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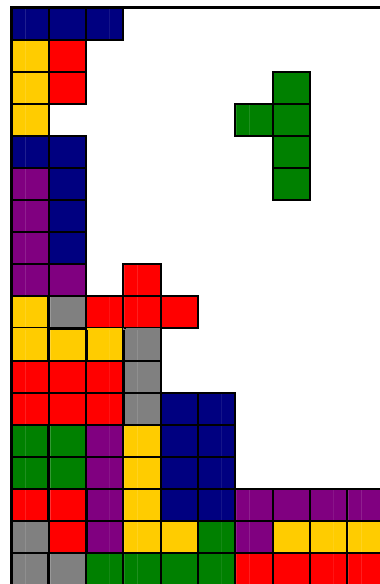
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Benchmarking – A “New” Contracting Practice

“Best practices” have long dominated recommendations to financial institutions; but the current and challenging economic environment, and the regulatory scrutiny that is being re-applied in its wake, mandate a searching inquiry for “new practices” – ones that demonstrate thought leadership.

Benchmarking

Anecdotal evidence suggests that in this economy companies that outsource information technology services are now ranking cost control over longer term objectives, like risk/reward tied to business outcomes.¹ One such company pin-points its problem this way:

In modernizing some of our outsourcing contracts, we found that some had been established without appropriate benchmarks. As a result, they didn’t ensure that the outsourcer was benchmarking pricing periodically and adjusting the costs to our company accordingly. Because of this, our company had been paying more than necessary for some outsourced functions over the past years.

The mistake is several years old, but we weren’t aware of its full magnitude until we took a close look at the contracts.²

Benchmarking can mean many different things, but in information technology outsourcing it most often refers to the periodic re-evaluation of pricing and, less often, service level agreements (SLAs) in an existing contract against prevailing market terms and conditions.

The cost and time required to perform the kind of benchmarking that is legally enforceable and that can produce meaningful results may well exceed the needs of the parties to many IT services arrangements. So, benchmarking makes best sense in the context of a longer-term contract for which price changes resulting from the benchmarking would be material. Within these limits, benchmarking is a “new

¹ Cf. Marianne Kolbasuk McGee, *Pay For Performance*, Info. Week 32, Mar. 23, 2009, available at <http://www.informationweek.com/news/services/outsourcing/showArticle.jhtml?articleID=215901168>.

² *What The Contracts Didn’t Say*, Info. Week 20, Nov. 17, 2008.

practice” that makes sense because it ensures fair, competitive pricing for the purchaser of services and a fair, market-based return for the vendor. (A vendor may well resist benchmarking because they see the practice as one that erodes their product margins.)

Benchmarking requires a well-defined process that is administered by a knowledgeable neutral. Here is an example of a benchmarking provision:

I. Benchmarking Company

Fees payable under this Agreement will be periodically subject to a benchmarking program as described herein. The benchmarking program will be conducted by an independent industry-recognized benchmarking service provider (“Benchmarking Company”) designated by Company, but subject to all requirements described in this Section I. The Benchmarking Company shall: (i) be independent, (ii) have demonstrable experience in performing benchmarking reviews of information technology outsourcing transactions (“Benchmarking Services”), (iii) agree to maintain the confidentiality of all data by signing a Non-Disclosure Agreement with Company and with Vendor with terms reasonably acceptable to each party, and (iv) not be a direct competitor of Vendor. Vendor and Company acknowledge that, without limiting the generality of the foregoing, (a) the following companies would be acceptable Benchmarking Companies: . . . and (b) the following companies would be direct competitors within the meaning of clause (iv) Vendor reserves the right to revise this list of direct competitors, in its reasonably exercised discretion based on market data regarding such companies’ business lines, when notified by the Company of the commencement of Benchmarking Services via a Benchmark Notice.

II. Scope of Benchmarking Services.

With Vendor’s and Company’s cooperation, Vendor shall conduct a benchmarking program that shall enable Company to compare the Fees with, and so that the Fees are competitive with, fees and/or rates paid by reasonably comparable third party customers for such services in view of their Service Levels (or analog) and other conditions of performance. The costs for such Benchmarking Services shall be paid by Company.

. . .

III. Benchmarking Procedure

Company may request Benchmarking Services pursuant to a Benchmark Notice for all Services on any date after the eighteenth month of the Term on up to two occasions – one during the second Contract Year, and one during either the third or fourth or fifth Contract Year. As part of the schedule for Benchmarking Services, a date will be set by both Parties on which resulting pricing changes, if any, will be effective. If such schedule is delayed due to a longer than expected time frame for such Benchmarking Services, such pricing changes would be retroactive to such effective date. . . .

. . .³

Commoditization of information technology services has made benchmarking a precise and useful tool in IT services relationships.

Commoditization

IT services providers look at outsourcing services in 3 phases: First, the launch phase in which buyers are capturing market advantage by being “the first kid on the block to have it” and paying for development of the product. Second, in commoditization a product becomes substantially

³ H. WARD CLASSEN, A PRACTICAL GUIDE TO SOFTWARE LICENSING FOR LICENSEES AND LICENSORS 639–642 (2d ed. 2007).

indistinguishable from its competitors, and the competition results in a reduction in costs. Finally, differentiation with new features and functionality becomes the path to breaking from the pack and producing additional revenue sources.

Benchmarking is appropriate when either a long-term, launch phase contract is overtaken by the cost reductions forced by commoditization or the IT services in a contract have already been commoditized. Thus, benchmarking can refresh a contract and as well as partnership trust and confidence.

For many years IT services vendors and purchasers have employed other techniques to keep long-term contracts in line with current market conditions. Among these are the most favored customer clause and periodic contract re-negotiation.

Most Favored Customer

Financial institutions with leverage have used the “most favored customer” contract clause to ensure that they are getting their vendor’s best pricing. “Most favored customer” goes something like this:

In no event shall Customer pay a fee for any Services, whether such Services are provided on a Fixed Fee basis or on a time and materials basis, that exceeds the fees paid by any of Licensor’s other customers for services comparable to the Services. On an annual basis Licensor’s auditor shall certify in writing that (1) no Fixed Fee arrangement and no rate or price . . . exceeds this limitation and (2) any fee that would exceed this limitation has been reduced to be the same as or less than the lowest price charged to any of Licensor’s other customers for comparable services. Licensor’s compliance with this provision shall be subject to audit . . .⁴

While this clause protects the outsourcing business against their vendor’s offering a more competitive price to another of its customers, it does not ensure that the vendor’s pricing remains responsive to current competitor pricing. Most favored customer internalizes the process rather than looking outward to the marketplace. Thus, this solution is less effective than benchmarking.

Purchasers have sought, and obtained, extensions of the above scope by expanding the terms and conditions subject to benchmarking, for example:

Notwithstanding any other provision of this Agreement, Company agrees to treat Customer as a most favored customer in the provision of services. Among other things, Company agrees not to reassign any staff assigned to the performance of this Agreement to other projects until such time as the System is satisfactorily operational, unless such reassignment would not materially affect the quality or progress of System Implementation and is agreed to by Customer, which agreement shall not be unreasonably withheld. Company shall inform Customer of, and make available to Customer, at a reasonable rate not to exceed that charged to any other Company customer, any newly developed enhancements of the System. Company shall provide Services, including (but not limited to) programming request priority, production quality and level and availability of dedicated resources, at a level at least equal to the services Company provides to its other customers.

This most favored customer clause, like most others, includes qualifiers that limit applicability to “similar services” or other agreements with “similar terms and conditions,” qualifiers that make enforcement difficult. And, the process remains internally focused. The more formalized benchmarking process administered by a knowledgeable neutral would be better than relying upon the general contract dispute resolution mechanism to interpret these vague terms of art.

⁴ *Id.* at 233.

Re-Negotiation

Focusing on the marketplace generally and specifically on other competitors, parties to an IT services agreement have also resorted to mandated, good faith re-negotiation to ensure market-based commodity product pricing:

Prior to the second anniversary of this agreement, and prior to each second anniversary thereafter, the parties shall commence discussions regarding the pricing for services provided pursuant to this agreement and shall negotiate in good faith to reach revised pricing for such services that is comparable to that generally prevailing in the industry for such or substantially similar services.

If the re-negotiation does not yield a mutually agreeable result, the dissatisfied party might have a right to terminate the contract. In other cases, the parties may take the matter to arbitration or another formal dispute resolution forum, like a court.

Enforcing re-negotiation is problematic. First, “good faith,” while a recognized legal standard, may have meanings that vary in the specific circumstances of a case and, certainly, ones that vary depending upon the parties’ respective positions. Ultimately a judge or jury will decide what “good faith” means without more objective criteria, and more objective metrics are difficult to develop.

In the re-negotiation process, the parties are likely to differ on the services that are either the same or “substantially similar” to those contracted. Thus, one metric is often in dispute. Finally, the generally prevailing pricing metric is also likely to be a matter of dispute.



Benchmarking prescribes terms and conditions to be re-examined (usually price and service level agreements) and the process by which it will take place (a market

analysis using specific metrics) and who will perform the benchmarking analysis (often a widely recognized firm in the technology consulting space). Benchmarking offers an externalized process that considers not only a vendor’s own terms, but also those of other vendors. It demonstrates a thoughtful approach that improves upon the less certain “most favored customer” or periodic re-negotiation options.

Raw Capitalism Revisited

Raw Capitalism observed that the current economic crisis was a real shock to Alan Greenspan. As Chairman of the Federal Reserve for many years, Greenspan fed the de-regulation fire, but in 2008 Greenspan admitted that his de-regulation ideology included a significant flaw; he thought market mechanisms would protect investor interests.¹

The breadth of Greenspan’s de-regulation ideology, now revealed, may be cause for other market failures, like the Bernie Madoff scandal. Brooksley Born, former Chair of the Commodity Futures Trading Commission, lunched in 1996 with Greenspan. He told her, “. . . you probably will always believe there should be laws against fraud, and I don’t think there is any need for a law against fraud.”²

¹ *Raw Capitalism*, CARPENTER LAW OFFICE CLIENT NEWSLETTER 1 (Robert H. Carpenter, Jr., Plano, Tex.), Jan. – Feb. 2009, http://www.carpenterlaw.net/images/Raw_Capitalism_Capital_Markets_-_Jan._09_.pdf.

² Richard B. Schmitt, *The Born Prophecy*, ABA JOURNAL 50, 52 (May 2009), http://www.abajournal.com/magazine/the_born_prophecy.

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