

Don't put your deal timeline at risk

Contract separation in divestitures

A typical divestiture includes hundreds or thousands of supplier and customer contracts that need to be correctly assigned to the company being divested (DivestCo). Whether a carve-out sale or tax-free spin, separating contracts may take up to 12 months, so companies should begin the process as soon as they identify an asset to divest. Contract separation should also be a top-of-mind issue for procurement teams, as more than 84% of global organizations expect to divest in the next two years, according to the EY 2019 Global Corporate Divestment Study.

Effectively managing third-party supplier and customer contract separation is a critical task for CFOs and supply-chain leaders. A lack of coordinated strategy among functions can lead to significant compliance risks and high separation costs, including escalating one-time and stand-alone costs. In extreme cases, the deal timeline and business continuity may be adversely impacted.

Experience in facilitating M&A transactions has revealed several leading practices across the contract separation life cycle. Organizations undertaking divestitures would be well served to establish a contract separation work stream and leverage these practices to enable business continuity.

Identify risks early in the separation life cycle

Organizations tend to underestimate the cross-functional and external dependencies, along with the level of effort required to manage contract workload. To best manage such complexities, contract separation efforts need to be started early in the divestiture process by tapping the right supplier and customer management, legal and functional teams that will enable clean DivestCo agreements for Day One. Among the issues that need to be considered:

- ▶ **Cross-functional dependencies:** Separating contracts is highly cross-functional and requires various departments to work together closely. While the procurement department is generally expected to drive the supplier contract separation effort, business functions, such as information technology (IT) and human resources (HR), must determine the technical scope of the contract. Drafting and sending supplier notification letters, tracking responses, and aligning with legal in case of negotiations require significant collaboration across functions.
- ▶ **External dependencies:** It is also common to see large suppliers, especially technology software providers, exercise leverage at the time of transaction. If their contracts are not addressed on a timely basis, it can jeopardize the timing of the separation process. It can also cause unanticipated financial or regulatory roadblocks, as contractual terms may not allow the assignment of assets or operationalization of transition services between the separating entities.
- ▶ **Level of effort:** To reduce transaction costs, organizations may insource this effort and execute manually. For large transactions, this approach often creates additional burdens and last-minute surprises. Individual functions may not have the proficiency or experience to review contracts and decide necessary actions. Leveraging advanced analytics and experienced third-party providers can help mitigate some of this risk.
- ▶ **Identification of critical contract attributes:** In some cases, organizations are well into their contract separation effort before taking the necessary time to identify "critical" attributes to be extracted from the contract documents. This can result in a reworking by all teams involved.
- ▶ **Alignment on milestones and templates:** Deal teams should make sure that their contracts work-stream team is aware of and aligned with the sales and purchase agreement (SAPA) to understand how much time is available for the effort and communicate urgency across the organization.

Steps for managing contract separation through the deal life cycle

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Establish contract separation work stream governance

One of the first steps in the contract separation life cycle is to establish a separate work stream with cross-functional leadership from legal, procurement and other groups, with one single owner accountable for program delivery.

Several leading practices to establish and sustain contract separation governance include:

- ▶ A cross-functional contracts separation kick-off meeting to align on roles, responsibilities and workflow, including who will collect contracts and where they will be stored for dispositioning
- ▶ A central tracker managed by the contract separation team with inputs from business stakeholders
- ▶ Weekly cadence to address contract risks as they develop
- ▶ Contracts status dashboard to communicate an executive summary view of weekly progress

The volume and complexity of contract separation efforts will vary across transactions. For large transactions, the level of effort is often beyond the limited resources of the organization. The following criteria can be considered when evaluating whether external support would benefit the transaction:

- ▶ Number of contracts in scope
- ▶ Nature of contract storage and maintenance
- ▶ Degree of comingled contracts between DivestCo and parent
- ▶ Availability of internal experts who can extract key terms and conditions to determine the contract disposition
- ▶ Resource bandwidth

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Establish the right scope and baseline

As with any major separation program, an overall deal perimeter of the contract separation work stream must be assessed, approved and documented. Creating a list of in-scope contracts can be a significant undertaking. The transaction team needs to allocate time to coordinate across the organization to solicit and validate in-scope contracts. It is important that leadership from all functions validate that none of their contracts are missing from the separation scope, and that all contracts are represented. An increasing number of companies are leveraging M&A technology tools, including EY Capital Edge, to assist in this process.

Organizations should identify contracts in multiple sources:

- ▶ Supplier contracts managed by procurement and legal teams or tracked under the sourcing spend using accounts payable (AP) and purchase order (PO) reports
- ▶ Customer contracts managed by sales or marketing, which may include trade agreements or limited contractual terms and conditions
- ▶ Manufacturing and distribution center locations for local facility-based contracts
- ▶ Suppliers associated with applications and infrastructure inventory managed by IT and other DivestCo business functions
- ▶ Additional resources, including finance and supplier management teams and reports

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Prioritize and focus on critical relationships

Once the overall contract list is finalized, the next step is to prioritize contracts based on contracted amount and other qualitative measures such as Day One business criticality and supplier or customer relationship. Categorization enables the contracts separation team to prioritize time and resources on contracts that are important to the transaction. For contracts deemed “critical,” creating supplier profiles, formulating what-if scenarios, and determining quantitative and qualitative negotiation levers will enable a seamless separation.

Technology suppliers may need special treatment. Unlike other sectors, technology sector organizations tend to have a large third-party application and infrastructure footprint and may rely heavily on external technology suppliers to take their products to market. In typical divestitures, some technology suppliers tend to exercise greater bargaining power, and thus separating contracts becomes challenging. Citing issues with implementing contractual changes and administrative overhead, suppliers may delay granting transition, duplication and assignment rights or insist on purchasing temporary licenses to support the transition services agreement (TSA) period.

To tackle such issues, organizations should prioritize these suppliers in the overall contract separation process and work with the supplier’s account representatives in a collaborative way to secure necessary separation rights. “Bridging agreements” – through which the parent and the suppliers agree to amend the contract to authorize the DivestCo to either use the licensing seats or benefit from the services as a pass-through for the remainder of the contract – are a possible option. Upon completion of the bridging agreement, the DivestCo is often required to establish a new contract directly with the technology supplier.



Perform contracts analysis and finalize Day One dispositions

Contracts analysis is a critical and elaborate effort that includes reviewing contract clauses to determine what rights are contractually available or what requirements must be upheld. For example, contract clauses may cover assignment rights, change of control, notification requirements, TSA (divestiture or right to use), duplication and termination rights.

We have seen that, generally, agreements are not centrally located. Instead, agreements are spread across organization units, geographical locations and individuals. This makes the contracts analysis process difficult and error-prone. Thus, functional areas are advised to take proactive measures in collating all contracts and agreements.

Involve key organization stakeholders who can help provide inputs to formalize contract dispositions, generally driven by the Day One operating model. The following matrix can help organizations easily determine supplier contract level plans:

Contract assignment matrix		Implications for execution
Yes DivestCo usage	Complete assignment <i>Suppliers used exclusively by the DivestCos</i>	Complete assignment <ul style="list-style-type: none"> Parent may transfer existing agreements and solutions used exclusively by the DivestCo at close. Partial assignment or stand-up <ul style="list-style-type: none"> Parent may assign a specific portion of existing agreements and solutions to the DivestCo or duplicate the existing contract (though this may result in a change of terms).
	Partial assignment/stand-up <i>Suppliers shared between DivestCo and seller's organizations</i>	
No	<i>Suppliers not required by either buyer or seller post-close</i>	Terminate <ul style="list-style-type: none"> Contracts that are no longer required post-close may be terminated. TSA <ul style="list-style-type: none"> Contracts that are required to provide TSA services to the DivestCo need to remain with the parent.
	Terminate TSA	
No Parent usage Yes		

Execute third-party communication and set up the DivestCo for success

Once the gaps between Day One disposition and contractual rights are determined, the process of customer and supplier communication can begin, with priority on critical contracts.

- Assignment notification templates need to be drafted by the legal department and provided to functions for customization. Multiple formats are often necessary, covering different scenarios, such as complete or partial assignment, notification-only vs. explicit supplier consent.
- For suppliers requiring partial assignment, determine assets and associated costs, including software licenses, telecom and IT equipment, contingent workers, real estate facilities and other elements to be transferred to the DivestCo.
- For Day One critical suppliers, determine the risk if rights to assign contracts are not secured, and create back-up plans to ensure business continuity post-Day One.

This step may prove complex given dependencies on external stakeholders. Suppliers or customers may not be timely in their responses to acknowledge any communication and grant requested rights. In the worst case, some suppliers may use this opportunity to charge a one-time fee for granting divestiture or assignment rights, or increase the licensing fee to supplement their revenue stream. Similarly, some customers may seek to exploit the transaction and increase their royalty or promotional fees.

Thus, it is important for the contract separation work stream to track all supplier and customer responses, follow up and escalate as required. If planned and executed right, all relevant contracts are either assigned, duplicated or ready for enabling transition services as planned.

Case study

A mid-tier consumer products client recently divested a non-core division. One of the most complex issues was the separation of more than 950 contracts. Several weeks into the sign-to-close period, the team encountered issues, such as a lack of clear governance and limited clarity on ownership of the effort, which resulted in missed milestones. The EY team assisting management recommended to the leadership team that a formal governance structure was critical to defining functional roles, responsibilities, workflow, milestones and a reporting cadence. Consequently, along with establishing a formal governance structure, the leadership team also augmented specialized external support to accelerate the contract analysis, review and dispositioning process. Key components of this process included assistance in determining whether each contract contained a shared or exclusive product mix with the DivestCo and whether assignment consent was contractually required from the third party.

With contracts analysis completed, the team initiated efforts to draft and send assignment notification letters to third parties. Cross-functional coordination was critical to ensure notification efforts were led by a single function, even when multiple functions typically interacted with the third party. This helped enable a single message to be sent by one point of contact and avoided duplication of effort or an assignment notification letter not being sent. Multiple third parties sought more favorable terms and required the team to negotiate to reach agreement. In summary, the dedicated contracts management team, led by legal counsel, was essential to providing the right guidance throughout the complex contracts separation process.

Conclusion

As highlighted above, contract separation is a core enabler to a successful Day One for parent and DivestCo. It is also one of the few workstreams in separation management where the desired outcomes are dependent on the right level of engagement from multiple internal and external stakeholders. However, in early stages, very often there is limited recognition of the rights reserved by customers and suppliers to provide contract assignment consent or to enable transition services, and the amount of time it can take to negotiate necessary divestiture rights. When the contract separation process has a delayed start and slippage in meeting key milestones, it can have significant adverse implications on TSA structuring, timing of exit, synergy delivery, and third-party relationships. Leveraging leading practices outlined above can help streamline the process and optimize the resource load throughout the deal lifecycle. Proactively engaging the right stakeholders early on to align on the separation roadmap and key milestones can set up the parent and DivestCo for a cleaner separation, minimal downstream complexity during the TSA period, and in some cases, even an earlier TSA exit.

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