



## 8 key elements for a successful lift-out transaction

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### **To Our Clients and Friends:**

Over the past few years we have observed a trend in companies seeking to outsource (and monetize) certain core, best-in-class processes. These transactions, dubbed “lift-outs”, include examples such as insurance companies lifting-out their insurance claims processing capabilities, medical device companies lifting-out their medical device manufacturing capabilities, and pharmaceutical companies lifting-out their research and development capabilities.

While the benefits of these transactions are potentially significant, lift-outs are complex and require a broad array of legal disciplines, such as technology, corporate, tax, privacy, real estate, intellectual property, and employment law specialists, often in multiple jurisdictions. They also demand a significant amount of effort and advance planning in order to address issues such as pricing, governance, change management, limits on liability, indemnification obligations, intellectual property rights, termination rights, and exit rights, among others. As a result, successful lift-out transactions require robust legal expertise in order to document and support the long term goals, opportunities and arrangements of the parties.

From a legal perspective, many of the challenges that arise from lift-out transactions stem from the fact that lift-outs are a hybrid of several better known transactions, namely IT outsourcing transactions, business process outsourcing transactions and carve-out divestiture transactions. While lift-outs have elements that on their face look familiar to either an outsourcing attorney or M&A attorney, these elements and issues are often not addressed in a traditional manner. As such, understanding how to address these elements is critical to a successful lift-out transaction. This alert will discuss several of these key elements.

## The Business

An important aspect of most lift-out transactions is the description of “the business”; in other words, what internal capabilities is the service provider acquiring from the company that will be used to provide services back to the company (and eventually the service provider’s other customers). This is often the most difficult aspect of a lift-out transaction because the internal capabilities being acquired are unlikely to have been operated as a separate business. Moreover, these internal capabilities are rarely even housed within a single legal entity. More often, the personnel, infrastructure and processes that make up these internal capabilities are spread across disparate pieces of a company, multiple entities and potentially even

different business units. Furthermore, the internal capabilities have typically never been commercially exploited and are rarely subject to the types of procedures and performance standards of a commercial offering. As a result, referring to these internal capabilities as “a business” is in name only. For these reasons, typical requirements of an M&A carve-out transaction, such as requiring a financial statement or a sufficiency of assets representation, are often impractical, if not impossible in lift-out transactions; and a significant degree of analysis, both legal and financial, and ultimately negotiation, is required to properly define the internal capabilities being transferred.

## Purchase Agreement vs. Services Agreement

Another critical aspect of most lift-out transactions is the interplay between the purchase agreement and the outsourcing agreement. Obligations and requirements in one agreement often have a direct impact on the obligations and requirements in the other agreement, and in some instances such obligations and requirements may unwind the parties arrangement in the other agreement. For example, an obligation of the service provider in the outsourcing agreement to indemnify the company for third party infringement claims in connection with the services may be unwound if the company is representing to the service provider in the purchase agreement that the assets being purchased by the service provider do not infringe on a third party’s rights. Moreover, the parties are often focused on the liabilities the service provider is assuming under the purchase agreement, and its ability to recover

those liabilities under either the purchase agreement or the outsourcing agreement. Consider for instance a typical employee-related obligation in a carve-out transaction such as accrued paid time off. Is accrued time off valued as debt, for which the service provider should obtain a purchase price adjustment under the purchase agreement, or is it an ongoing expense that the service provider can seek to recover through its pricing under the outsourcing agreement? Either of these options may make sense depending on the specific lift-out transaction, but the failure to coordinate between the documents as to how this obligation is addressed can lead to an inadvertent benefit to either the service provider or the company. As such, it is critical that attorneys negotiating lift-outs carefully coordinate the negotiations of the obligations and liabilities among the various agreements.

## Indemnification/Representation Coverage

One of the more complicated areas in a lift-out transaction is the tension between the indemnification provisions in the outsourcing agreement, and how much indemnification and representation coverage the service provider should be provided under the purchase agreement. Often service providers will demand more coverage than usual under a typical carve-out transaction because of the inherent limitations on the service provider under the outsourcing agreement. Moreover, in many lift-out transactions, the outsourcing agreement imposes certain limitations or even prohibitions on who the service provider may provide services to using the purchased capabilities, further limiting the service provider's upside on the arrangement. Companies on the other hand will demand

less coverage than usual under a typical carve-out transaction due to the fact that they are often selling the internal capabilities at book-value, with little to no premium, or even at a loss. As the company is not making money on the sale of the internal capabilities, and the service provider is not paying for the goodwill or going-concern value of the internal capabilities, the company will often seek to limit its indemnification exposure under the purchase agreement. Achieving the correct balance between the two competing positions is critical to the success of these arrangements. Too one-sided in either direction can achieve the short term goal of a party under the purchase agreement, but can undermine both parties' long term goals under the outsourcing agreement.

## Transitional Services

As with most carve-out transactions, the service provider in a lift-out transaction will often need the company to continue to provide the services for a period of time following the closing until the service provider can successfully transition the people, infrastructure and processes to its own systems. However, in a lift-out transaction this standard arrangement for a carve-out transaction can become circular, as under the outsourcing agreement the service provider is providing these same services back to the company. To avoid the situation where the company provides transitional services to the service provider who provides services back to the company, the parties need to tailor the transitional services with the implementation services under the outsourcing agreement. This starts with a careful inventory of all of the various people, infrastructure and processes

(including third party services and contracts) that the customer uses to perform the services. Once the inventory is documented, the parties then need to agree-on a detailed implementation plan for each, person, piece of infrastructure and process that is being transferred to the service provider, as well as identifying any gaps in people, infrastructure and processes that the service provider will need to solution, and the plan for addressing those gaps. The implementation plan should ideally be documented and agreed to in sufficient detail prior to contract signing, or at the latest, prior to closing. Otherwise, even minor discrepancies in the parties' understanding as to how particular people, infrastructure or processes are transferring (or not) can have significant impacts on the pricing of the outsourcing aspect of the transaction.

The foregoing is a sample of the complex issues that arise in connection with the negotiation and documentation of the purchase aspects of a lift-out transaction. There are similar complex issues that arise in connection with the negotiation and documentations of the outsourcing aspects of the lift out arrangement as follows.

## Pricing

While lift-outs are driven by a variety of business drivers – such as introducing a change agent, getting access to best-of-breed services, and refocusing on competitive advantages – the pricing of the services back to the customer under the outsourcing agreement is often the most critical consideration. A basic goal of these transactions is for a company to obtain variable pricing for what is otherwise a fixed cost. Moreover, built-in flexibility in the pricing structure is typically a sought after feature of the pricing model under the outsourcing aspect of a lift-out transaction as companies are looking for their service provider to accommodate the inevitable

changes that arise in the company's own product and service offerings. Given the complexity of these transactions, rarely does the pricing model fit neatly into a typical outsourcing pricing model (e.g., fixed fee, variable unitized fee, or time and materials). Instead, the pricing model under lift-out transactions is often a mix of these various pricing models. Often the pricing model in these transactions must take into account increases in the cost of raw materials, labor and other service inputs, and efficiencies that arise from new technologies and innovations in the processes comprising the internal capabilities transferred to the service provider.

## Limits on Liability

The liability provisions in typical outsourcing arrangements often involve the most negotiation, and lift-out transactions are no different. However, most companies and service providers will acknowledge that the standard construct whereby the service provider will seek to limit its liability for direct damages to a function of the fees paid by the company under the outsourcing arrangement, and have the company completely waive its right to seek consequential damages, does not work well for lift-out transactions. Especially given the fact that the people, infrastructure and processes used to provide the services came, in large part, from the company. Moreover, given the critical nature

of the services provided by the service provider, rarely are the parties able to agree to a straight-forward liability structure. More often, the liability structure for lift-out transactions is a complex combination of acknowledging that the people, infrastructure and processes were originally the customers, but also recognizing that the service provider will modify, evolve and potentially even replace or sunset these assets over time once in the possession of the service provider, and include numerous separate caps and baskets for certain types of liabilities, and carve-outs to the consequential damages waiver for certain liabilities.

## Governance

A comprehensive governance process is critical in most outsourcing transactions; and this is equally, if not more, important in a lift-out transaction. The decision making processes under the outsourcing agreement must be efficient and enable the company to respond quickly to market changes, similar to the manner in which the company was able to respond prior to the lift-out. A number of elements often contribute to an efficient and effective governance process. First, the governance model should identify the roles both parties will maintain and describe with as

much precision as possible the responsibilities of those roles. Second, contractually requiring a regular meeting cadence is important. Third, the parties should include an efficient dispute resolution process to address operational issues, before they become impediments to the transaction's success. By providing a strong governance process upfront and addressing these and other key issues in advance, the parties to a lift-out transaction can provide a mechanism that will allow the parties to resolve future disputes when they do inevitably arise.

## Exit Rights

Whether due to the arrangement's natural expiration, poor performance by the service provider, or a change in strategy by the company, exit rights vary dramatically transaction to transaction depending on the type of internal capabilities transferred, and when in the life-cycle of the arrangement the arrangement is terminated. In anticipation of the potential for a termination of the arrangement, the parties should establish in the outsourcing agreement the appropriate distribution of assets, including people,

facilities, IP rights and processes and determine whether the company will have the right to take back any of the capabilities transferred to the service provider under the purchase agreement. In almost all cases, given the complexity of these arrangements and the interdependencies between the services provided by the service provider, and the success of the company's own business, the parties should provide for a significant transition period in the event the arrangement is terminated for any reason.

Please note that we have only highlighted some of the issues that arise in connection with these complex transactions. Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these transactions. We have a team of experienced partners across the U.S., EU and Asia dedicated to assisting customers on these and related outsourcing matters. Please contact the Gibson Dunn attorney with whom you usually work, any member of the firm's [Strategic Sourcing and Commercial Transactions Practice](#), or the authors.

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