

Morgan Lewis

together

Seminar for Sourcing:
Efficient and Effective Contracting



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Wednesday, May 4, 2011

Chicago, Illinois



Introduction

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Agenda

- Introduction
- Outsourcing Trends (*Liam Walsh*)
- Hot Topics in Outsourcing Contract Negotiations (*Peter Watt-Morse*)
- The Next Generation: Renegotiating and Rebidding Your Outsourcing Contract (*Barbara Melby*)

Logistics

- Facilities
- Contact Information



Hot Topics in Outsourcing Contract Negotiations

Hot topics

- Tougher negotiations in general
- Limitations on liability and exceptions
- Compliance with laws
- SAS 70 / SSAE 16 update
- Personnel issues – Automatic transfer
- Other issues

Tougher negotiations

- Contracting process seems to be more contentious and challenging
- Reasons?
 - Service provider prior experience (terminations; re-negotiations) – now taking more aggressive legal positions on key issues, including those to be discussed today
 - Involvement of customer sourcing personnel – sourcing and legal guidelines contrary to legal positions taken by service providers

Limitations on liability

- Harder to move off basic positions:
 - Disclaimer of all consequential, indirect and special damages
 - Basic direct damage cap – 12 months of fees paid or payable
- Negotiations typically revolve around exclusions to disclaimer and cap

Limitations on liability (continued)

- Potential Exceptions
 - Indemnities for third party claims
 - Breaches of confidentiality
 - Breaches of data security
 - Misappropriation of IP
 - “Abandonment” of services
 - Fraud and Willful Misconduct
 - “Gross Negligence”

Limitations on liability (continued)

- Exceptions to Disclaimer of Consequential Damages and Basic Direct Damages Cap
- Same exceptions for both?
- Pure exceptions vs. placement in Secondary Direct Damages Cap
- Secondary direct damages caps
 - Amount?
 - Separate cap or extension of basic direct damages cap?
 - More than one?
 - Within these caps – both direct and consequential damages recoverable? OK, but limit on amount of consequential damages?

Limitations on liability (continued)

- Provider sensitivity: damages relating to data security breaches
 - Indemnities for third party claims arising from breaches of data security
 - Direct claims for breaches of data security
- Issue of direct damages vs. indirect damages
- Defining direct damages (cost of remediation efforts)
- Provider liability for indirect damages

Compliance with laws

- Service Providers objecting to broad compliance with laws:
 - Allocation of obligation to monitor and comply with laws
- “Supplier Laws” are those law which:
 - (i) regulate the operation of the business of Supplier including laws relating to the employment or engagement of Supplier’s personnel;
 - (ii) regulate Supplier in its capacity as a provider of the Services [Note: this alone is Supplier’s desired outcome];
 - (iii) are privacy and data protection Laws applicable to Supplier as the processor of Customer Data or otherwise in its capacity as a provider of the Services; and
 - (iv) are promulgated by a country other than the United States and that are applicable to the performance by Supplier of the Services in, or the provision or receipt of the Services from, the Service locations where such Services are provided, and such laws would not have applied but for the outsourcing of the Services from or to such locations (e.g., there are no business operations of Customer in such country)

Compliance with laws (continued)

- “Customers Laws” are:
 - (i) Sarbanes-Oxley Act of 2002 and other similar Laws that govern the maintenance and assessment of a company’s internal financial auditing controls, in each case as applicable to Customer;
 - (ii) laws specifically promulgated for implementation or compliance by businesses in the [Insert] industry;
 - (iii) laws applicable to the operation of the business of Customer, including laws applicable to the receipt and use of the Services and not included in clause (iv) of the definition of Supplier Laws; and
 - (ii) privacy and data protection laws applicable to Customer as the controller of Customer’s Data
- Customer Compliance Directives / Policies
- Supplier must comply with Supplier Laws and Customers Laws, to the extent Customer has provided a Compliance Directive

SAS 70 and SSAE 16: Introduction

- Both standards are applicable when an entity outsources a function to another entity, and data resulting from that function is incorporated into the outsourcing entity's financial statements.
- SSAE 16 will supersede SAS 70 and will be effective for audits covering periods ending on or after June 15, 2011 (earlier implementation is permitted).
- Why the change to SSAE 16?
 - SAS 70 is a U.S. standard, and the International Auditing and Assurance Standards Board issued a new global standard for audits to report on controls at service organizations (ISAE 3402).
 - To align the U.S. standard with new international standard, the AICPA designed SSAE 16 to mirror ISAE 3402.

SAS 70 and SSAE 16: Similarities

- The procedures required by SSAE 16 are either the same as, or more rigorous than, those required by SAS 70.
- Similarly to SAS 70 report preparation, auditors prepare one of two types of SOC 1 reports:
 - As with a SAS 70 Type 1 report, a SOC 1 Type 1 report includes the auditor's opinion of whether the service provider's description of its system and controls is fairly presented and whether the controls are suitably designed and implemented (and are therefore capable to achieve control objectives).
 - As with a SAS 70 Type 2 report, a SOC 1 Type 2 report includes (in addition to the items in a Type 1 report) the auditor's opinion of whether the controls were operating effectively. However, unlike the SAS 70 report, which addressed a specific point in time, the SSAE 16 report will address the entire period covered by the audit.

SSAE 16 and SSAE 16: Key differences

- Under SAS 70, management of the service organization must provide a letter including written representations regarding the design and effectiveness of the controls.
- Under SSAE-16, management of the service organization must provide written assertion including the following:
 - There are specific requirements that management must meet in order to provide this written assertion, including selecting appropriate criteria for evaluation and identifying risks that threaten the achievement of the controls.
 - If the service organization relies on controls in place at a subcontractor, and management's description of the service organization's controls includes the controls in place at the subcontractor, the management of the subcontractor will also need to provide this type of written assertion.
 - In a Type 2 report, if the SSAE 16 auditor is using the work of an internal auditor, the report must include a description of the internal auditor's work and how the SSAE 16 auditor treated that work.

SAS 70 update

- Just a note to include the new standards ... for example:

The requirements of Supplier in this paragraph shall apply to any standards that supersede or supplement the SAS70, including the Statement on Standards for Attestation Engagements (SSAE) No. 16 – Reporting on Controls at a Service Organization (US standard) and International Standard on Assurance Engagements (ISAE) No. 3402 – Assurance Reports on Controls at a Service Organization.

Personnel issues – Automatic transfer

- Primarily a concern when EU employees/contractors are involved
- Significantly different than U.S.
- Front-end concerns
- Protecting the parties on the back end

Front-end concerns

- Will any customer personnel or personnel from a current provider auto transfer?
- What does your current contract say?
 - Redundancy costs
 - Unfair dismissal
 - Notice requirements
 - Employee claims
- What do you want your replacement provider to do?
 - Retain personnel
 - Terminate

Back-end concerns


- Same issues as the front end
- An opportunity to be smarter

Other Provisions

- Change of Control / Assignment
- Termination rights – convenience fees vs. cause
- Renewal and Termination/Expiration Assistance
- Vendor solvency - guaranties



Questions and Answers



The Next Generation: Renegotiating and Rebidding Your Outsourcing Contract

What we want to accomplish

- Overview
- Drivers
- Process
- Assessing the contract
- Critical terms
- Q&A



Overview

Overview

- The outsourcing industry is maturing and renegotiation, termination and resourcing can be viewed as part of the natural cycle
- Dynamic deals are being reviewed and adjusted periodically
- Strategy shifts (e.g., from full scope to multi-source strategies) drive renegotiation, termination and resourcing activities



Drivers

Drivers

“Change” Drivers:

- Change in Customer’s business (acquisition, divestitures)
- Material changes to original scope of services
- Changes/advances in methodologies/ technologies
- Change in Customer’s management
- Change in sourcing strategy (multi-sourcing, insourcing)
- **Requirements to “change” contract economics**

Contract and Performance Drivers:

- Expiration
- Three year itch
- Poor performance by Supplier (real or perceived)
- Poor customer satisfaction
- Disagreement on contract interpretation
- Unexpected cost creep
- Unrealized expectations
- **Governance issues**

It's a tough economy: Are there ways to reduce costs?

- Market pricing: bringing the fees in line with the market
 - Negotiating
 - Benchmarking
- Variable pricing: pay for what you use
- Transaction or FTE based pricing: shifting the pricing model
- More flexibility: better ability to bring services in and out of scope
- Better termination options
- Less “add on” fees
- Less “nickel and diming”

Other pricing issues

- Addressing pricing errors
- Addressing true ups and due diligence errors
- Address performance issues that impact pricing due to Supplier failures (particularly transformation failures)

Vendor objectives

- Retain profit
- Increase customer involvement and awareness
- Improve communications and escalation paths
- Clear the air

Top 10 governance issues

1. Post-contract processes and decision rights not defined
 - How does service request process work? Who needs to approve (from client & provider)?
 - What are roles, responsibilities, and workflow?
Any new tools/systems requiring integration?
2. Little or no support from client leaders receiving services
 - Lack of buy-in, which can result in active or passive resistance.
 - Root Causes: No active engagement on front end. No active ongoing engagement.
3. Poor mutual understanding of the contract
 - Client/Provider have multiple interpretations of contractual requirements.
 - Root Causes: Multiple new people involved on both sides. Provider employees bring what they did on their “last deal.”
4. Client governance team not in place or too small
 - No one in place to direct traffic or too much traffic to handle.
 - Root Causes: Focus on “doing the deal” vs. “managing the deal”; not enough resources.

Top 10 governance issues (continued)

5. Client governance team lacks required skills
 - Even if team is in place, they may not have the right skills. Of client staffs, 60% assigned have no prior outsourcing experience/40% provide no initial training for retained team.
6. Loss of key talent/poor knowledge transfer
 - Can cause degradation of service.
 - Root Causes: Poor/no communication from the client, Poor knowledge transfer execution by provider.
7. Inability to meet pent-up demand for services
 - Client curtailed investment/activities in services prior to outsourcing. Methods to prioritize, estimate, approve, and perform are all in the midst of other changes.

Top 10 governance issues (cont'd)

8. End-user resistance to adopting new methods

- Lack of compliance and/or delays in adapting to new requirements
- Root Causes: Lack of leadership commitment. Uncomfortable/resistance to change.

9. Culture clash between client and Supplier

- Different styles in terms of speed, style, decision making, and organizational structure
- Root Causes: Inflexibility based on expectations:
Service Provider: “deliver to the contract”
- Client: “deliver to expectations.”

10. Changes don't last

- Old habits die hard.
- Root Causes: Reduced dialogue with business stakeholders and/or providers. Cut backs in governance team staff. Reduction in process rigor.



Process

The renegotiation process

- Define customer's objectives and desired results
- Obtain management support
- Identify point people
- Involve Legal Counsel
- Involve HR
- Involve Audit
- Identify timelines
- Build project plan

The renegotiation process (continued)

- Determine impact of change/termination on business
- What is the transition/back up plan
- Initiate dialogue with the Vendor

Key success factors

- Practicality of objectives
- Commitment of management
- Commitment of organization
- Underlying customer/vendor relationship
- Profitability of original deal
- External economic factors

Practical considerations

- Customer must be ready, willing and able to exercise its rights and alternatives
- Re-competes require as much detail and diligence as the original procurement, and renewals require as much detail and diligence as re-competes
- Work at the highest levels within Supplier because Supplier's account team may have its own agenda
- Supplier has no incentive to concede margin or contract terms without good reason
- Supplier must deliver on its transition assistance obligations
- But, once a relationship has been lost, Supplier will make sure it gets everything to which it is entitled under the contract
- The best renegotiated contract in the world won't mean much without good governance

Creating leverage

- Effective leverage comes from Customer developing viable alternatives that are financially, technically, and tactically feasible and desirable, and being ready, willing and able to execute
- The single most powerful tool for creating leverage is the ability to get up and walk away from the table without a deal
- Is termination with the incumbent an option?
 - **At expiration?**
 - **For convenience?**
 - *What is the cost?*
 - *Can you terminate in part or only the entire relationship?*
 - *Do you expect to recover the termination fees? If so, how?*
 - **For cause? Is renegotiation an option in the presence of a default?**
- Is insourcing or resourcing an option?
- If you don't renew or if you can terminate, insource or resource, what are the transition risks and mitigation options?

Creating leverage (continued)

- Carrots

- Demonstrating pending growth, richer renewal, expanded scope
- Working toward restructuring financial and performance requirements that have been problematic for the incumbent
- Even in a termination scenario, leaving some scope with the incumbent may be helpful

- Sticks

- Developing an RFP, qualifying other service providers or developing an insource option
- Demonstrating the probability of termination or expiration and transition
- Demonstrating cost-effective exit options and alternative sources, including insourcing
- Halting new work and starting to re-source or insource existing work; are there other options for existing or new work?
- Demonstrating that current pricing is materially above market
- Planning for excluding incumbent from re-compete opportunity



Assessing the Contract

Key contract issues

- At Signing
 - What is it
 - Who does it
 - Who owns it
 - How much will it cost
 - What happens if it isn't done
- At Renegotiation
 - Has there been a default
 - Are there termination rights
 - Are there renegotiation rights
 - Ability to Use a Third Party
 - Assistance/Training

Assessing the contract

- Term
- Termination Rights
 - For convenience
 - For cause
 - Others
- Resource/Insource rights
- Termination Assistance
- Continued Performance

Assessing the contract (continued)

- Termination and wind down fees
 - Do the calculations up front
 - Do you have what you need to determine wind down
 - Review notice periods
- Look at overall exposure
 - Supplier and internal costs

Assessing the contract (continued)

- Who owns what?
- What can you reuse/share?
- Look at confidentiality restrictions
- Rights to Share Documentation/Data

Assessing the contract (continued)

- Employee issues
 - EU: consider automatic transfer
 - Review of employee transfer rights and requirements
- No solicitation?
- Staffing requirements

Be prepared

- Know the Contract
- Review Ancillary Agreements
- Read the Exhibits
- Establish a Time Line
- Establish Grounds for Termination
- Comply with Notice Requirements
- Comply with Dispute Resolution

Be prepared (continued)

- Develop a Transition Plan
- Identify Key Personnel
- Identify Key Technology/Tools
- Identify Key Documentation
- Identify Key Assets



Critical Terms

Critical terms

- “Unsuccessful transformation” may require remediation and re-engineering and may impact steady state services
- Services description
 - **Clearly defined and inclusive services, client responsibilities and financial responsibilities**
 - **Sweep-up clauses**
 - **New Services concept carefully defined**
- Service level management methodology with meaningful amounts at risk
 - **Based on history, are the service levels measuring the “right things”?**
- Flexibility going forward
 - **Non-exclusivity; unrestricted right to use third parties**
 - **Cooperation in a multi-vendor environment**
 - **Low or no contract minimum commitments**
 - **Viable exit strategy – full and partial terminations at reasonable costs excluding future profits**

Critical terms (continued)

- Technology and process evolution
 - Continuous improvement
 - Gain sharing
- Pricing
 - Variable pricing structure with meaningful ARCs and RRCs to handle material fluctuations in service volumes
 - Invoicing requirements in a global transaction
 - Inflation risk (on-shore and off-shore)
 - Currency fluctuation risk
 - Tax allocation (domestic and foreign)
 - Right to withhold disputed charges
 - Benchmarking

Updating terms

- Information security requirements
- Data protection and privacy
 - Data breach notification
 - Mandatory encryption
 - HIPAA
- Audit rights
 - Compliance with client's internal controls
 - SAS 70 Type II Audit requirements and practices evolving
 - Audit assistance included as part of "Services"
- Compliance with law
 - Import/export and offshoring
- Service provider's financial condition

Conclusion

- Both parties should define objectives and bottom lines
- Be prepared and be aggressive -- but remain practical
- Termination should remain an option (contingency planning is important)
- Consider costs/consequences of a formal dispute (is an equitable settlement a better option?)



Questions and Answers



Thank you



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