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NEW YEAR'S RESOLUTIONS

With each New Year, well-intentioned resolutions abound. List after list has appeared in recent weeks. And, by now, most have been forgotten or broken. Here is one for information technology vendors:

Resolution #6: *We will promptly fix at our own expense errors, bugs, and omissions found in our systems.*

There always seems to be discussion about what is a "bug fix" and what is an enhancement. If it doesn't do what is described in the documentation, it is a bug. If it does something stupid, it is a bug. If your clients are getting written up by the regulators, it is a bug.

We have also seen vendors argue that they have no responsibility for changed regulatory requirements. Frivolous changes (can you say "Reg. CC"?) that go well beyond what anyone ever reasonably expected banking software to provide may be exceptions, but banking is a regulated industry and you're already making lots of money off the industry. Just do it.¹

Actually, there is something more behind this resolution than "just do it" might imply.

What Did We Bargain For?

Most contracts for the outsourcing of data processing will include a provision something like this one:

Company shall maintain the Software and Services so that they will be in compliance with the applicable federal banking data processing output requirements specified by the Federal authorities applicable to Customer. Customer will make Company aware of any applicable local and/or state regulatory requirements that are different from those imposed by federal banking regulatory authorities. Customer shall be responsible for compliance with all applicable laws and governmental regulations related to the Services except as set forth herein.

¹ Bill McFarlin, *An Open Letter to Vendors*, GONZOBANKER, Jan. 6, 2006, <http://www.gonzobanker.com/article.aspx?Article=262>.

This language is not much better than some used several years ago:

Company will endeavor to maintain the Company Systems so that they will not be disapproved by any federal or state regulatory authority with jurisdiction over Customer's business. If Customer believes that any modifications to the Company Systems are required under any laws, rules, or regulations, Customer will promptly so inform Company. Company will perform any modifications to the Company Systems or recommend changes to operating procedures of Customer that Company determines are necessary or desirable. Notwithstanding the foregoing, Customer acknowledges that the Company Systems may, from time to time, consist in part of Systems licensed by Company from third-party vendors and, therefore, Company shall have no duty or responsibility to modify any such third-party System under this Section, except to the extent that the vendor thereof has such a duty or responsibility to modify such System pursuant to the applicable license agreement between Company and such vendor.

Software vendors often address the same issue this way in their maintenance agreements with customers who perform their data processing in-house: "Company will provide Licensee with all revisions, upgrades and enhancements that are generally made available to other users of the Licensed Program."

In neither the outsourcing nor the software maintenance provision is there a contractual assurance that regulatory updates are included. Now, competition will arguably compel an information technology vendor to provide services or maintain its software so that its customers, particularly those in a highly-regulated industry like financial services, will be in regulatory compliance. But, the fact that *GonzoBanker* sees fit to include a New Year's resolution on the topic suggests that prevailing market forces are not that efficient.

Promises, Promises

Remember our old friend "clarity"?² What do the foregoing contract excerpts promise? Really, nothing! (Most assuredly, vendors believe that they have promised something, and so do their customers. But without clarity, there probably has not been a "meeting of the minds" on what that is. There may not even be a legally enforceable agreement on the point; and, if there is, it may not be what one party or the other, or even both parties, expects.)

First, none of the Federal banking agencies issues "output requirements" for data processing systems. Further, those same Federal banking agencies do not approve or disapprove data processing systems.³ In their bank examination procedures they do test the adequacy of bank systems, and in their examination reports they do comment on vendor management (including systems and software providers) and the performance of a technology service provider (TSP). But the burden for regulatory compliance is on the financial institution, not any of its third-party providers.

The Federal Financial Institutions Examination Council's (FFIEC) IT Examination Handbook describes in detail the member agencies' expectations for TSPs and the responsibilities of financial

² See *C³ = The Right Word*, CARPENTER LAW OFFICE CLIENT NEWSLETTER (Robert H. Carpenter, Jr., Plano, Tex.), May 2005, http://www.carpenterlaw.net/images/C3_The_Right_Word_May_2005_2007.pdf, for a simple set of drafting rules to improve any document – "*be clear, be concise, be complete.*"

³ The Tennessee Department of Financial Institutions maintains the right to "disapprove [a Tennessee-chartered] financial institution's choice of servicer," TENN. COMP. R. & REGS. 0180-13-.03(1) (2007), *available at* <http://www.tennessee.gov/sos/rules/0180/0180-13.pdf>, but this provision does not necessarily imply approval or disapproval of "systems" or "software."

institutions to ensure that these expectations are met.⁴

What's a Guy to Do?

If a financial institution is ultimately responsible for regulatory compliance that is, at least in part, dependent upon its TSP, then the contract between TSP and financial institution should clearly, concisely and completely identify the TSP's responsibilities. So, what should the contract say?

The FFIEC suggests that a TSP might "agree to keep disclosures or calculations [produced by their systems or software] in compliance with banking regulations."⁵ Further, the FFIEC counsels that "contracts with service providers [should] include an agreement that the service provider and its services will comply with applicable regulatory guidance and requirements" – the latter presumably being those regulatory guidelines and requirements applicable to the financial institution itself.⁶ These suggestions do in fact go further than most contracts to define a TSP's responsibilities.

How about this solution that attempts to balance competing interests?

Company will use commercially reasonable efforts to provide its services in a manner that will allow Customer to comply with Federal laws, rules and regulations as the same may be amended or replaced from time to time. If Customer believes that a modification to Company's services is required for Customer's compliance with any such law, rule or regulation, Customer will promptly so inform Company. Company will perform any modifications to the manner in which it provides its services that Company reasonably determines are necessary or desirable.

And for maintenance agreements covering licensees who process their data in-house:

Licensor will provide Licensee with all revisions, upgrades and enhancements that are generally made available to other users of the Licensed Program. Licensor will use commercially reasonable efforts to produce such revisions, upgrades and enhancements so that the Licensed Program will allow Licensee to comply with Federal laws, rules and regulations as the same may be amended or replaced from time to time.

Of course, there are the related issues of who will pay for such changes and is there some threshold of change below which the technology vendor should pay? The point, regardless of how the fundamental question and such related ones are decided, is that parties to a contract must express their agreement so that in the event of a dispute – when the vendor "Just Says No!" – a judge and jury who are informed only by the contract can determine what the parties intended.

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⁴ See generally FED. FIN. INST. EXAMINATION COUNCIL, IT EXAMINATION HANDBOOK, OUTSOURCING TECHNOLOGY SERVICES (2004), available at http://www.ffiiec.gov/ffiiecfobase/booklets/outourcing/Outsourcing_Booklet.pdf [hereinafter OUTSOURCING BOOKLET], and FED. FIN. INST. EXAMINATION COUNCIL, IT EXAMINATION HANDBOOK, SUPERVISION OF TECHNOLOGY SERVICE PROVIDERS (2003), available at http://www.ffiiec.gov/ffiiecfobase/booklets/tsp/tech_ser_provider.pdf [hereinafter SUPERVISION BOOKLET].

⁵ SUPERVISION BOOKLET at 4.

⁶ OUTSOURCING BOOKLET at 16.