MAYER | BROWN

Governing Service Provider Relationships: Seven Legal Tips for Strengthening and Leveraging Contract Rights

May 19, 2022

Announcer:
Welcome to Mayer Brown's Tech Talks Podcast. Each podcast is designed to provide insights on legal issues relating to Technology & IP Transactions and keep you up to date on the latest trends in growth & innovation, digital transformation, IP & data monetization and operational improvement by drawing on the perspectives of practitioners who have executed technology & IP transactions around the world. You can subscribe to the show on all major podcasting platforms. We hope you enjoy the program.

Julian:
Hello and welcome to Tech Talks. Our topic today "Governing Service Provider Relationships: Seven Legal Tips for Strengthening and Using Contract Rights."

I'm your host, Julian Dibbell. I am a senior associate in Mayer Brown's Technology & IP Transactions practice. I'm joined today by Brad Peterson and Reg Geoke. Brad co-leads Mayer Brown's global Technology Transactions practice. Reg co-leads Mayer Brown's Litigation & Dispute Resolution and Commercial Litigation practices. We have a transactions guy and a litigation guy.

And today, I am going to talk with them about ways to effectively govern service provider relationships after contract signing. Brad and Reg have worked with numerous companies to get sourcing deals back on track, and they're here today to help with some advice for contract governance teams on how to stay out of trouble and what to do if trouble finds you. Now, Brad and Reg have in fact shared with me a lovely laminated card listing the seven key tips on dealing with this problem, and we are going to go through each of those one by one. But, I want to start by talking about the fundamental problem or set of problems that these tips are trying to address. Brad, can you frame the problem for us?

Brad:
Thanks, Julian, and hello, everyone. Julian, the way I'd frame the problem is as follows:

- Lots of time and money are spent negotiating and drafting a contract
- The negotiating team then hands the contract off to a governance team
- The people managing the relationship are not familiar with what the contract says, and they do not understand how their communications and conduct might affect the company's legal rights
- As a result, the contract gets weaker over time
    - Contract benefits are lost

- Disputes arise that could have been avoided
- Disputes result in losses that could have been wins

By contrast, the best practice is to act in ways that actually strengthen the contract during governance.

Julian:
Reg, from your litigators' perspective, how do you view the problem?

Reg:
Thank you, Julian. I agree with Brad. As a litigator, in troubled deals, we see many of the same repeating elements. These include problems and issues with the service are discussed but aren't documented, so we have little to point to if the company wants to exit the contract or initiate a dispute resolution proceeding. Further, bad documents and communications exist because the people who are not familiar with the agreements write communications for the company, often creating what's referred to as a "course of conduct" argument for a vendor that weakens the company's position. And finally, the supplier which is sometimes failing to deliver the required services will often see what is happening faster than the company will and starts to position the discussions, or use ambiguous contract terms, in ways that are going to favor the vendor in any disputes.

So, as a result, it's harder than it should be build a case, and that makes it easier for the supplier to just ignore a legitimate customer request.

Tip 1: Control Messaging and Contractual Communications

Julian:
That sets it up for us, let's head into our seven tips to protect your deal. Starting with tip number one – control messaging and contractual communications. Brad, what do we mean by that?

Brad:
Julian, a smart service provider will do what we lawyers call "forum shopping." They look for friendly or at least pliable people at the company to at least win concessions from. And large-scale sourcing deals often involve dozens of stakeholders, and many of them are executives who would be allowed under corporate protocols to waive breaches or graded contract modifications. So, we recommend that as a first step you designate in writing *all* employees authorized to speak on behalf of your company for purposes of the contract. Ideally, that designation is right in the contract. But if not, you can strengthen your contract after signing by sending a notice to the provider.

The notice doesn't need to be fancy, it can be simple: "Dear Service Provider, We are writing to notify you that _____, _____ and _____ are the only employees of the company authorized to sign change orders, work orders, approvals, waivers, or other documents under our contract. Communications are only binding if provided to one of us in writing."

This sort of notice doesn't need to be a surprise to the provider, and this is not a hostile act. Every company, when it's doing its internal operations, seeks to clarify its decision rights and approval rights. So it makes equal sense to do so externally with service providers.

Tip 2: Require a Log of Supplier Requests and Company Failures

Julian:
Good advice. Tip two – require a log of supplier requests and company failures. Reg, help us understand that one.

Reg:
When work doesn't get done in a complex commercial agreement, the supplier's best excuse is that the company was at fault somehow. And there's a particular danger in contracts that have broad language about partnering, collaborating, or cooperating. The supplier can say, for example, that the customer should have done more to prevent the failure so the failure to deliver was really the customer's fault. When we hear that, we look at the contract and we are hoping to find as litigators some language that says that none of provider's failures will be excused unless provider notifies company of the problem, gives company a chance to fix it, tries to perform despite the problem, and verifies that the problem caused provider's failure. Whether that's there or not, it's good to notify the provider that it must quickly identify in writing to an authorized employee any of the company's actions that might excuse a provider obligation. You want the provider to know that it's your expectation, that they are going to provide you that information, that is what the provider is supposed to do.

To catch problems early, another good practice is to require that the supplier maintain a log showing its requests to the company and the company's responses on contractual matters. This prevents the company from missing problems that you had chances to fix. And it also prevents the supplier from conjuring up reasons after fact for its failures. The log should be on a shared site that provides alert messages about the changes and, also, it should be discussed on a regular basis in meetings between the company, whether that's daily or weekly.

Tip 3: Keep the Written Record as Clear, Complete and Accurate as Possible

Julian:
Tip three – keep the written record as clear, complete and accurate as possible. Now, Reg, when we talk about the "written record" here, what exactly do we mean and why is it important?

Reg:
As a litigator, the way I view most complex contractual disputes, they are usually won or lost based on the written communications. People's memories obviously fade over time and litigation is usually conducted years afterwards. Or, more often the case, people's memories are conveniently colored to favor their perspective. Often, clients will tell us that the arrangement with their vendor is not working well, but then we ask for details, and they struggle even to identify the specific failures, and they often don't have any documentation to support the claims of those failures, or the delays by the vendor in addressing those failures. So, the first part of the equation is simply having written evidence of the problem and the communications about it.

The second part of the equation is making sure that the documentation is accurate and complete. Often, when we do have written communications with the vendor, the person from the company may have made concessions, such as extending deadlines, or agreeing to less-than-complete service, or may have acquiesced to the vendor's interpretation of its obligations in the contract, or may have described only part of the issue.

This is typically because most people want to be cooperative problem solvers or to work with the vendor to solve problems. It's fine to do that but it is important that the documentation make clear what the full problem is, and what the company views as the vendor's obligations. If the solution deviates from what is contractually required, that should also be documented, preferably in a change order.

Julian:
So keeping the written record clear, complete, and accurate is a good north star for businesses. How do you put that in practice? Brad, what are some ideas for keeping things clear, complete, and accurate?

Brad:
Ideally, your record starts with a clear, complete, and accurate contract. And that's well worth investing in. But, any long-term services contract is going to be incomplete in important ways. You just don't have time in negotiations to get all the details right before signing, and you get new information as the contract progresses. Often there is even a transition period with a designated knowledge capture phase. And, realistically, there are always ways to improve the contract. So, the question is how to keep the record as clear, complete, and accurate as possible. And ideally to strengthen your contract by having it become more clear, more complete, and more accurate as you go forward.

A first step is to decide what documents are going to be created as contract documents and where you will store them. Reg, earlier mentioned that you should have the supplier maintain a log showing its requests to the company and the company's responses on contractual matters. In addition, you might decide that there will be amendments, work orders, requests, deliverables, reports, invoices, and email correspondence. But that's the whole set of categories of records that you intend use for the contract. You then identify a very standard format for each of those so that it's easy to search for them in your systems and find a way to make sure that each one is drawn into the right storage location. Finally, implement processes to drive the relevant information into those types of records. Do everything you can to make sure that, for example, there are records for oral conversations and if you do send an email, for example, you blind copy that email to an email box, which is designated as a repository. It's going to take a lot of time up-front to develop these good processes, but these will pay off tremendously in lower costs and ease of governance and administration when you do need to examine the record, or when you bring in someone like Reg to seek to resolve a dispute in a favorable way. Also, it will reduce costs because the supplier knows that you know the deal well, and thus will work more carefully and more consistently to make sure the deal goes well.

Tip 4: Send Timely Breach Notices

Julian:
Tip four – here is an interesting one – send timely breach notices. Reg, what do we mean by sending a timely breach notice and why does that matter?

Reg:
What we mean by sending *clear written correspondence* and timely breach notices is sending such notices at the first reasonable opportunity that the company considers the vendor's conduct to be a contract breach. If you followed step three, which was maintaining written communications, there are already going to be communications with the provider making the provider aware of the problem and the provider's responsibility.

But often that's not enough. Many provider contracts require formal notices of breach, where they require the provider be given an opportunity to cure the breach. Providers will argue that the email communications between its team and the company's team are not sufficient. Or, they will claim that the conduct did not arise to a breach, because if it had, the company would have given it notice. Or, the provider will, at the least, insist on restarting the clock on its opportunity to cure the breach from the time a formal notice is sent. Some contracts, including one I was reviewing just last week, require notice of breach within 30 days of its occurrence. The failure to give that notice can result in waiver claims by the vendor. There are a variety of legal doctrines that the vendor can use – including estoppel, waiver, latches, and so forth – to argue that the breaches should be excused for lack of timely notice. So, it is important to send formal breach notices when they occur.

Julian:
Okay, but this sounds pretty straight forward, send a breach notice when you notice the breach. Why is this a key tip; what's the problem here?

Reg:
The problem really deals with human interactions. We find that often clients decide that conversations are sufficient. They have a meeting with the vendor, the vendor promises to address the problem, and people often feel like it's too formalistic to do more than that. And as a result, little documentation is sent around after the meeting is done. And months later, the company is frustrated but has little to point to.

Further, many people in those meetings often feel that sending a formal breach notice is too confrontational. They have personal relationships with the vendors and the personnel they are working with on a daily basis, and they don't want to create a tense relationship. So, for those reasons, they will often end a meeting and conclude that they are good to go and don't need any further documentation.

Julian:
You mentioned, Reg, people feel like this could be too confrontational; is that a concern, Brad? Maybe from the business' perspective, isn't it going to feel like a hostile act all by itself, like you're lawyering up or pulling out the contract on the provider?

Brad:
Yes, it's a great concern and I agree with Reg that that is often the number one concern on whether you are going to send a notice or not. The solution to this, I think our best practices, clients, send formal notices all the way through. If they send a formal notice in the middle of a hot dispute, it looks like lawyering up and it looks like you're pulling out the contract. But if you've always been sending notices or you started sending notices on a regular basis when thing were going well, and you say management asked us to begin to send notices, it just looks like ordinary course, and it doesn't disrupt the course of the relationship. In fact, it becomes part of the fabric of the relationship.

Reg:
The other point I want to jump in to say, Brad, is that you don't need to make the notices hostile. You can explain to the vendor personnel that the company has a policy, for example, of sending out formal notices of breach, and that the notice will reflect any agreed-upon corrective activity. The notice itself can simply describe what's happening or not happening, what contract terms are that apply, and the risk to the company and the ask of the vendor. So, for example, I pulled out an example of a recent notice. I genericized it a bit, but it says:

> Dear *[Provider Relationship Manager]*:
> We learned recently that you are not encrypting our data in transit between your facilities. That encryption is required by Section 13.2 of our MSA and Section 7.5 of Exhibit 2, of our Information Security Policy. //so, now this letter notice has notified them that there is a breach, it also notifies them of the specific provisions that have been breached. It will go on to say that… //This breach could expose us to regulatory action, loss of data, reputational harm and other damage. //so, you've told the vendor of the risk is to the company. And then the notice might go on to say…// You have told us that you will begin to encrypt all data with 10 days and will confirm to us in writing that you have done so. Please do contact me with any questions.

So now you have a very cordial and professional letter – it doesn't feel like you're calling in the lawyers. But you've communicated there is a breach, what the provision is, the impact to the company, and what is agreed upon for the vendor should be doing.

Tip 5: Before Doing the Provider's Work, Demand that the Provider Do Its Work

Julian:
Tip five – before doing the provider's work, demand that the provider do its work. That's a little bit mysterious. Brad, what do we mean by this? How does this come up?

Brad:
Julian, I agree. This seems mysterious, but it happens surprisingly often. It's a common fact pattern. The provider fails to do work or does it badly. The work is important to the company, so the company picks up the slack, does the work, like they would if it was an internal colleague. The company then asks the provider for something off the price or short pays the invoice because the customer did the provider's work. The provider comes back and says well obviously the work was not in scope, as demonstrated by the fact that the company did the work itself. So, by failing once, the provider manages to create almost a long-term waiver of what would otherwise be in-scope work. Or, the provider claims that the company's doing the provider's work, badly or in an uncoordinated way, prevented the provider's performance, which caused the other problems. So at least saying, maybe the provider has a waiver for the immediate instance and a claim.

Julian:
Okay, so a familiar scenario. Now that you have laid it out, what then do we do about it?

Reg:
The critical point, Julian, is that you don't add resources or assume direction of a provider's work under a contract without demanding a cure and warning of the cost. So, again, you want to provider a written notice and an opportunity to perform. A notice might read something like this:

> Dear *[Provider Relationship Manager]*:
>
> I am following up on my notice of last Thursday regarding the lack of management talent and specialists required by Section 12 of SOW 14. Unfortunately, the problem has not been corrected. If it is not corrected within 10 days, we intend to add resources from our own team to make up for delays. These team members will be doing work that you agreed to do within the fixed price, and thus we will deduct their fully loaded cost from any future milestone payment.

Now you've given the vendor notice of the potential breach, what you are going to do, what it's going to cost them, and you get around arguments the vendor might have regarding waiver and course of dealing.

Tip 6: Trade Waivers for Future Assurances

Julian:
Tip six – trade waivers for future assurances. Brad, what do we mean by that?

Brad:
You've got a sort of dispute, the vendor has admitted that it did badly, but it wants to be back in the position where it doesn't have a claim hanging over its head. The common approach is to have a meeting, get a sort of apology, a personal promise to do better, call it good, and move on. Or maybe there is an email and you write something like, "Okay, let's do better in the future." The governance team, of course, wants to be nice. The open issue is awkward, and everyone wants to move on. What we would advise instead is that you grant a formal waiver of the breach only for promises that make that breach less likely to happen again. So you might, for example, agree to waive the breach in exchange for an obligation to do a root cause analysis of the breach, correct any fundamental promises – you might say that there additional time to perform, but limited additional time to perform – and you might ask for other similar concessions to avoid broader problems.

Julian:
It's an interesting approach, but isn't the whole idea of contract law that when there's a breach you collect some money?

Reg:
Well Julian, in theory, you could collect money, which might motivate future performance. But the court and the provider will be more impressed with the value of the obligation if you focus on assuring future compliance. Also, as any litigator will tell you, damages are generally contractually limited in ways that make them hard to assess or collect. Finally, it's going to be easier to maintain a good operational working relationship if the conversation about an operational failure is about an operational solution and not about who's going to pay whom what.

I would note that the reason to have a policy of getting further assurances in exchange for waivers is also the alternative, which is most likely, doing nothing. Once you go down the path of doing nothing with respect to breaches, you risk, as I mentioned before, a course of conduct argument or a waiver argument – that the course of conduct somehow defines the obligations so that you agreed that the vendor do nothing and no longer needs to perform. It's much better to insure that some corrective steps are taken so that you can establish a good record to show what the course of conduct is supposed to be and what the expectations are.

Tip 7: Involve Lawyers Early

Julian:
Tip seven – our final tip, last but not least – involve lawyers early. Other than the fact that we're lawyers and we like being involved, why?

Reg:
Contracts are often very detailed, often very clear, about what each party is supposed to do in normal times. Thus, what I find is that a lot of clients, particularly the business folks and clients, will lose sight of the fact that these contracts often say little about how disputes are going be handled. For that, contracts typically rely on statutory and common law, rules of contract interpretation, judges, and arbitrators. So, even when people believe they know what the contract means, other interpretive rules can often have an effect that is not anticipated. Or, unbeknownst to the company or the individuals working on the contract, a provision in a different portion of the agreement may raise an ambiguity about how the contract was intended to work. Or, in the alternative, the words used to deal with breach in a contract often mean something different or require interpretation. So words like "material breach" and "consequential damages," for example – those words have defined legal meanings that are often unknown to non-lawyers. And, of course, if that isn't enough, as the lawyers in the audience know, contracts are hard to enforce even in the best of times. So, it's important to make sure that early on you understand the areas in the contract that might be used by the other party in a dispute.

Julian:
Brad, what are some specific examples of times when a contract governance team should bring in the lawyers? What's "early" for this purpose?

Brad:
Let me offer a few examples. First, involve lawyers before responding to a significant breach. And that might be when a milestone is missed or when more than one service level is missed over the course of a two-month period, or the provider's performance is failing to meet expectations, whether or not you're sure that it's actually breaching the contract.

Second, involve lawyers when you realize that you might be amending. For example, when there is disagreement or uncertainty about which party is responsible for a particular action or whether a charge is correct on an invoice that may be leading to an amendment. Certainly before approving any detailed plan, desktop operating procedures, or other documents that change who does what under the agreement, even if it's just adding detail. Get the lawyers involved before a decision is made.

Third, involve lawyers on any of the legal topics, probably the obvious one, indemnified claims, for-cause termination, and so forth.

Fourth, involve lawyers when you're not going to follow the six prior tips. If you think of these as rules that you should follow unless you've talk to a lawyer about why you are not doing it. That would be good guidance for when to come and talk to the law department or talk to outside counsel about what would be best to do. In each of those, and the other examples, there is some sort of decision point, an opportunity to improve your position under the contract, and also an opportunity to risk making your position under the contract worse – an opportunity to strengthen your contract or an opportunity to let your contract get weaker. And you want your lawyers involved before you make the decision, with enough advance time to collect facts and give sound advice. In doing so will help you build a stronger contract, maximize value, and avoid costly pitfalls.

Closing

Julian:
Great advice, Brad and Reg. Thank you so much for coming in today and sharing these 7 tips and related principles. Listeners, if you have any questions about today's episode – or if you would like your very own copy of the laminated card I mentioned before, listing the seven tips that Brad and Reg have just talked about – please email us at TechTransactions@mayerbrown.com. Thanks for listening.

Announcer:
We hope you enjoyed this program. You can subscribe on all major podcasting platforms. To learn about other Mayer Brown audio programming, visit mayerbrown.com/podcasts. Thanks for listening.