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Healing Troubled Contracts

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Outsourcing has been a phenomenon of the Nineties, as companies entrust vital IT operations to contractors. Nirvana is rarely achieved, and the trade press now reports disappointed customers, troubled contracts, and occasionally, terminations or legal proceedings.

What can go wrong, often does. Costs may exceed expectations while service does not. Projects may be late, overrun budgets, or misfire. Experienced staff may leave. Customers' remaining staff, accustomed to managing technology or operations, may tend to "micro-manage" the supplier's service, rather than manage the contract, which is a different skill. Some users may dislike change, especially critics who opposed the decision to go outside. Customers and suppliers alike must contend with changes in business conditions, strategy, and technology, as well as competing demands upon the customer's purse.

When contracts sour, none of the customer's options is attractive. Living with a bad contract has few charms. So-called "convenience" termination is a misnomer that may cost millions in termination charges. Default termination may mean litigation, with its delights – subpoenas, depositions, lawyers' fees and the rest. Disengagement may take months, and all the while, the customer must depend upon an unsatisfactory (and by then unhappy) supplier, whose staff is eagerly searching for other opportunities. Divorcing couples may separate quickly, but outsourcing suppliers and customers must continue to live together. It's not a cheery prospect.

Unhappy customers sometimes respond angrily, threatening termination and litigation. "Sue the bastards" becomes the war cry, and tough tactics may seem invigorating, but drastic measures (even when justified) are not always effective or wise.

The supplier may capitulate, fearing liability and tarnish upon its reputation. But the supplier has probably been through this before, and may respond in kind: demanding compensation for services it thinks out-of-scope, limiting service to the bare letter of the contract, issuing its own default notice, and asserting that the customer's claims are pretexts, meant to avoid termination charges.

When battle is joined, each side has something to lose, neither is likely to win a clear victory and, as most participants privately recognize, both sides usually share responsibility for the underlying trouble. Legal proceedings are disruptive, costly and unpredictable. Complete vindication is rare. More often, after prolonged aggravation and expense, the parties settle, or have compromise imposed upon them when a court or arbitrators award half a loaf.

Again, the divorce analogy seems apt. The unhappy couple can carry on in misery, negotiate separation and settlement, or have a nasty, destructive fight, and split assets three ways – one third to each, and the remaining third to the lawyers. Or they may attempt reconciliation, before any drastic, irreversible action is taken that shatters remaining trust, fixes positions in concrete, and lets legal strategy dictate decisions.

What, should a CFO or CIO do when faced with these dilemmas?

First, get independent advice. When evaluating what went wrong, and considering options, experts who know the marketplace can provide great value. They may know what has worked (or failed) elsewhere, and at what cost, and provide realism, impartial advice and hopefully, some imagination. Companies often discover that their troubles (and their suppliers') are not unique. Even successful relationships encounter difficulties, and even the best suppliers have problem accounts. When contracts turn sour, both parties usually bear some responsibility, and these insights may be more palatable when expressed by outsiders – who are less constrained by organizational pecking orders, thus more willing to articulate unpleasant or unwelcome conclusions.

Second, find out what went wrong. Conduct a thorough, dispassionate, internal investigation, taking pains to reassure all concerned that honest answers (and not scalps) are the goal. Engage inside or outside counsel to interview key participants, so that they can evaluate the strength or weakness of possible claims and defenses.[1] These matter in negotiation, as well as in any later proceedings; and in the event of proceedings, legal counsel's conversations, files and findings are generally protected by legal privileges and immune from disclosure during the Chinese water torture called "civil

[1] If possible, talk to the supplier's key personnel. The supplier may not talk to the customer's counsel, but often will talk to outside consultants (as they commonly talk to the customer's auditors).

discovery" or an eventual trial.[2] Do not, however, rush to turn this over to the trial warriors, whose business is doing battle. Their moment may come, but initially, counsel's role is secondary: to investigate, evaluate and advise, in hopes of helping management to find a solution.

Third, to get the full picture – which management will need to make or ratify decisions — compile the findings into a report or briefing, summarizing conclusions. Since the law protects communications with counsel, investigative reports or briefings, prepared by counsel and delivered to key management, can usually be kept confidential in the event of legal proceedings. A frank assessment is essential for sound decisions, but need not become a courtroom exhibit.

Fourth, evaluate the legal position under the contract. What rights exist to audit performance, engage senior management, or assess financial sanctions for poor performance? Strangely, these contract mechanisms are often neglected, when their use might forestall more serious difficulties. If the situation is already serious, consider what grounds, if any exist, for one party or the other to claim breach. Is the breach sufficiently serious to justify terminating the contract? What claims might the supplier assert? What defenses exist to claims by both sides? How strong are both sides' claims and defenses? These legal issues matter in court, but also provide leverage, and so affect bargaining strength. For example, the supplier who risks default termination, and a public rupture with a major customer (the worst advertising imaginable), may prefer an orderly retreat, dressed up as a convenience termination, even without large termination fees. The dissatisfied customer who has received mediocre service, without suffering severe disruptions, may be reluctant to attempt default termination, rather than risk a court determination that the termination was really for convenience, and obliged the customer to pay a large termination fee.

Fifth, decide upon ultimate goals, whether separation, scope adjustment, financial accommodation or some combination of measures calculated to salvage the situation. Business objectives must drive the strategy, and in most organizations, that strategy,

[2]Under the rules of civil procedure and evidence, most business records and communications must be disclosed, if requested during pretrial "discovery." Legal privileges protect (i) confidential communications between lawyers and clients, (ii) the attorney's work papers (including, in some circumstances, papers prepared by others for the attorneys), and (iii) settlement proposals. Details vary between state and federal courts, and from one state to the next, and are subject to various qualifications and limitations.

whatever it may be, will need strong executive support. This is especially true when contemplating the "nuclear options" of termination and litigation, with their costs, uncertainties and risks of disruption.

Finally, develop and execute a strategy to achieve those goals. The options – termination, legal proceedings, re-negotiation, and others – are usually alternatives. The preferred option may change over time. Pursuing multiple paths is good contingency planning that (coincidentally) provides leverage. For example, the supplier who learns that his customer has retained counsel, engaged consultants, begun writing a request for proposals, formed a working group and contacted competitors will instantly recognize that the customer is dead serious.

Cost-benefit analyses are helpful when weighing options. Replacing a supplier, for example, means turmoil, distraction, and substantial hidden costs — notably, loss of unwritten "tribal knowledge" of legacy systems and other institutional memory — in addition to the initial payments to a new supplier, and costs of a formal selection process. Litigation may be uneconomic, if one considers the real costs of transition, and adjusts potential recovery to reflect probabilities of success, delays in ultimate payment, legal costs, contract limitations upon the supplier's liability and the hidden costs of legal proceedings (especially the diversion of valuable time and attention from the company's business).

Strategies may vary depending upon the situation, contract terms and customer goals. Where the customer intends, or at least hopes, to renegotiate the contract and salvage the relationship, consider appointing a joint working group to discuss all issues, in confidence, with an agreement that nothing said or proposed will later be used in evidence. Confidentiality helps assure frankness, and minimize posturing.

Senior executives from both sides, without day-to-day responsibility for the relationship, may bring a different, more independent perspective to discussions. An experienced mediator can help the parties to find common ground, and assess their positions realistically, despite accumulated frustrations on both sides.

Throughout, consider the other side's position and perspective.

For suppliers, the process is similar. To begin with, find out what went wrong. Get independent advice (which is often available within the company, rather than from

outsiders). Consider the legal position. Pay attention to legal privileges to protect confidential assessments of that position. Then develop and execute a strategy.

For the supplier, however, there are some significant differences. Suppliers prefer to avoid nasty, public divorces from major customers, that may affect their reputation. So long as the customer has paid undisputed bills, the supplier may have little or no ground to terminate for default. Suppliers rarely, if ever, have any rights to terminate unilaterally, and without cause for their own convenience.

Suppliers have other leverage. No reputable supplier would deliberately disrupt operations (and the potential liability should deter any such temptations); but the supplier who formerly accommodated special requests may work to the letter of the contract, and let loose a flurry of change requests and claims.

Suppliers will scrutinize the customer's performance for possible breaches of the customer's obligations. These may or may not be sufficiently serious to justify termination, but delays, crossed signals, failures to provide facilities or equipment in a timely manner and other common miscues may permit the supplier to claim damages or compensation for additional services performed.

If the customer's grounds for claiming breach are debatable, the supplier will almost certainly claim that the customer's default notice is really a "convenience" termination, and demand a termination charge. If the termination charge is substantial, the customer's risks in any proceeding are magnified accordingly.

Suppliers rarely need to attend seminars or read articles on any of this, which is a disagreeable (but unavoidable) part of their business. Their experience with the process, with change orders, claims and the rest, may give them some tactical advantages over many of their customers, especially those more accustomed to managing IT or other operations than to managing contractors.

The supplier's liability for damages is often limited; but even so, the potential liability on large contracts can be very substantial – even before accounting for operating losses from troubled contracts, or the direct and indirect costs of termination or proceedings, or the impact upon reputation and future opportunities.

Usually, though not inevitably, dispassionate analysis of the risks and potential costs to both sides will confirm that some form of resolution – to re-negotiate, restructure, phase

out or even to arrange for orderly termination – is the best (or least unattractive) choice on an unappetizing menu. It is therefore helpful, if possible, to keep these situations free from personal antagonism, and maintain civil relations, so that resolution is possible. Both sides have legitimate interests. Both sides usually share responsibility for whatever difficulties exist; and usually, it is better to salvage than to scuttle.

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