



FENWICK & WEST LLP



Advanced Issues in Outsourcing Agreements

by David L. Hayes



FENWICK & WEST LLP

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I. INTRODUCTION

In recent years, many companies have begun to outsource information systems operations to third party vendors. The outsourcing services may be based on one of two broad types of models:

(1) *Facilities Management*. The services may consist of what has traditionally been called “facilities management,” in which the outsourcing vendor (referred to in this article as the “Vendor”) takes over operation of the information systems (IS) facilities of the outsourcing customer (referred to in this article as the “Client”) at the Client’s premises. In this form of outsourcing, many of the Client’s IS employees often simply transfer onto the payroll of the Vendor, and continue to operate the IS facilities under the direction and control of the Vendor.

(2) *Remote Computing Services*. Alternatively, the Vendor may provide remote computing services from the Vendor’s data processing center located off the Client’s premises. In this form of outsourcing, the Vendor may purchase or assume the leases for the Client’s IS equipment and move the equipment to the Vendor’s data processing facility, or such equipment may be sold off or the leases terminated (with concomitant penalties paid).

The trend in many recent outsourcing arrangements has been toward use of the second model for several reasons:

- As the information technology industry continues its strong movement toward downsizing of architectures and use of distributed computing, many companies are beginning to transfer their mainframe computing needs to an outsourcing Vendor as an interim step while new, distributed computing architectures are designed and installed ultimately to replace the use of mainframe hardware.
- The outsourcing Vendor can typically achieve larger economies of scale by transferring the Client’s IS services to the Vendor’s data processing facilities than could be had by rendering those services at the Client’s site through a facilities management model.
- Transferring the IS services off-site enables the Client to eliminate or reduce the physical plant devoted to IS services or to re-deploy those resources for other uses, thereby enabling the Client to focus on its core business competencies.

The outsourced IS operations are often critical to the primary business of the Client. Accordingly, a smooth transition of operations must be carefully planned, regardless of which model of outsourcing operations is adopted. The second model, however, presents a set of unique problems to the Client that must be addressed in the outsourcing agreement:

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- *Parallel Operations.* Because the second model requires transfer of operations from the Client's site to the Vendor's data processing facilities, there is a greater risk of encountering problems in the transition of services. To minimize the risk associated with transition to the Vendor's data processing facilities, parallel operations may need to be run for a transition period at both the Client's facilities and the Vendor's facilities to verify that identical data processing results are being achieved before final cutover to the Vendor's facilities.
 - *Direct and Reputational Damage.* If problems are encountered with the transition of operations from the Client's facilities to the Vendor's off-site data processing center, the Client can be damaged not only in direct loss of business or penalties incurred under customer contracts for late delivery of information or goods, but also in reputational damage. The outsourcing agreement should address both forms of damage, perhaps in the form of liquidated damages that are carefully tied to specifically defined triggering events.
 - *Performance Measurements.* Performance measurements must be defined. Because the IS services are typically being rendered on a very different equipment configuration, with very different economies of scale, the existing performance measurements and costing the Client has been using to manage the operations may need to be significantly redefined. Definition of performance measurements may require significant negotiation, as the Client will typically be accustomed only to the performance measurements and costing models that it has previously used in its business, which may bear little relation to the range of performance measurements and costing models the Vendor will wish to use.
 - *Pricing Model.* A pricing model must be established. In traditional facilities management arrangements, prices charged by the Vendor can be calculated based on detailed computation of the direct and indirect costs to run and manage the Client's on-site data processing facilities. For remote computing arrangements, this approach to pricing cannot readily be used, for the Vendor will typically have a large configuration of computer equipment, only a portion of which at any given time will be devoted to the Client's processing needs. Thus, new pricing models, such as a rate card structure, may be required.
 - *Price Reductions Based on Improved Technology Performance Ratios.* A closely related issue to the pricing model, particularly in the case of a long term outsourcing agreement, is how to measure and reflect in the pricing to the Client decreased price to performance ratios of new equipment acquired by the Vendor as technology improves.
 - *Post-Termination Assistance.* In the event that the outsourcing arrangement is terminated, because the Client no longer has in-house capability to perform its data

processing operations, significant post-termination assistance may be needed from the Vendor to transition the Client's data processing operations to another vendor. The level of assistance the Vendor must provide at no additional cost will often turn on the reason for the termination — whether by cause, for convenience, or for other reasons. A special issue arises in the event the Vendor has been using proprietary software on the Client's behalf, and the Client has become dependent on such software. Provisions should be made for a license from the Vendor to the Client's new vendor of services, or some other form of assistance from the Vendor to “wean” the Client from its dependence upon the Vendor's proprietary software, whether operating system software or application software.

The remainder of this article discusses in greater depth each of these special issues related to an outsourcing agreement founded upon a remote computing model. The article sets forth several suggested approaches for handling the various issues, and provides sample contract clauses that embody the suggested approaches.

II. MIGRATION OF DATA PROCESSING OPERATIONS

1. The Migration Project Plan

Perhaps the single largest risk to a Client of outsourcing its data processing operations to a Vendor's remote computing site (referred to in this article as the “Vendor Data Center”) arises during the migration of such services from the Client's facilities to the Vendor Data Center. In some instances, the risk can be reduced if the Vendor is purchasing or otherwise moving the Client's own computer hardware from the Client's facilities to the Vendor Data Center for use in rendering the outsourced data processing services (referred to in this article as the “Data Processing Services”) to the Client. In such case, the Vendor may be able to perform the Data Processing Services using an identical, or nearly identical, configuration of hardware, operating system software, and application software as the Client itself was using at its own facilities — a configuration which has generally been proven reliable by the Client's previous use of it.

In most cases, however, the configuration to be used by the Vendor at the Vendor Data Center will differ, perhaps in significant ways, from that previously used by the Client at its own facilities, even if the Vendor is purchasing the Client's hardware. The operating system software may differ entirely, or perhaps in version number, from that used by the Client. Even a switch from one hardware platform to that of another vendor that is supposedly “compatible” with the first platform can cause malfunctions or quirks to show up in the execution of the Client's application software. Moreover, when the Client's services are moved out of a dedicated environment into a shared, or more heavily shared, environment, problems can show up resulting from the increased complexity of the operations environment.

Accordingly, it is essential that the outsourcing agreement define a detailed migration project plan (referred to in this article as the “Migration Project Plan”), pursuant to which the Client’s data processing operations will be migrated from the Client’s facilities to the Vendor Data Center. The ultimate goal of the Migration Project should be to establish an equipment configuration at the Vendor Data Center that is at least equivalent to the configuration currently used by the Client at its own facilities.

Sample Clause: Migration Project

- In preparation for migrating Client’s data processing services from Client’s facilities to the Vendor Data Center, Vendor agrees to perform the Migration Project described in this Section in order to establish an equipment configuration at the Vendor Data Center that is at least equivalent to the configuration currently used by Client at its facilities and to test the operation of such configuration to demonstrate that Vendor can successfully migrate Client’s data processing operations to the Vendor Data Center. The Migration Project will be performed by Vendor in multiple Phases, as described below, and Vendor and Client will perform the other duties set forth in this Section.

2. Establishment of a Parallel Equipment Configuration

The Migration Project Plan should call for the Migration Project to proceed in multiple phases, with milestones and acceptance tests defined that must be passed before the next phase is entered. Typically, Phase One would consist of producing and approving the Migration Project Plan, and installing and testing the parallel equipment configuration at the Vendor Data Center.

Sample Clause: Phase One

Phase One. Phase One of the Migration Project will begin on [date] and end on or before [date] (which date may be changed upon mutual agreement of the parties). During Phase One:

(a) *Migration Project Plan.* Vendor will supply, for approval by Client, a fully detailed, written Migration Project Plan detailing a task list with target dates and responsible personnel, pursuant to which Vendor will migrate Client’s data processing operations from its facilities to the Vendor Data Center. The Migration Project Plan may be modified from time to time by the mutual agreement of the parties. Vendor will be responsible under the Migration Project Plan for all project management and project planning. Client and Vendor will, however, share responsibility for certain migration activities. The Migration Project Plan will form the basis upon which the Migration Project hereunder will be accomplished and each of Vendor and Client will perform its tasks in accordance with the Migration Project Plan so that the Migration Project will be accomplished on the schedule established in the Migration Project

Plan. The Migration Project Plan includes multiple checkpoints or milestones to enable Client and Vendor to monitor the ongoing progress of the project on a daily basis and to anticipate any scheduling problems.

(b) *Configuration of Parallel Operations.* Vendor will, in accordance with the Migration Project Plan, install, integrate and test a parallel operations equipment configuration at the Vendor Data Center, which configuration shall be at least equivalent in processing capability to the configuration currently used by Client at its own facilities.

(c) *Completion of Phase One.* Upon completion of installation, integration, and testing of the parallel operations equipment configuration at the Vendor Data Center, Vendor shall so certify to Client in writing. Phase Two of the Migration Project will not commence until Client has, after an opportunity to perform any inspection desired by Client of the Vendor Data Center to verify the configuration, given its written consent to Vendor to commence Phase Two, which consent shall not be unreasonably withheld. Any delay on the part of Client to grant its consent to Vendor to enter Phase Two in accordance with the schedule of the Migration Project Plan, if such delay is not caused by the fault of Vendor, shall, upon the request of Vendor, cause all remaining timetables in the Migration Project Plan to be extended by an amount equal to the delay on the part of Client.

3. Test Suites for the Parallel Equipment Configuration

The Client should maintain its data processing equipment configuration at its site until the parallel equipment configuration at the Vendor Data Center can be fully tested to ensure that it produces identical results to those produced at the Client's configuration on the same data. During subsequent Phases of the Migration Project, the Client should supply the Vendor with one or more test suites of data, upon which the Vendor will run the Client's application programs on the parallel equipment configuration at the Vendor Data Center and deliver the results of the processing to the Client for comparison to results generated by the Client on the same data using the equipment at the Client's facilities.

During these Test Phases, the Client may wish to test both batch processing and on-line processing, if applicable. If on-line processing services are to be supplied by the Vendor, then the Migration Project Plan should specify the telecommunications links that are to be established to the Vendor, as well as the timeline and who has responsibility for the installation, testing, and maintenance of the same. Upon successful completion of the Test Suite processing, the Vendor should take all steps necessary to make the final cutover of all data processing operations from the Client's facilities to the Vendor Data Center.

Sample Clause: Phase Two

Phase Two. During Phase Two of the Migration Project:

(a) *Test Suite.* In accordance with the schedule and terms set forth in the Migration Project Plan, Client will supply to Vendor a master set of data (the “Test Suite”). Vendor will load the Client applications programs on the parallel operations equipment configuration at the Vendor Data Center, and will process the Test Suite at the Vendor Data Center on the parallel operations equipment configuration using the Client applications programs and deliver the results of such processing to Client, in a format reasonably specified by Client, for comparison by Client to the results previously generated by Client in processing such data at Client’s facilities. If the results do not match those previously generated by Client, Client and Vendor will work to resolve and correct the differences.

(b) *Final Cutover.* Upon successful completion of the Test Suite processing, which is currently targeted to be on [date], Vendor shall, in accordance with the terms and conditions of this Agreement, immediately complete all steps necessary to make the final cutover of all data processing operations from Client’s facilities to the Vendor Data Center and begin rendering the Data Processing Services to Client. Upon successful completion of the Test Suite processing, the parties shall enter the Final Acceptance Test Period. The date upon which the Final Acceptance Test Period begins, which is currently targeted to be [date], shall be the “Actual Commencement Date.”

4. Final Acceptance Test Period

After final cutover of data processing operations to the Vendor Data Center, the Client may wish to have a “Final Acceptance Test Period” during which to operate its business in the ordinary course with the Vendor performing the Data Processing Services on the Client’s behalf, just as a final safety valve to ensure that everything is going to operate satisfactorily on an ongoing basis. If the Vendor is purchasing equipment from the Client, the final transfer of title to such equipment would typically occur upon successful completion of the Final Acceptance Test Period. Similarly, if the Vendor is hiring some or all of the data processing employees of the Client, the final transfer of employment will typically occur only after successful completion of the Final Acceptance Test Period. This is to ensure that, should the Final Acceptance Test Period not be successfully completed, the Client still has title to its data processing equipment and has on its payroll the employees that may be necessary to operate it, should those operations have to be resumed by the Client.

Sample Clause: Final Acceptance Test Period

- *Final Acceptance Test Period.* The Final Acceptance Test Period will begin on the Actual Commencement Date and will run through [date] (which may be extended upon mutual agreement of the parties). During the Final Acceptance Test Period,

Vendor will render the Data Processing Services in accordance with this Agreement, and Client will evaluate Vendor's rendering of such Data Processing Services and make any reasonable suggestions for changes or improvements based on Client's business needs. Vendor agrees to exert reasonable efforts to accommodate any such reasonable requests from Client. If Client is satisfied with the Data Processing Services being rendered by Vendor during the Final Acceptance Test Period, Client will notify Vendor in writing that the Final Acceptance Test Period has been successfully completed on or before the scheduled date of expiration thereof. If the Data Processing Services being rendered by Vendor are deficient in any material respect, then Client will notify Vendor thereof before expiration of the Final Acceptance Test Period and the parties will extend the Final Acceptance Test Period for a period of time sufficient for Vendor to remedy the deficiencies specified by Client. If Client does not notify Vendor before expiration of the Final Acceptance Test Period, as the same may have been extended by the parties, that the Data Processing Services being rendered by Vendor are deficient, or continue to be deficient, in any material respect, then the Final Acceptance Test Period shall be deemed to have been successfully completed on the then scheduled date of expiration thereof. The date upon which the Final Acceptance Test Period is successfully completed, either upon notice from Client or upon expiration of the Final Acceptance Test Period, shall be referred to herein as the "Final Acceptance Date."

5. Administrative Mechanisms

A number of administrative mechanisms should be considered to make the Migration Project run more smoothly. It is often helpful to have each party designate a "migration project executive" who has authority to act for and bind each party with respect to all aspects of the Migration Project. Such person provides a consistent, central contact for managing any problems that arise during the Migration Project, and facilitates communication between the parties.

Sample Clause: Migration Project Executive

- Vendor will designate a Vendor Migration Project Executive to whom all communications from Client relating to the Migration Project may be addressed and who has the authority to act for and bind Vendor and its subcontractors in connection with all aspects of the Migration Project. The Vendor Migration Project Executive shall devote substantially all of his or her full time and effort to the performance of Vendor relating to the Migration Project. Before assigning an individual as Vendor Migration Project Executive, Vendor agrees to introduce the individual to Client, provide relevant information about the individual, and discuss any objections Client may have to such assignment and attempt to resolve such concerns on a mutually agreeable basis. Vendor will give Client at least 30 days

advance notice of a transfer of the Vendor Migration Project Executive and will discuss with Client any objections it may have to such transfer. Client may at any time request that Vendor change the Vendor Migration Project Executive if Client believes it is in its best interests to do so. Promptly after receipt of any such request, Vendor will investigate the matter and, if Vendor determines that Client's concerns are reasonable, Vendor will take appropriate action to replace the Vendor Migration Project Executive.

6. Public Relations Efforts

The Client will often be worried about the possibility that its customers will become concerned upon learning that the Client intends to outsource its data processing operations. This may particularly be true for Clients in a service business in which data processing and/or the results of such processing constitute a significant part of the service sold by the Client. In such situations, if the Vendor has a public relations department, the Client should consider requiring the Vendor to get that public relations department involved early in the Migration Project to jointly develop a plan for informing the public of the outsourcing relationship and to manage any adverse publicity that may occur in the event the Vendor fails to migrate the data processing operations successfully or on schedule.

Sample Clause: Public Relations Efforts

- Vendor's public relations department will be involved with the Vendor migration team and Client to jointly develop a plan with Client for informing the public at the appropriate time of the Client/Vendor relationship and to make preparations to prevent any potential adverse publicity to Client. In the event that Client receives adverse publicity because of failure on the part of Vendor to perform the migration as required under this Agreement, Vendor will, in consultation with Client, take steps to assume public responsibility for such failure and to protect the reputation of Client.

III. DAMAGES FOR FAILURE TO PERFORM MIGRATION

Failure by the Vendor to perform the Migration Project in a timely and complete manner may cause considerable damage to the Client — both direct damage and reputational damage — particularly for Clients in a service business that consists of rendering data processing services, or packaging the results generated thereby, to customers as a main product. Accordingly, the outsourcing agreement should specify a number of mechanisms to compensate the Client for such damages.

1. Performance Bond

The most direct protection for the Client will often be to require that the Vendor post a performance bond of a specified amount to guarantee the performance of the Vendor in accordance with the Migration Project Plan. The agreement should specify that upon one or

more triggering events, the Client will be entitled to recover its actual damages against the bond. In addition, if the Client is to be entitled to recover its actual damages beyond the bond amount (perhaps subject to overall limitations set forth elsewhere in the agreement), then the agreement should explicitly so state. One of the triggering events will often be failure by the Vendor to perform the Migration Project Plan so that the cutover of all data processing operations to the Vendor Data Center does not occur by a certain specified date (referred to as the “Actual Commencement Date” in the Phase Two Sample Clause set forth above).

The bond will often be reserved only for actual damages to the Client other than reputational damage, which is typically very difficult to quantify. For reputational damage, the Client should consider using a liquidated damages provision, perhaps in the form of a per diem damages figure, as discussed further below.

Sample Clause: Performance Bond

- Vendor will, within ten (10) days of the Agreement Date, supply to Client a performance bond in the amount of \$_____ to guarantee Vendor’s performance of the Migration Project in accordance with the Migration Project Plan. In the event that Vendor fails to perform the Migration Project in accordance with the Migration Project Plan so that the Actual Commencement Date occurs on or before [date] (or such other extended date as may have been set by the mutual agreement of the parties), Client shall be entitled to recover its actual damages (other than damages to Client’s business and reputation resulting from adverse publicity) in accordance with the following:

(1) Client shall be entitled to recover any such actual damages under the performance bond, up to the full amount of the performance bond.

(2) In addition to the amounts recoverable under the performance bond, Client shall be entitled to recover any such actual damages from Vendor, subject to the limitations set forth elsewhere in this Agreement.

2. Reputational Damages in the Event That Cutover of Operations Does Not Occur by a Certain Date

In the event that problems are encountered in the Migration Project and the Vendor becomes unable to meet the deadline for cutover of operations to the Vendor Data Center, the Client will need a mechanism to protect itself against damage to its reputation, particularly if the Client’s customers have been made aware of (or have found out about) the fact that the Client intends to outsource a key part of its operations to an outside vendor.

In the usual case, damages to reputation for failure to achieve timely cutover of operations to the Vendor Data Center will be very difficult or impossible to compute precisely. Accordingly, liquidated damages provide a convenient mechanism both to compensate the Client for failure to achieve timely cutover of operations, and as an added incentive to the Vendor to complete the Migration Project on time. These liquidated damages (which in the sample clause below are based on a per diem mechanism) will, of course, be the subject of heavy negotiation.

It is often useful to weave the reputational per diem damages into a staged set of remedies in which additional remedies layer onto existing remedies as the failure to meet the cutover deadline extends in time. For example, in the sample clause set forth below, if the Vendor fails to meet the original planned cutover date, the reputational per diem damages commence, and the Vendor is obligated to provide the Client with such personnel, equipment and other resources as may be necessary to keep the Client's own data processing center functioning in the interim. In addition, the Client becomes free to initiate discussions or negotiations with another data processing vendor to provide data processing services to the Client. If the problems continue in the Migration Project so as to cause the cutover date not to occur by a second, later, deadline, then the Client obtains the right to terminate the data processing agreement with the Vendor. Finally, if the cutover does not occur by a third deadline, the agreement will often provide for automatic termination.

Sample Clause: Cutover Does Not Occur by Defined Dates

- Actual Commencement Date Does Not Occur By [Date 1]. In addition to any recovery of actual damages as provided in subsection (a) above, in the event that Vendor fails to perform the Migration Project in accordance with the Migration Project Plan so that the Actual Commencement Date has not occurred by [Date 1], then, commencing upon [Date 1] and subject to the provisions governing apportionment of fault below:

(1) In order to compensate Client for any damages to its business goodwill and reputation resulting from adverse publicity, Vendor will pay to Client per diem damages for each day beyond [Date 1] that the Actual Commencement Date does not occur due to the failure of Vendor to perform its obligations in accordance with the Migration Project Plan. Subject to the provisions governing apportionment of fault below, such per diem damages shall be \$_____, up to a maximum cumulative total (not including the amount of any actual damages recovered as provided in subsection (a) above) of \$_____. The parties agree that the liquidated damages set forth in this subsection (1) are a reasonable estimate as of the Agreement Date of the applicable damages Client will incur to its business goodwill and reputation in the event that the Actual Commencement Date does not occur by [Date 1] due to the failure of Vendor to perform its obligations in accordance with the Migration Project Plan.

(2) In addition to the preceding reputational and actual damages and subject to the provisions governing apportionment of fault below, Vendor shall, at its expense and with the reasonable cooperation and assistance of Client, provide Client with all personnel, equipment and other resources in addition to the personnel, equipment and other resources then available to Client that are required to keep Client's data processing facility fully operational at the processing service level at which it was operating on the Agreement Date, including hot site backup. In addition, Vendor shall reimburse Client, on a monthly basis, for the costs incurred by Client in connection with the operation of such facilities after [Date 1]. The obligations of Vendor in this subsection (2) shall continue until the Actual Commencement Date or such earlier date upon which this Agreement may be terminated.

(3) Client shall be free to initiate discussions and/or negotiations with another data processing vendor to provide data processing services to Client.

(4) If the Actual Commencement Date has not occurred by [Date 2], then Client may, by giving Vendor written notice thereof at any time after [Date 2] and prior to the Actual Commencement Date, terminate this Agreement as of a date specified in the termination notice, but no later than [Date 3], without any further financial obligations to Vendor. If the Actual Commencement Date has not occurred by [Date 3], then, unless the parties mutually agree otherwise, this Agreement shall be terminated as of that date without any further financial obligations to Vendor.

3. Failure to Achieve Final Acceptance by a Defined Date

In addition to remedies for failure to achieve cutover of operations by a certain date, it is wise to make provisions for the circumstance in which cutover of operations occurs, but final acceptance does not occur by a specified date. This provision protects the Client in the event that, although initial cutover of operations is achieved, the Vendor is unable to demonstrate an ongoing ability to render the Data Processing Services to the satisfaction of the Client during the Final Acceptance Test Period. A staged set of remedies similar to those just described for failure to achieve cutover may be used.

Sample Clause: Final Acceptance Does Not Occur by a Defined Date

- Final Acceptance Does Not Occur By [Date 2]. In the event that the Actual Commencement Date occurs but Vendor fails to perform the Migration Project in accordance with the Migration Project Plan so that the Final Acceptance Date has not occurred by [Date 2] (or such other extended date as may have been set by the mutual agreement of the parties), then, commencing upon such date at which Client determines reasonably and in good faith that such failure by Vendor materially threatens Client's business:

(1) Client shall be free to initiate discussions and/or negotiations with another data processing vendor to provide data processing services to Client.

(2) Client may, by giving Vendor written notice thereof at any time after [Date 2] and so long as such failure by Vendor continues to materially threaten Client's business, terminate this Agreement as of a date specified in the termination notice, but no later than [Date 3], without any further financial obligations to Vendor.

(3) Upon termination of this Agreement as provided in subsection (2) above, Vendor shall provide to Client "Termination Assistance" in accordance with the provisions of the Section governing Termination Assistance below.

4. Apportionment of Fault

The failure to complete the Migration Project and achieve cutover by the various defined dates may result, in part, from the fault of the Client, since the Client will typically have defined responsibilities under the Migration Project Plan. Accordingly, a provision is often used that apportions the remedies available to the Client in accordance with the relative fault of the parties.

Sample Clause: Apportionment of Fault

- Vendor shall not be responsible for any delay or failure to perform the Migration Project in accordance with the Migration Project Plan that is caused solely by the fault of Client or failure by Client to perform its obligations under the Migration Project Plan in a timely and complete manner. In the event that any delay or failure by Vendor to perform the Migration Project in accordance with the Migration Project Plan is caused in part by the fault of Client or failure by Client to perform its obligations under the Migration Project Plan in a timely and complete manner, the parties shall negotiate in good faith to apportion the aggregate of any actual damages suffered by Client and any actual damages suffered by Vendor as a result thereof in accordance with the relative fault of the parties. Any disputes between the parties concerning the application of the provisions of this Section will be resolved in accordance with the dispute resolution procedures set forth elsewhere in this Agreement.

IV. PERFORMANCE STANDARDS AND PENALTIES

1. Performance Standards

Ongoing performance standards that the Vendor must conform to are one of the most important aspects of an outsourcing agreement to ensure that the Vendor renders the Data Processing Services in a fashion that meets the Client's ongoing internal business requirements and/or enables the Client to meet its own contractual commitments to its customers. In a mainframe environment, performance standards will typically be defined with respect to one or more of the services listed below. Response time standards will generally be measured in wall clock seconds, but the Agreement should explicitly so specify.

- *System Availability*: System availability is usually defined as the percentage obtained by dividing (i) the total time during the applicable month that the computer hardware and associated peripherals, including the operating system software, utilized to render Data Processing Services to the Client and its customers are actually available to render such Data Processing Services, by (ii) the total time during the month that the same is scheduled to be available to render such Data Processing Services.
- *CICS Response Time*: CICS response time is usually defined as the elapsed time, measured internally to the CICS region within the applicable CPU (and usually excluding all network response time), to process a CICS transaction. The performance standard may be divided into classes of transactions (based on the number of CPU processing seconds and physical I/Os required by the transaction), and may be further divided by shift (prime versus non-prime time). The standard generally takes the form of a requirement that a specified percentage of CICS response times be less than a defined response time standard by class and shift of transaction.
- *TSO Response Time*: TSO response time is usually defined as the elapsed time, measured internally within the applicable CPU (and usually excluding all network response time), to process a TSO transaction. As in the case of CICS response time, the performance standard may be divided into classes of transactions (based on the number of service units required), and may be further divided by shift. The standard generally takes the form of a requirement that a specified percentage of TSO response times be less than a defined response time standard by class and shift of transaction.
- *DIS Response Time*: DIS response time is usually defined as the elapsed time, measured internally to the DIS software within the applicable CPU (and usually excluding all network response time), to process a DIS transaction. As in the case of CICS and TSO response times, the performance standard may be divided into classes

of transactions (based on the amount of CPU time required), and may be further divided by shift. The standard generally takes the form of a requirement that a specified percentage of DIS response times be less than a defined response time standard by class and shift of transaction.

- *Tape Mount Response Time:* Tape mount response time is usually defined as the elapsed time required to satisfy a tape mount request, measured from the time the request is posted to the tape management system. The performance standard often has separate components for specific input mounts and scratch mounts. The standard generally takes the form of a requirement that a specified percentage of tape mounts take place in less than a defined response time.
- *Scheduled Batch Production Completion:* If the Client is relying on the Vendor to run regular batch production jobs, the Client will often specify the weekly days and times by which various batch runs must be completed and/or the results delivered to the Client or its customers. This type of performance standard is generally the easiest to define and measure compliance with.
- *Demand Batch Processing Initiation:* In addition to performance standards for scheduled batch production completion, the parties may wish to set standards for demand batch processing initiation. This standard will generally be defined as the elapsed time from the demand batch job submission or demand batch job hold release to the start of demand batch job execution.

Because the Client's IS services are typically being rendered, prior to outsourcing to the Vendor, on a very different equipment configuration, with very different economies of scale, the existing performance measurements and costing the Client has been using to manage the operations may need to be significantly redefined in the outsourcing agreement. Definition of performance measurements may require significant negotiation, as the Client will typically be accustomed only to the performance measurements and costing models that it has previously used in its business, which may bear little relation to the range of performance measurements and costing models the Vendor will wish to use.

To compound the problem, the Client may not have maintained detailed records of the levels of service it has been achieving at its data processing facilities before outsourcing to the Vendor that will enable the parties to readily agree upon appropriate performance standards at the cutover date. Accordingly, the parties may wish to agree that the performance standards (other than perhaps system availability) will not become operative until some defined time period (such as 60 days) after the Final Acceptance Date, during which period the parties can gain sufficient operational experience with the Client's particular data processing needs to set the final performance standards that are to govern the Data Processing Services. In addition, the agreement may contain a provision that the parties will

mutually review the performance standards from time to time, but no less frequently than some specified period (such as annually), and make any modifications thereto that they mutually agree are then appropriate to reflect changes in the Client's business or in the Data Processing Services being rendered to the Client.

2. Service Level Penalties

In the event that the performance standards of the Agreement are not satisfied during a particular time period, the outsourcing agreement should specify service level penalties to which the Client will be entitled based on such failure. The penalties usually take the form of a reduction of charges for the Data Processing Services for the period during which the failure occurred, or a credit against future charges.

Service level penalties will typically require a lot of negotiation to define. The Vendor is often rightfully concerned that the penalties not be used as a mechanism to reduce its revenues for every small slip in performance. Conversely, the Client will want to provide an ongoing incentive for the Vendor to provide consistently reliable service. Thus, a mechanism is needed that both protects the Client, yet recognizes that the Vendor may occasionally slip up in providing services that are otherwise of consistently good quality.

One such mechanism is to set up a service level penalty structure that is comprised of one or both of the following components:

(i) *Earn Back Provision.* An ability on the part of the Vendor to "earn back" penalties by exceeding the performance standards. The earn-back may be based either on exceeding in future time periods the performance standard that was previously breached, or on exceeding in the same time period other performance standards in other areas, or both. With respect to the latter option, the Client will want to set up some mechanism to ensure that the Vendor is not able to consistently fail to perform in one area of service (system availability, for example) by consistently exceeding the performance standard in another area (tape mount response time, for example). In all cases, there must be an accrual mechanism to accrue the monthly adjustments for a defined period to give the Vendor an opportunity to earn back accrued penalties. In addition, one may consider allowing the Vendor to accrue "positive" performance credits for exceeding performance standards during some defined "look back" period that may then be used to offset "negative" performance penalties that may arise during some defined "look forward" period.

(ii) *Weighting of Performance Standards.* The parties may provide a weighting factor for each performance standard in accordance with the importance of that standard to the Client. These weighting factors can cause the penalties to be higher for the more important performance standards, and, if combined with the earn back provisions previously discussed, can make it more difficult to earn back penalties that result from failure to meet

the most important performance standards. If the performance standards have been divided by classes of transactions and/or by shifts, two sets of weighting factors can be used: a first set that weights the various classes and shifts (which weights will sum to one), and a second set that weights the importance of that performance standard (including all classes and shifts) against other performance standards (the second weighting factors across all standards will sum to one). The outsourcing agreement should specify how often the Client may readjust the weighting factors and the criteria, if any, upon which such weighting factors will be adjusted.

For example, the performance standards for system availability might have the following weighting factors:

Performance Standard	First Weighting Factor	Second Weighting Factor
System Availability	0.33	0.3
Prime Shift	0.5	0.2
Off Shift	0.3	0.2
Weekend	0.2	0.2

The first set of weighting factors for system availability indicates that the performance standard for the prime shift is the most important, and is to be weighted one half, while the system availability standards for off shift and weekend shift are to be weighted, respectively, 0.3 and 0.2. Note that all the first weighting factors for the system availability performance standard sum to one. The second weighting factor for system availability is one-third, which indicates that system availability is very important relative to the other types of performance standards that have been defined (such as TSO response time, CICS response time, scheduled batch production completion, and tape mount response time, which will each have second weighting factors of less than one-third, all of which together will sum to one).

3. An Example

Set forth below are sample performance penalty provisions that incorporate an earn-back mechanism, dual-set weighting factors, and the ability to accrue “positive” performance credits that may be accrued to offset future “negative” performance penalties.

Sample Clause: Computation of Accrued Monthly Adjustment

- For each calendar month, an Accrued Monthly Adjustment shall be computed using these steps:
- *STEP ONE:* Compute Actual Performance Measures for each component of the Performance Standards.
- *STEP TWO:* For each applicable component of each Performance Standard, compute a “Delta Performance Measure” as follows:
Delta Performance Measure = Actual Performance Measure — Standard Performance Measure
- *STEP THREE:* For each applicable component of each Performance Standard, retrieve the “Service Level Adjustment Percentage” corresponding to the Delta Performance

Measure for the component thereof from the applicable table. The Service Level Adjustment Percentage may be either positive or negative. [The Service Level Adjustment Percentage specifies the percentage adjustment in service charges (positive or negative) that is to occur based on the delta in performance; it can be set so that small deltas do not incur much penalty or credit, whereas larger deltas incur proportionately higher penalties or credits.]

- *STEP FOUR:* For each Performance Standard, compute a weighted average of the retrieved Service Level Adjustment Percentages for the applicable components of that Performance Standard by multiplying each such Service Level Adjustment Percentage by the applicable First Weighting Factor for such component, and adding together all such products.
- *STEP FIVE:* For each Performance Standard, compute an “Accrued Monthly Adjustment” by multiplying (i) the weighted average of the applicable retrieved Service Level Adjustment Percentages, by (ii) the applicable Second Weighting Factor for such Performance Standard, and then multiplying the result by (iii) the service charges for the month at issue.

Sample Clause: Billing Adjustments Based on Accrued Monthly Adjustments

- A negative Accrued Monthly Adjustment will be accrued in favor of Client for a maximum of three (3) months, while a positive Accrued Monthly Adjustment will be accrued in favor of Vendor for a maximum of two (2) months, as follows:

(a) A negative Accrued Monthly Adjustment will be used to reduce Vendor’s invoice to Client for the fourth month (or the last month of the term of this Agreement, if earlier) after the month for which the negative Accrued Monthly Adjustment first accrued. Such negative Accrued Monthly Adjustment can be reduced or completely eliminated if Vendor can accrue compensating positive Accrued Monthly Adjustments during the intervening three (3) month period.

(b) A positive Accrued Monthly Adjustment can only be used to compensate for negative Accrued Monthly Adjustments. A positive Accrued Monthly Adjustment can never increase a Vendor invoice to Client and must be used to compensate for negative Accrued Monthly Adjustments within two (2) months after the positive Accrued Monthly Adjustment is accrued or it (or any residual portion of it that has not been used to reduce a negative Accrued Monthly Adjustment) will be eliminated.

V. PRICE REDUCTIONS BASED ON IMPROVED TECHNOLOGY PERFORMANCE RATIOS

Most outsourcing agreements contemplate running for a number of years. Over that time, improvements in the price/performance ratio of new equipment can be expected. As the Vendor takes advantage of such improvements in technology, there should be some mechanism to pass the savings on to the Client. If, for example, a rate card structure is being used to compute all charges to the Client based on the actual amount of resources used, or to compute incremental charges to the Client beyond some defined base level of resources for which the Client pays a fixed monthly charge, then as new technology is acquired by the Vendor having improved price/performance ratios, the rate card charges should be reduced accordingly.

One convenient mechanism for determining the amount by which the service charges of the Vendor should be adjusted is to compute an average annual price/performance improvement factor for certain resources (such as CPU or DASD resources) over a defined initial period of the agreement (three years, for example), and then apply a percentage rate reduction to the relevant resource charges based upon the size of such factor over a subsequent period of years. The average annual price/performance improvement factor for CPU resources might, for example, be determined by computing the average market price per million instructions per second (MIPS) for a specific high end mainframe CPU from a defined manufacturer and each comparable plug compatible CPU made by another reputable manufacturer, and then computing a weighted overall average of the individual average prices-per-MIPS, with the weighting being based upon the then current relative market share of the various manufacturers. A similar factor could be computed for DASD resources using the market price per gigabyte of a number of plug compatible DASD vendors.

VI. POST-TERMINATION ASSISTANCE

The termination provisions of an outsourcing agreement require some of the most careful thought. This is especially true for an outsourcing relationship founded upon a remote computing model, for at the time of termination the Client will no longer have in-house capability to perform its data processing operations. Accordingly, significant post-termination assistance may be needed from the Vendor to transition the Client's data processing operations to another vendor or back to the Client itself.

Whether or not the Vendor is entitled to charge for the post-termination assistance will often turn on the reason for the termination — whether by cause, for convenience, or for other reasons. If the termination is for convenience of the Client, the Vendor may reasonably insist upon charging its current commercial billing rates for providing the post-termination assistance. If the termination is for cause based upon breach by the Vendor, then the Vendor should be expected to provide the post-termination assistance at no charge. If the

termination is by the Vendor for failure by the Client to pay service charges due under the agreement, then the Vendor may often insist that it have no obligation to provide post-termination assistance, or a reduced obligation.

The various types of post-termination services that may be needed from the Vendor include:

- Notifying the new service provider of procedures to be followed in order to turn over data processing operations to the new service provider
- Reviewing all system software libraries (test and production) with the new service provider
- Explaining any applicable naming conventions used by the Vendor to the new service provider
- Assisting the new service provider in analyzing space required for the databases and system software libraries necessary to service the Client
- Generating a tape and computer listing of relevant source code for programs owned by the Client that are to be turned over to the new service provider
- Unloading the Client's production databases and making available tapes thereof with content listings to the new service provider staff
- Assisting with the loading of the databases at the new service provider Assisting with turning over necessary telecommunications network links to the new service provider
- Answering miscellaneous questions on an "as needed" basis for a defined period of time after termination

A special issue arises in the event the Vendor has been using proprietary software on the Client's behalf, and the Client has become dependent on such software. Provisions should be made for a license from the Vendor to the Client's new service provider, or for some other form of assistance from the Vendor to "wean" the Client from its dependence upon the Vendor's proprietary software, whether operating system software or application software. In addition, provisions should be made for the orderly transition to the new service provider of generally commercially available system software that the Vendor has been using on the Client's behalf.

Sample Clause: Transition of Vendor Proprietary Software and Other System Software

- Upon termination of this Agreement:

(a) For system software proprietary to Vendor and not generally commercially available, Vendor will either (i) grant Client, for use by Client or a third party service provider rendering services to Client, a license to use such system software on commercially reasonable terms, or (ii) at Client's option, recommend a commercially available substitute (if one exists) to perform the same function. However, if a commercially available substitute exists, then Vendor may elect not to grant Client a license to use the Vendor proprietary system software, in which event Vendor will, at its expense, perform and deliver to Client all conversions necessary to enable Client or a third party service provider rendering services to Client to utilize such substitute in a manner that does not prevent timely transition to Client or a third party service provider.

(b) With respect to generally commercially available system software, if Vendor has licensed or purchased and is using any such system software solely for providing the Data Processing Services to Client at the date of expiration or termination, and Client desires to use or have a third party service provider use such system software, Client will reimburse Vendor for initial license or purchase charges for such system software in an amount equal to the remaining unamortized cost of such system software, if depreciated over a five year life, and pay any transfer fee or charge imposed by any applicable vendor.

(c) With respect to generally commercially available system software, if Vendor has licensed or purchased and is using any such system software for providing the Data Processing Services to Client and other Vendor customers in a shared environment at the date of expiration or termination, Vendor will assist Client in obtaining licenses for such system software subject to Client's payment of any license fee or charge imposed by any applicable vendor.

