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Renegotiation Success: How to Manage the Legal Pitfalls

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Companies involved in outsourcing arrangements sometimes find themselves considering termination of the agreement because the service provider's deliverables are not meeting contractual expectations. Or the current contract is nearing its expiration date and the company wishes to continue with the arrangement but with more favorable terms. Such crossroads lend themselves to renegotiation, often culminating in a reduction of services, and should be anticipated as a normal business event in today's global sourcing marketplace.

Other events that give rise to renegotiations include perceived misalignment of charges relative to the market, increased regulatory requirements, changes in technology, and other situations not contemplated or adequately addressed in the current agreement.

Timing can often play a crucial factor in negotiation discussions. A renegotiation undertaken independently of the pressure of an expiring agreement will usually yield more favorable results. If the service provider is proactively engaged, both parties can work toward a new agreement that is more closely aligned to mutual interests absent any defensive posturing. Nonetheless, the customer should ensure that the desired changes are reflected in the contract terms of the new agreement.

Contemplating Renegotiation

Any organization contemplating renegotiation should approach the situation with the same competitive outlook used to negotiate the original agreement. However, if the discussions involve only the incumbent service provider (as is often the case), then the renegotiation is more akin to a sole source, non-RFP transaction. As a result, such positioning may reduce the competitive pressure felt by the provider as compared to that felt during the original negotiation (assuming not sole-source). This may weaken the customer's leverage during renegotiation, but several best practices can aid the customer in the renegotiation process.

The use of a comprehensive agreement that contains market-tested terms and conditions can play a particularly critical role. It is important that the documentation be based upon solid industry practice and, ideally, consistent with terms and conditions familiar to the incumbent service provider. Also, in order to facilitate and expedite negotiations, the customer should

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present its proposed contract and critical contract schedules to the service provider with instructions that a specific, non-general response is required. This can be an important step in efficiently confirming as many basic terms and conditions desired by the customer as instructions that a specific, non-general response is required. This can be an important step in efficiently confirming as many basic terms and conditions desired by the customer as possible, so that renegotiations can focus only on transaction-specific issues and concerns. Other best practices include setting clear objectives for the renegotiation, involving appropriate parties, establishing financial baselines, and seeking external advice when necessary.

Renegotiation discussions predictably focus on pricing and scope of services, including the recalibration of service levels. The operating assumptions developed during the initial negotiation now have real historical data that can be leveraged by both the customer and the service provider for their individual benefit. Armed with this historical knowledge, customers would prefer to set the lowest possible minimum service levels, so that the guaranteed revenue accruing to the service provider is the smallest possible number, while having service providers place a greater percentage of charges at risk (but recoverable via performance incentives). It is important that the customer promotes service levels as tools for establishing the services themselves, not merely devices to measure performance. In this sense, historical service levels met by the service provider offer insight but do not determine service levels that should be adopted by the parties going forward.

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In addition to including a pre-determined expiration date, sourcing contracts typically include termination rights that allow the customer to end the relationship before the expiration date upon payment of a monetary sum. Termination rights may also allow the relationship to continue in a reduced manner while the services are "in-sourced" back to the customer or "re-sourced" to another service provider. Generally, the customer has the broader termination rights, often allowing it to terminate a sourcing agreement "for cause" or convenience, while the service provider typically has limited termination rights usually tied to either the customer's failure to pay or confidentiality breaches.

Termination rights can be extremely useful during interim (pre-expiration) renegotiation. Without such rights, the customer may face limited choices when dissatisfied with the current arrangement which is not naturally expiring: honor the existing agreement, regardless of whether or not the customer is satisfied from the services, or terminate the agreement, while risking a potential breach claim by the service provider. As a practical matter, typically neither party to a sourcing contract has a strong interest in proceeding to litigation as the parties are keenly aware of the negative repercussions, such as being branded a difficult partner. Moreover, service providers are extremely sensitive to "losing an account," so leveraging termination rights can strengthen the customer's bargaining position at renegotiation.

Preparing for Renegotiation

Once the decision to renegotiate has been made, it is critical to define a strategy and analyze the materials that support the approach. In this regard, it is important for the customer to capture any institutional knowledge gained and lessons learned as a result of the current sourcing arrangement and operational experiences.

Moreover, while the incumbent service provider has detailed operational and financial knowledge of the services underway, the customer must evaluate its rights to access or use this information. To determine whether any current operational data is accessible, the customer should consult the confidentiality provisions of the original agreement. If such provisions limit access to meaningful data, useful operational information frequently can be gleaned from current statements of work (or updated service levels) for defined services. Again, the ability of the customer to use this data may be restricted by the existing agreement.

A common theme in renegotiation often involves the customer's desire to tie the provider's performance (and financial incentives) to guaranteed and continued improvement. Sometimes, the customer simply wants to negotiate pricing to levels that are more consistent with the external market. Competitive benchmarking, and in particular "mark to the market" analysis, can be instrumental at this stage to focus the interim renegotiation on key areas where the customer can exert leverage to align pricing and service levels.

However, competitive benchmarking can be an expensive undertaking and can slow the renegotiation process. To address these concerns, many of the larger sourcing advisors are beginning to offer abbreviated competitive analyses that rely on internal databases to provide benchmark-like information with much faster turnaround.

While there may be a tendency in renegotiation to focus on an absolute reduction in pricing levels, other creative methods exist to structure more financial flexibility into a renegotiated agreement. Before engaging the incumbent service provider, the customer should consider the following inflection points to drive additional financial savings: 1) use of increased variable pricing, 2) reductions in incremental charges, 3) declining Additional Resource Charges (ARCs) commensurate with volume growth, and 4) forward-looking declining pricing that assumes productivity and technology improvements.

Another financial concession to enhance future flexibility is a reduction in "termination for convenience" costs. While it is reasonable in most circumstances to allow a service provider to recover direct wind-down costs and unamortized investments in a termination for convenience, recovery for lost profits function is a disincentive to service provider performance and should not be granted under any circumstances. Timing is another important consideration. In fairness, the customer should provide advance notice to allow the service provider the opportunity to redeploy committed resources.

Conducting the Renegotiation

Once the strategy and supporting materials for the renegotiation have been determined, the customer must decide whether to exclusively engage the incumbent service provider or to invite others to participate in the discussions. By conducting the renegotiation in an RFP-like manner, the interjection of competition can negate some of the advantages accruing to the incumbent service provider. To maximize the effectiveness of this approach, the customer must be willing (and able) to shift a portion of the outsourced work to a third party.

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The renegotiation process should yield a new agreement that addresses the customer's concerns. While financial terms are often a major focus of renegotiation, other contract terms must not be neglected. A recent trend in sourcing contracts has seen a shift towards agreements of shorter duration; although service providers will be inclined to offer higher pricing for the shortened term, the customer gains valuable flexibility.

Other issues, such as ownership and usage rights of intellectual property, data, equipment, and documentation, should be updated in light of the new agreement and statements of work. Exit strategies, such as the right to in-source or resource services, should also be revisited during the renegotiation. Finally, termination assistance services should also be restructured to reflect the operational knowledge gained from the original agreement.

Final Thoughts

Before entering into a renegotiation, the relationship must be objectively assessed. If the relationship is damaged, the customer must assess whether it is irreparable or amendable. Renegotiation is unlikely to fix a dysfunctional relationship. Lower rates and additional promises of higher levels of service will not usually alter the behavior of a service provider that has failed to meet expectations.

Switching service providers is never an easy undertaking. However, there are situations when it makes sense to forego a renegotiation and re-enter a competitive RFP process. Most outsourcing agreements allow for short extensions, so this should alleviate potential service disruptions when transitioning between providers.

Nonetheless, a successful renegotiation depends on the customer maintaining its leverage. The ability to do so usually originates from the customer assessing all viable alternatives and committing to execute an alternative option if needed.

One certain lesson learned from a renegotiation is that it will happen again to your organization. The knowledge acquired during each renegotiation should be applied to the inevitable future renegotiations, and should be institutionalized, so that personnel changes won't negatively impact your organization's negotiating position. ◆

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