agreements.

• **Damages:** A potential conflict in any services transaction with an equity component is that the customer will indirectly bear the economic burden of any damage or indemnity payments made by the service provider, as a result of a possible diminution in the value of its ownership interest following the payment. A customer can protect itself by either having the damage payments grossed up to reflect this diminution, or otherwise being compensated for the economic loss, for example by adjusting the relative ownership stakes of the parties.

SERVICES AGREEMENT ISSUES

A number of other service agreement-related issues that arise in these transactions are outlined below.

Transfer of Assets: In many services transactions, particularly in the outsourcing marketplace, assets and employees are transferred from the customer to the service provider. Among other matters, the parties will have to address issues relating to notice, transfer of employee benefit plan assets, and any financial commitments to the employees that may be triggered because of a change of control.

Audits and Compliance With Law: The customer will want to ensure that it has the right to conduct an audit of the operations of the service provider and that deficiencies be rectified. The audit rights are particularly important, especially in the wake of the passage of the Sarbanes-Oxley Act and its requirements under Section 404 to maintain adequate controls and procedures for financial reporting purposes, as well as the generally heightened scrutiny being placed on the conduct of corporations by shareholders and the various regulatory agencies.

IP Ownership: An increasingly important—and complex—question to consider in any equity-based deal involves the ownership of newly developed intellectual property. In providing services to the customer, the service provider may develop software, processes, or other intellectual property that will have commercial application beyond the customer’s own use. The agreements should therefore address which party will own the newly developed intellectual property and whether there will be a royalty sharing arrangement or restrictions on the use of any developed intellectual property.

STRUCTURING THE TERMS OF THE ACQUISITION

Equity participations by customers in their service providers will involve an important investment decision and, as a result, the parties will have to address the legal and business issues that will typically arise in most corporate acquisition transactions. The customer should conduct sufficient due diligence of the business

of the entity that will be issuing the securities to understand the business and legal risks of making the investment. As the recent accounting, ethics, and stock option back-dating scandals have made clear, background checks on the officers and directors of the target may also be desirable. The legal due diligence exercise should also focus on any consents or other rights that may be triggered as a result of the acquisition. In the due diligence process, a very important issue that the customer should assess is whether there are any intercompany arrangements among the service provider’s affiliates that are not at fair market value, or that otherwise would permit the target company to distribute value to its shareholders or affiliates at the expense of any other equity owner. The customer should also investigate the regulatory, tax, and accounting issues that will be raised by the proposed acquisition.

KEY ACQUISITION TERMS

The nature of the acquisition agreement covering the purchase of a joint venture interest can vary greatly depending upon the percentage equity stake that the customer will be purchasing and the form of joint venture entity, among other matters. In the event the purchase involves the acquisition of an interest in an existing entity, the acquisition agreement should contain appropriate provisions concerning the purchase price, seller representations and warranties, closing conditions, and indemnification rights, among others.

Purchase Price: In negotiating the purchase price for the equity interest, the customer will have to determine the form of the consideration, the timing of the payment, and any appropriate post-closing adjustments to the purchase price. It is also worth noting that many transactions do not include additional stated consideration for the equity stake; the equity stake or warrants are granted to the customer as an additional “kicker” as part of the overall terms of the transaction.

Representations and Warranties/ Indemnification: The acquisition agreement should contain appropriate representations and warranties of the service provider relating to the business and assets of the issuer. If the joint venture is a newly formed entity, the scope of the representations will typically be limited to items such as title to the equity interests, due authorization, corporate existence and power, and other appropriate matters. An acquisition of an interest in an existing ongoing business should ordinarily involve more detailed representations on the business of the joint venture entity, covering such matters as financial statements, absence of material adverse changes, liabilities, material agreements, intellectual property ownership, litigation, employee matters, and taxes.

Closing Conditions: If the purchase agreement will be executed prior to the effective time of the transaction, the customer and service provider will also have to agree upon the appropriate closing conditions for the transaction. In most transactions, the closing under the purchase agreement should occur simultaneously

with the effectiveness of the services agreement. Other appropriate closing conditions to protect the parties include accuracy of the representations as of the closing date, the receipt of any material governmental approvals and contractual consents, passage of any required waiting periods (such as the waiting period under the Hart-Scott-Rodino Antitrust Act), and the absence of any material litigation.

Termination: If the parties expect that the closing will occur some period of time following the signing, the agreement should terminate upon the occurrence of certain events, such as the issuance of a court order enjoining the transaction or the passage of any law that would make the transaction illegal. In addition, it would ordinarily be advisable to include a “drop-dead” outside date for the transaction, as the parties should not be obligated to close the transaction if a substantial period of time elapses between signing and closing.

SHAREHOLDERS AGREEMENTS

The parties to an equity-based transaction will also need to enter into a shareholders or similar agreement to set forth the ongoing rights and obligations of the parties to the venture.

Newly Formed Joint Ventures: If the transaction involves the creation of a new entity to conduct the business operations, the parties will need to consider the appropriate form. This determination will usually be driven by tax and accounting considerations. A corporate entity may give rise to double taxation on its earnings. It should ordinarily be possible for the parties to a joint venture to eliminate any dual taxation by conducting the operations through a properly structured limited liability company or partnership.

Governance: Perhaps the most important issue that the customer must address in the shareholders agreement will be governance of the joint venture; creating sound governance procedures for any venture will be critical to achieve success, especially in a marketplace that is becoming increasingly competitive. First, the communication channels among the parties at all levels of the joint venture should be clear, including the identity of the key individuals who will be representing the interests of the partners, the procedures for choosing the key personnel, as well as the individual roles and responsibilities.

The joint venture or other entity should have an ultimate decision-making body and a mechanism, preferably agreed in advance, for the governing body to resolve fundamental issues. Among other matters, the shareholders agreement should establish the time period for making decisions, the responsible parties, and the consequences to the joint venture of the failure to reach a satisfactory resolution. There will be a tension in any joint venture between structuring a clear decision-making process that will have a relatively predictable set of rules on the one hand and creating a process that will have a sufficient degree of flexibility and responsiveness to meet the demands of a competitive

marketplace.

As a minority owner, the customer will want to ensure that the shareholders agreement provides it with certain control and other rights. Absent specific rights in the governing agreements, the majority owner could control all of the operations of the issuer, subject only to any rights of the minority party arising under law, which are relatively limited. The customer should consider whether its representatives on the Board or other governing body should have the right to approve certain fundamental issues with regard to the issuer’s business, such as material acquisitions, changes in the scope of the business, incurrence of debt, appointment of key personnel, compensation arrangements, issuance of additional securities, dividends, agreements with any affiliates, and asset sales. The challenge for the parties will be to create a list of veto rights that is broad enough to give the customer a meaningful governance role, but not so extensive as to unduly hinder the day-to-day business affairs of the issuer. The parties should also consider whether certain control rights should lapse upon termination of the services agreement, if the relative ownership interest of a party falls below a certain threshold or following an initial public offering.

Exit Rights/Transfer Restrictions: In structuring any venture, the customer should recognize that, even with the best governance procedures, the parties might not be able to reach agreement on all issues facing the joint venture entity. In the event that a disagreement arises between the parties, the customer will want to ensure that the service provider continues to provide services without interruption. A customer with a minority stake will ordinarily be concerned about its ability to exit the venture in the future, especially given that it may not be able to exert great influence over the strategic direction. The customer should therefore consider requesting securities registration rights, as well as the right to participate in any permitted private sales of securities to a third party. “Put” arrangements that would enable the customer to sell its equity interest at an agreed price upon the occurrence of certain events, such as a disagreement over a fundamental issue, may also be appropriate.

CONCLUSION

Services transactions with an equity component will be substantially more complicated for a customer than the typical deal. Although no customer can ever be assured of success, proper planning by the customer, as well as the consideration of the many issues involved in the transaction, can help improve the chances of achieving the dual objectives of improved service delivery, along with a valuable equity stake. □



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