

The art of negotiating vendor contracts

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If you are nearly ready to sign a vendor contract, there are a number of points you should address to better protect the long-term interest of your institution. Negotiating fees may be one of the easiest items discussed in such a complex process.

The FFIEC and FDIC have published several documents that identify important elements contracts should contain. These documents are focused on outsourced contracts versus in-house. However, many of the same principles apply for either mode of processing.

Combining information provided by these organizations, along with insights we'll share from our experience of reviewing and negotiating numerous contracts as a result of client engagements in the financial industry, can build a more strategic and informed view of how to proceed with negotiating such a complex and confusing task. The content of this document is not intended to be all-inclusive and is provided in a nonlegal capacity. Your organization should contact a knowledgeable attorney who deals with technical contracts on a regular basis to provide appropriate legal counsel.

Getting to the table

A vendor typically presents their contract during a meeting. They may intend to have you sign the documents and leave that day with your down payment. We recommend that a sample contract be requested long before the day you intend to sign the agreement. It may be appropriate to request it along with the initial price quote and to review it prior to selecting your vendor. This allows time for you to fully review the terms and conditions and to negotiate changes that are more favorable to your institution. It also removes much of the pressure to move forward when the vendor may have an advantage due to timing for any number of reasons, including pending price increases, securing a desired conversion date, or getting the order in before the end of a quarter (to help the salesperson meet his/her quota).

Also keep in mind that the company you select is likely to be one of your vendors for a long time, and it is important to have them as a partner for your future success. Negotiating a win-win situation is healthy. The company you select must be profitable—not only to meet your ongoing support needs, but also to have sufficient funds to invest in product enhancements.

Negotiating a deal that is a money-loser for the vendor may cause them to cut future support or forgo investment in product enhancements that will be important to you.

Recommended points to review and negotiate

When reviewing a contract, consider each of these areas as a point of negotiation. It is helpful to rank each point within these areas relative to its importance to your institution (using a high, medium or low ranking) and whether you believe that the vendor will agree to your request (again, using high, medium or low). This will clarify the effort that may be in front of you.

Scope of services

A contract should clearly spell out what the vendor is to do as a result of contracting with your organization. This can be written into the contract at a fairly high level (with the use of addendums, for example), unless the service involves customization—such as modifying the base system to provide unique requirements. It is also appropriate to refer to attachments such as vendor literature or detailed documentation. Detailed time frames should be included for significant milestones, including training dates and conversion dates.

If a request for proposal (RFP) was used to define the requirements to a vendor, this document and the vendor's response should be incorporated as part of the agreement. You may also want to state that any representation of the product made in sales presentations becomes part of the product's "capabilities" and, therefore, part of the contract.

If the agreement is to include custom requirements, the contract should include a detailed scope of work (SOW) that covers specifically what is to be delivered and within what time frame. Without a SOW for these types of projects, the vendor does not know exactly what to develop, and the project can become endless at added cost to your institution.

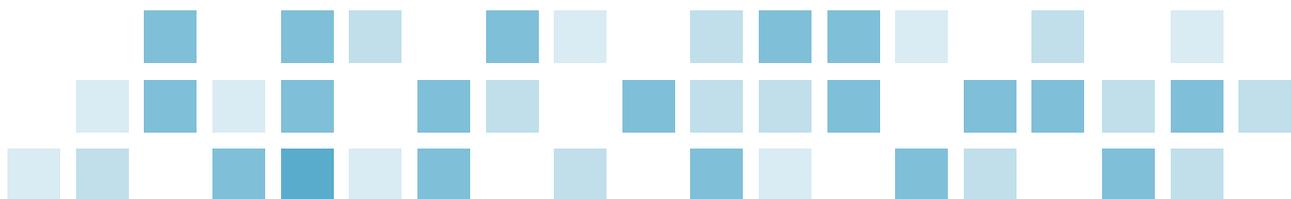
Performance standards

Once the scope of services is defined, performance standards should also be developed for the delivery of services. Performance standards are generally more detailed in a service bureau delivery mode versus processing in-house; however, each will have its unique criteria. Vendors may have their own standards that can be reviewed during the selection process that will provide some guidance. However, your organization will likely want much tighter conditions since it's in the vendor's best interest to make them somewhat vague.

For the service bureau delivery model, items such as processing availability are critical. The hours of online operation and average uptime should be considered. As an example, your vendor needs to know that your branches are open certain days of the week and hours of each day. Branches may be open late on certain days or your grocery store branches may be open on Sundays. Uptime as a percentage of total online time is also important. One example is having no more than one-half of 1 percent downtime over a period of one business month.

Measuring this is important because the downtime may not be the fault of the processor. It may be your data carrier, in which case, this should be a performance criterion in that agreement. Other examples of performance criteria include delivery of statements, reports, notices, posting of data, accuracy of data and response time to resolve processing errors or support calls. Review the scope of services and identify the performance you desire.

If the system is going to be installed in-house and operated by your staff, similar performance standards should be defined, e.g., hardware, uptime, time to respond to service calls, response time to return and resolve support calls on software and after-hours support.



Any defined performance standards should have specific penalties in place if they are not met, based on the degree of severity. It is important to establish the penalties within the contract. Trying to recover any damages without having them defined is very difficult.

Security, controls and confidentiality

Much emphasis has been placed on security and confidentiality of client and bank information as required by the Gramm-Leach-Bliley Act Section 501(b). The terms and conditions for the contract will vary based on whether the vendor is providing an outsourced service or you are acquiring a system to run in-house.

Outsourced services

If you are contracting to operate in a service bureau mode, it is your responsibility to ensure that the vendor is maintaining an environment to safeguard customer information. The contract should identify the records and logs the vendor maintains (e.g., system uptime, system processing errors, processing completion start and completion times, physical access) and your right to review those records. It should also identify any material changes to your service, the systems or controls. You should be notified when such changes are being made.

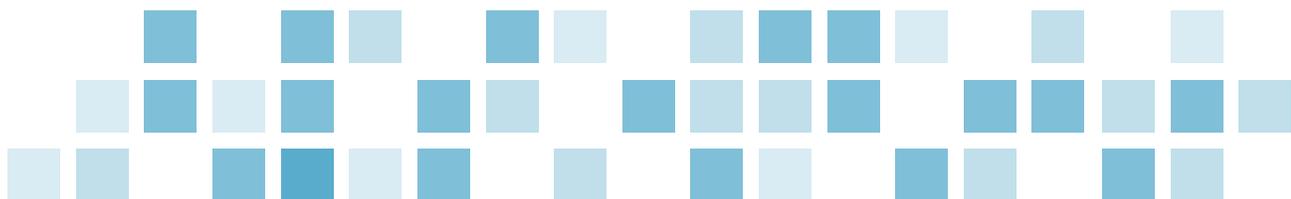
The vendor's assurance should not only be spelled out in the contract, but you should also include a provision that the vendor is to have a third-party review of the security and provide a SAS 70 Type II report for your review and files. Carefully evaluate the scope of this audit, which includes a description of the controls and testing, and the third party's findings. Based on the results documented in the report, you may still need to require other information and reports to be satisfied that the appropriate controls are in place and, most importantly, are effective.

Finally, contractually identify the requirements to have your institution back online and processing should there be a disaster and your servicer has to invoke its disaster plan. The requirements should include the minimal capabilities of processing your organization's work and time frames to be operational again. It should spell out the penalties if you are not operational within the specified time frames.

In-house mode

Ensuring the appropriate security, controls and confidentiality for an in-house system is a function of the vendor providing the appropriate capabilities within the system and your policies and procedures. Wording should be included in the contract that states that the vendor's system must provide the appropriate security options within the system that, when implemented, maintain data confidentiality. Additionally, ask if the vendor has had a third-party review of the controls included in the code. If so, obtain a copy of that report prior to signing the contract.

Finally, once the system has been installed, consider having a third-party information technology controls (IT) review that provides a report of any areas that may need to be addressed by either your institution or the vendor. Consider writing terms into the contract that identify that it is the vendor's responsibility to resolve any major system-related deficiencies found as a result of the IT controls review. Tie the resolution to the deficiencies found in the controls review to a time frame and require the deficiency to be remediated by the vendor prior to final payment of a certain percentage of the contract.



Ownership of data, licenses and other critical items

In an outsourced mode, the data processed by the servicer must be identified specifically as being owned by your institution and cannot be used by the servicer for any purpose other than identified in the scope of services.

This is also the time to think about the terms and fees for deconversion. The deconversion process and cost should be spelled out specifically in the contract. Trying to negotiate this once you have notified the vendor you are moving to a new provider will not have any leverage for you at that point. It's your data and you should not be held hostage for significant fees to get it back for a conversion to another vendor.

When working with Internet/Web vendors, be sure to maintain ownership to items, such as domain names and logos, that may be designed and used specifically for your Web site and Internet banking. This may become a significant deterrent in switching vendors if the vendor owns these items and will not allow you to move them to a different vendor's site without paying exorbitant fees.

Duration of agreement

Several areas in the duration terms of a vendor's contract require your attention—they could cost your institution a significant amount in the future.

Length of term

License agreements vary regarding their length of term. Some are for a specific time period, while others are in perpetuity or may be tied to the term of the support agreement. Vendors are typically willing to provide additional discounts for a longer term. But this can be a two-edged sword if you get into a long-term agreement with a vendor who does not live up to their commitments. If you do not have a bad experience with a vendor or if their references are not solid, a short-term contract may be the best choice, allowing you to convert to a different vendor if necessary.

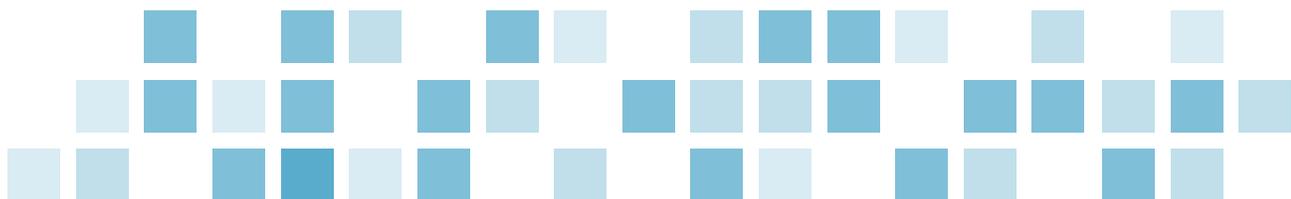
Watch for contract language that gives a specified time period, such as five years, and does not address what takes place at the end of that term. The exclusion of these details may conceal that the initial license fee is due and payable again for another term. For major contracts, such as core application processing, this could be tens of thousands of dollars that you are obligated to pay.

Be aware that most major vendors' support agreements include a multiyear term. When agreeing to such language, your institution is obligated for the full multiyear term, even though the fees are paid monthly, quarterly or annually. Consider negotiating more favorable language that allows any unused portions of support agreements to be cancelled or that a reduced fee be paid for unused services.

Automatic renewal

Many contracts will have automatic renewal clauses, particularly core accounting and item processing, for both the ongoing license and for the support agreements. There is typically a clause that says that "unless notified in writing 'X' months prior to expiration," the contract will automatically renew. It may renew for one year or for the length of the original term, which may be five or more years, at the then-published rates. We recommend that this type of terminology be deleted or modified to require the vendor to notify you in writing at least six months before the notification date.

If an existing contract has such terms, send the vendor a registered letter immediately notifying them not to renew the agreement. This places the vendor on notice that they will have to renegotiate with you or they are at risk of losing you as a customer. You always have the option to renew.



Penalties or early termination

Specific language should be included regarding events that could trigger vendor penalties (reduction in your fees) or termination of the contract. To have these triggers, performance criteria—such as maintaining regulatory compliance, maintaining security and system availability— must be well-defined. As an example, if the system is available for less than “X” percent of the processing hours defined, the monthly fee is reduced by “Y” percent (perhaps a tiered structure would be appropriate).

This is one of the most difficult areas to develop and negotiate. Picking the most important areas for your situation helps reduce the number of items to negotiate. Using a risk-based approach as previously described helps by identifying the importance of a particular item and then assigning a probability factor that such an event would occur.

Summary

Every contract from major vendors will contain similar clauses yet be very unique to the situation. You should always check references of both satisfied and unsatisfied customers (likely former customers) of the vendor before entering into any agreement.

Contract negotiation is an art, not a science. One of the most common leverage tactics a vendor uses is time. They may state that they need a signed agreement to meet a certain conversion date or maintain the current price because of a pending cost increase. Overcome this by asking whether a letter of intent is acceptable based on negotiating an acceptable agreement. Keep in mind, however, that this also puts a time limit on the negotiations and may lessen your advantage in the negotiation process.

Be prepared to walk away from the deal if any of your deal breakers are not met. Above all, as stated in the introduction, remember that a partnership with your vendors must be a win-win situation.

About us

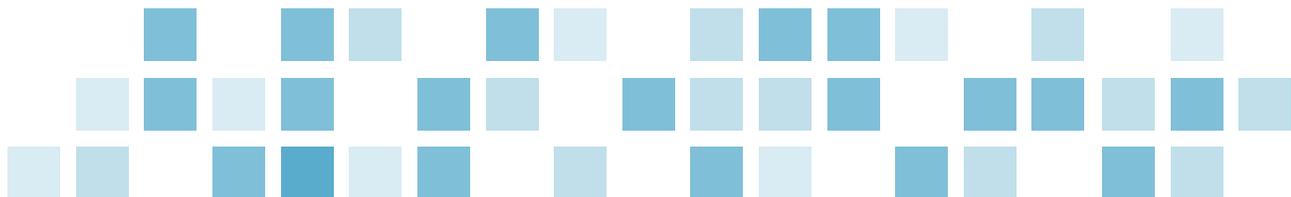
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In addition to technology and operational advisory services, we also offer accounting and tax consulting to help you succeed. And we provide them in an integrated manner that considers your organization as a whole.

About the author

Kent Conrad, *Director*, McGladrey, specializes in technology consulting services, including IT strategy plan development for the financial industry, core and ancillary system selection consulting, and information security policy and procedure development for all types of organizations. Kent has over 20 years’ experience working with information systems, which has allowed him to provide IT consulting services to domestic and international enterprises.



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