Vendor Service Contracts

Presented by

James H. Moore, III

VENDOR SERVICE CONTRACTS

I. Importance of Vendor Contracts.

- A. Numerous vendor contracts are entered into by every financial institution (software systems; operational systems; document platforms; electronic banking services, etc.)

- B. Even small financial institutions spend many thousands of dollars pursuant to the terms of these vendor contracts each year.

- C. Vendor contracts often receive little scrutiny.

  1. Task of reviewing vendor contracts often assigned to those who may be familiar with technicalities of particular operation in question, but not familiar or concerned with contractual terms.

  2. Vendor contracts often executed by bank management with little or no consideration given to contractual terms.

- D. Vendors are often trusted implicitly, although wording of contracts may vary significantly from provisions discussed orally (and contracts contain terms which render previous oral discussions irrelevant).

II. All Significant Vendor Contracts Should be Closely Scrutinized.

- A. Because of the resources being expended and the important services or products to be provided, vendor contracts today should be closely scrutinized.

- B. Especially important in recent years with a number of mergers in the banking vendor industry - contracts have become increasingly complicated and one-sided in favor of the vendor.

- C. Key issues: Emphasis in scrutiny of vendor contracts should be placed on vendor accountability and retention of maximum flexibility for the bank.

III. Areas of Emphasis in Scrutiny of Vendor Contracts.

There are a number of separate areas of emphasis to be considered in the process of selecting the appropriate vendor to meet your institution's needs and in scrutinizing that vendor's agreement.

A. Selection of a vendor.

1. Common sense approach - do your due diligence. Seek recommendations from institutions with which you are familiar who have utilized this vendor to provide <u>this</u> particular service and who have been receiving that service or product from that vendor for a significant period of time.

2. Don't be the "guinea pig" or the first to try out a vendor who is providing a product or service which is new to them. Also wise to be wary of newly-acquired vendors whose management structure has changed.

3. Clearly identify the needs of your institution before selecting a vendor. Don't start talking to vendors with only a vague or incomplete understanding of what your institution's needs are and end up "buying" far more than you really need.

4. Clearly define the officers of the bank with the authority to execute a contract on behalf of your institution - you don't want to get in the position where a representative of the bank, who does not normally have signature authority, has bound your institution to an unfavorable agreement.

B. Transition to a new vendor.

1. Must insure compatibility of services or products offered by vendor with your existing systems (need a representation and warranty in the contract from vendor to that effect).

2. Must be very specific in identifying and quantifying services or products which vendor is to provide and assure that those new services and products will interface with existing systems and products which are essential to the bank's operation.

3. There should be a definitive testing sequence to make certain that the new product/service operates properly.

4. There should be deadlines set for vendor performance and financial consequences if the vendor does not perform.

5. The payment structure should be established so that payments to vendor are contingent upon performance (e. i. bulk of payment to lender should not be made until system is up and running).

6. "Don't put your 'eggs' all in one basket" - have a back-up plan in the event that new services or products do not function properly in the required time frame.

C. Level of service required to meet your institutions' needs.

1. Service availability.

2. Manner in which service or product failures will be addressed (how quickly).

3. Be very specific in identifying exclusions from vendor's required service.

(a) To what extent is routine maintenance included?

(b) Problems caused by customer or customer's employees.

(c) Try to negotiate minimum amount of service to be included in annual or up-front fees paid to vendor (vendor will not offer. You will have to ask and "stick to your guns".)

D. Method by which vendor will track and maintain record of problems.

1. Need to maintain record of the frequency of reported problems and the method by which and the speed with which the vendor responds to those problems.

2. Provide for audit rights on the part of your institution to review vendor's records as to frequency of problems. If the contract is renewable annually and additional fees are due, an excess of reported problems should result in a decrease in compensation (or possibly a refund a previously paid fees).

E. Vendor accountability.

1. There are several remedies which may be considered for the vendor's failure to satisfy required service levels:

(a) Rebate of a percentage of previously paid fees based on degree of failure to perform.

(b) Specific fee reductions or rebates if performance criteria are not satisfied.

(c) Contract termination, with fee refund, for excessive or repeated failure to satisfy service criteria.

2. On the other hand, bonuses may be considered for exceeding desired service levels if of financial benefit to your institution.

F. Planning for contingencies.

1. Make sufficient arrangements for complete data back-up.

2. Have a plan in the event that vendor's service and/or product fails or "goes down". (i.e. plan to recover from a disaster).

G. Future modifications or updates of products or services.

1. Any future update or modification undertaken by the vendor should be provided to your institution at no additional charge.

2. Build flexibility into your contract for future changes, especially in long term vendor contracts.

3. With long term contracts, make certain that contract provides for the potential merger of your institution with another bank, or for acquisitions by your institution. You don't want to incur significant penalties in the event of a termination necessitated by the merger or acquisition by your institution where another similar product may suit the needs of the new entity better than that offered by the vendor.

4. Also be aware and guard against related services or products from vendor which must be purchased at a significant additional expense in order for service or product to perform properly (READ THE FINE PRINT - ASK QUESTIONS).

H. Security and protection of confidential information.

1. Identify, with the help of a consultant if necessary, needed level of security given the product or service being purchased.

(a) What firewalls are necessary?

(b) What needs to be done in terms of virus protection?

(c) What provisions need to be made to detect/prevent intrusions into the system?

2. The agreement needs to spell out who has the right to physically access the system/product.

3. The agreement should spell out reporting requirements to be imposed on the vendor as to any security breaches which may arise (for example, attempts to intrude into the system and the manner in which that intrusion was detected/prevented).

4. Depending upon the sensitivity of the information involved in utilization of the service or product provided by the vendor, you may want to consider requiring third party testing of the security measures proposed by vendor.

IX. Vendor personnel who will perform the services or install the product.

1. The agreement should set forth minimum standards for vendor's personnel who will provide the services or install the product.

2. If the provision of the service or the installation of the product will involve access to proprietary or confidential information, require that vendor's personnel submit to background checks.

3. In the event that your institution believes the proper performance of the contract hinges upon the involvement of one or more key employees of vendor, have the agreement say so and require those employees to be involved in the process.

4. IMPORTANT - Make certain your agreement includes the right in favor of your institution to have prior approval of all subcontractors. If you fail to do so, you may not end up getting what you purchased.

J. Support services offered by vendor.

1. Have contract provide the manner in which support will be made available and any fees to be charged for such support.

2. Make certain agreement defines the method by which support will be provided.

(a) Phone.

(b) Email.

(c) Vendor's website.

3. Set forth specific time frames within which the vendor must resolve problems (or suffer financially).

4. Describe the manner in which problems will be addressed internally by the vendor (for example, if the problem cannot be addressed by the first person assigned to the task, how does problem "work up the ladder").

K. Training and education by vendor.

1. Have the contract specifically describe any specialized training to be provided by the vendor and all charges for the same.

2. Specify the location, timing and size of all training classes. (Make certain training can be scheduled within a time frame which will allow timely implementation of the service or product you are purchasing).

3. Make certain and specify whether training fees are charged by the number of employees trained or by the number of trainers utilized.

4. Specify documentation requirements for training and who will pay the cost of such documentation.

L. Intellectual property issues.

1. Make certain and have the contract provide that you retain ownership of all customer data.

2. Have the contract specify who owns any customization of the services or product being provided to your institution and what can be done with those changes (for example, can vendor sell a customization made for your institution to another institution or is that customization exclusively your property).

3. Make certain agreement sets forth the scope of your license to use intellectual property of the vendor.

4. Agreement should deal with use of trademarks (whether your trademark or vendor's).

5. Intellectual property indemnification - need to make certain that vendor indemnifies you in the event that its intellectual property

rights relating to services or product are challenged by a third party (make sure indemnity includes not only any loss or damages but also attorney's fees).

M. Protection of Confidential Information.

1. Make certain the contract has stringent provisions requiring the vendor to observe and comply with all customer confidential information requirements.

2. Have vendor indemnify institution for any failure to maintain confidentiality.

3. Make certain agreement requires that all confidential information (including "residual" information) be returned to you at the end of the term of contract and that confidentiality be maintained.

N. Protections in the event of Vendor Insolvency.

1. Have vendor provide financial covenants and agree to financial reporting requirements.

2. Require pre-bankruptcy notification.

3. Have agreement allow for an alternative provider in the event of vendor's insolvency.

4. IMPORTANT - Prohibit assignment of contract without your institution's prior written consent.

5. In the event of the vendor's insolvency in connection with a services contract, provide that the "source code" be made available to your institution so that services can continue to be provided.

O. Term and termination of agreement.

1. The longer the term of the agreement, the more steeply the services should be discounted.

2. Be very careful with respect to renewal rights.

   (a) Some contracts provide for automatic renewal without specification as to what fees will apply during renewal term.

   (b) Some vendors will "spike" fees if there are no limits for renewal term.

P. Termination rights.

1. Need to decide the terms on which institution desires for contract to be terminated.

2. Termination for convenience?

3. Termination for breach.

(a) Most vendors will want notice and opportunity to cure.

(b) Make certain and document <u>all vendor breaches</u>.

(c) Provide for right of termination in the event of repeated breaches, even if breaches are cured (product or service is not much good to you if it requires some sort of problem-solving every other day).

Q. Provide for the unwinding of the relationship.

1. There should be a transition plan in the event of termination of the contract.

(a) How will transition to new vendor be handled?

(b) Make certain all bank information is protected.

2. Specify rights to use necessary vendor-owned items during transition.

3. Specify length of transition period and make certain length is sufficient to allow you to make successful transition.

4. Be specific about transition costs (some vendors will charge prohibitively when they think there is no future in the relationship).

5. Require vendor to reasonably cooperate with new service or product provider.

R. Dispute Resolution.

1. Arbitration.

(a) Different schools of thought on arbitration, but generally a much less expensive resolution.

(b) If arbitration clause included, make sure and specify that all disputes must be arbitrated.

2. Choice of forum. Whether arbitration clause or not, forum selection is important.

3. Choice of law provision (vendor will usually insist on laws of its state applying, but that is not usually a big issue).

IV. Favorable Vendor Contracts Significant to Maintain Soundness of Institution.

A. Remember, vendor contracts are a safety and soundness audit issue.

B. Thus, it behooves all institutions to begin paying close attention to vendor contracts and to make certain that these agreements are negotiated in a fashion advantageous to your institution.