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Top 10 Warning Signs of Problem Vendors

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By Susan M. Kornfield

Complex information systems, once predominantly the realm of the sophisticated, high-tech company, are now ubiquitous throughout for profit and nonprofit businesses, institutions, and governmental agencies. In light of the critical role information systems play in the automation and integration of business operations and in enabling companies to comply with a myriad of laws and regulations, attorneys are well beyond the stage when they just need sample software license agreements and annotated checklists to represent their clients in deals for the acquisition of these systems. The process of vendor selection, including contract negotiation, system implementation, and ongoing technical support of such systems, is significantly more complex than mere software licensing. Experience has shown that there are warning signs of problem vendors that often appear early in this process. This article identifies some of those signs and suggests possible strategies for addressing the related issues.

Vendor Discourages Use of Attorneys

#1

Most vendors know that if a qualified attorney gets involved in the process, the attorney will reject the vendor's standard contract. This is because the vendor's standard contract is generally one-sided and fails to fairly address a client's needs. Sometimes a vendor will "reassure" a client that it is unnecessary to bring in counsel because the vendor is offering "its standard contract" that has been signed by numerous Fortune 500 companies. Vendors may treat a client's suggestion of review by its counsel as an issue of whether the client "trusts" the vendor. A vendor may even offer discounts off the price of its system if the other party agrees not to have legal representation in the contract process. We recently had a vendor offer a client a reduction of nearly $200,000 off the price of the information system if the client agreed not to have legal counsel review the contract! (How often do attorneys see the marketplace immediately reflect the value of our services to the client?)

Recommendation

Bring in counsel early in the process, before the Request For Proposal (RFP) goes out, and keep counsel involved throughout the process. It will make negotiations more meaningful and efficient.

Vendor Retreats from Its RFP Responses

#2

Some clients believe that the preparation of an RFP assists them in the vendor/system selection process. Where a client has asked specific questions about system features, functionality, interoperability, migration commitments, data handling, etc., and where the responses of the vendor are material to the client's decision to proceed with a particular vendor, the vendor's written responses to specific RFP questions should be included in the contract as representations and warranties. Attorneys should be concerned when the proposed contract promises only that the system will perform substantially in accordance with the user documentation, and the vendor refuses to incorporate its prior promises into the contract.

Recommendation

Either the user documentation must reflect the system performance statements made by the vendor in the response to the RFP, or those statements (given their materiality to the client's choice of systems) must be incorporated into the contract. Even so, it is a bad sign that the same party making the promises now seeks to disavow them.

Vendor Balks at Drop Dead Dates

#3

One of the most frustrating (and common) aspects of a systems implementation project is missed deadlines. Deadlines can be missed for any number of reasons, some of which are no fault of the vendor (where, for example, the client has failed to timely acquire the necessary additional equipment, or convert data).

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On the other hand, there are many aspects to system implementation that are completely the responsibility of the vendor, such as completion of creation of an implementation plan, completion of software development, delivery, installation, integration, acceptance testing, and training. Additionally, there may be circumstances where a client, facing certain organizational deadlines (merger, internal restructuring, or compliance with new laws) must have the absolute right to examine the progress of a systems implementation project and elect to terminate the current contract. A vendor should agree that missed deadlines have consequences, including termination, without requiring the client to dispute whether the missed deadline was material or allocating fault.

Recommendation

The issue of liability for payment of certain termination fees should be distinguished from the right to terminate. If, for example, the client shares some or all of the responsibility for the missed deadline, it may be appropriate for the contract to specify a fee for termination. Furthermore, it is always possible that the client will encounter the very same problems with a different system and a different vendor, but that is beside the point. The issue is whether the client should have the contractual ability to walk away from a project that is unacceptably off-course and to contractually manage the cost for such a decision. We have found that the contractual right to terminate for missed deadlines results in more objectively realizable establishment of deadlines, greater attention paid by the vendor to the particular client project, and greater cooperation between the client and vendor; the client typically needs this contractual option.

Vendor Argues About Availability of Refunds

#4

Refunds are a standard element of most commercial contracts. They are typically available only after the remedies of repair (of the defect) and replacement (with conforming goods) have failed, but refunds should be available as the ultimate remedy. Somehow, vendors of information systems have come to see the contractual right to a refund as a threat to their revenue recognition instead of as a customer right in the event of vendor breach. Vendors may offer to extend the implementation date, acceptance date, or warranty period; or they may offer free support, additional training, and a price reduction for future software purchases. While these contractual gestures may appear financially attractive, they are unacceptable alternatives to refunds.

Recommendation

Run, do not walk, from a vendor that refuses to offer, as a remedy in the event of breach, a full refund of the fees and expenses paid by a client. A vendor in breach should not be entitled to keep the

client's money. A vendor in breach should not be entitled to force the client to accept "remedies" that are a substitute for the deal to which the parties originally agreed. Do not accept the "offer" from a vendor to allow the client to sue the vendor for damages and to recover the amounts paid. We have driven vendors to the settlement table based upon the client's unambiguous contractual right to a full refund.

#5 Money for Nothing

Vendors often structure the payment terms of a contract in accordance with the passage of time, meaning that payment is made in stages: a certain amount is due upon signing, then another amount is due 30 days later, then there are certain payments due monthly, and the like. Vendor contracts typically do not structure payment solely in accordance with the vendor's own performance, or in accordance with concrete events, such as the integration of the hardware and software and completion of acceptance testing of the system. This results in a client being contractually obligated to make payments even while the vendor may not have fully performed.

Recommendation

Tie payments to meaningful events. The client's initial, good faith payment upon execution of the contract (or 30 days thereafter) should be relatively modest. That is, in part, because the software should already be developed (thus there are no R&D or manufacturing expenses to the vendor to deliver the software). Payments for the vendor's services in the preparation of an implementation plan should be tied to the actual preparation of the plan. Never tie payments solely to the passage of time. Clients end up paying fees without vendor performance, and vendors do not have a sufficient incentive to perform.

#6 Vendor Charges for Technical Services Before System Acceptance

Some contracts seek to impose the obligation of the client to pay fees for technical services that are incidental/required for system acceptance. Those fees are not properly chargeable to the client as they are inherent in the vendor's obligation to deliver a conforming system. Indeed, we have seen some draft contracts that would enable the vendor to charge fees for maintenance and support services when the system has not yet completed acceptance testing!

Recommendation

Review carefully the nature of professional services for which the client is obligated to pay, and ensure that fees are not assessed on vendor professional services that must be provided just for the vendor to meet its own obligations. Some services, such as preparation of a needs assessment, development of internal documentation, development of a professional implementation plan, and Help Desk training, may be properly chargeable to the client.

#7 Vendor Threatens to Cut Off Technical Support

Some vendors will seek contract provisions that allow them to withhold technical support if the client is late on payments, or if the client refuses to pay certain fees. While this may seem symmetrical, and even superficially fair, it is not. Technical support is critical to the functioning of the system. Technical services may include access to the vendor's help desk, troubleshooting problems, discovering errors in the software, access to patches and other work arounds and the receipt of corrected versions of software. There may be any number of reasons why the client has not made certain payments, ranging from those that are perfectly valid (the vendor is alleged to be in default of its obligations), to the client's payment cycle (client regularly pays on a schedule later than that set in the contract), to a good faith dispute as to whether a payment is owed, to the client's simple failure to pay undisputed invoices.

Recommendation

The contract should be clear that payment disputes are one thing, and the provision of technical services another. The contract can provide for various remedies for the vendor if the client wrongfully fails to pay or delays payment, such as late fees, interest, attorneys' fees in the event of litigation to enforce the payment obligation, and a loss of certain negotiated benefits (caps on price increases, for example). This should be a completely separate issue from whether the contract should permit the vendor to stop providing support services in the event of a payment problem (and the contract should affirmatively state the opposite). The vendor always has the remedy of going to court to plead its case, either for payment of outstanding fees or for termination of its obligation to support. Some vendors promise that they would never, ever cut off technical support, and that the client should "trust" them. That client should be told of the attorney I met in federal court last year who was seeking an injunction on behalf of his client, a *hospital,* against a systems information vendor that had cut off technical support because of a payment dispute.

#8 A Prohibition Against Use of System by Affiliates and Partners

Some vendors seek to limit the use of the system to employees of the entity signing the contract. This is overly-restrictive and can have serious ramifications where a client spins off a division, merges, enters into a temporary collaboration, enters into an outsourcing contract, uses leased employees, or provides access to its system by a related business entity.

Recommendation

On the one hand, if the license fees are related to the number of employees/customers of the licensee, it is reasonable for the vendor to receive additional license fees. This, however, is an issue of

compensation and not an automatic breach of the license agreement (which may trigger a breach and possible termination remedies). Related to that point, the grant of license should contemplate that the licensee may use the system in connection with the strategic relationships, described in point #8, above; for example, where it brings in another organization to manage its IT, where it collaborates with a third party in connection with a particular project, where it spins off a division (it is common to allow ongoing use of the system for at least one year after the legal transition).

#9 Unreasonable Source Code and Employee Access Procedures

The issue of source code escrows should be so routine by now that it should not raise any serious questions. We know that vendors consider their source code as trade secrets and as a competitive advantage, and that they fear any third party having access to their code. We also know that access to a vendor's source code will not provide an immediate solution to a problem system. We bargain for the right to the source code because without it, the client is in worse shape. We bargain for the right to hire and consult with the vendor's staff (or former staff) most knowledgeable about the system and the code, so that our client's access and use is most useful. The vendor's employment contracts often prohibit employees and former employees from providing services to the vendor's customers. We should be concerned in circumstances where the vendor erects barriers to a client's access to source code (unreasonable escrow fees, unreasonable trigger events, unreasonable mediation-arbitration-litigation hurdles in order to access code, unreasonable restraints on the personnel the client is able to contact to seek technical assistance).

Recommendation

Vendors should fully cooperate in procedures designed to solve the client's problems with the vendor's system as quickly as possible. The source code should be deposited with a reputable source (a local bank's trust department is often as qualified as a national source code escrow company and has a substantially cheaper rate) on a regular basis (quarterly, and after each new version or upgrade/enhancement), should be able to be visually inspected and verified by the licensee, should be released immediately upon certain trigger events without the need for third-party rulings as to whether certain trigger events occurred (even if the code has to be returned when it is later determined that the licensee was not entitled to the code, in which case a source code license fee can be imposed), and the client should have access to whatever persons it desires in order to solve its problems and successfully operate its system.

#10 Rolling Acceptance, Rejection, and Termination Procedures

Some information systems "Go Live" in a sequence, as different software modules are developed, rolled out, tested, and integrated. Some vendors expect that their systems will have certain features and software modules, and promise the delivery of those modules. Vendors make various promises about interoperability and compatibility of the system, and the interfacing of its system to other client computers and/or third-party software or databases. A client makes its purchasing decision, and chooses one vendor over another, because of those promises. A client must be able to reject a module, and to reject the entire system (yes, the entire system), if the system contractually promised by the vendor is not delivered within the specified time period, or if the system fails to meet specified requirements after upgrades and enhancements.

Recommendation

No client wants to be in a situation where it has to exercise this remedy. But if the circumstances are so dismal that termination is the best option, the client must have the option where the system for which it contracted has not been delivered (and may very well never be delivered). A vendor must realize that the dramatic remedy of system rejection (even years into a project) is a necessary remedy when the vendor cannot do what the vendor promised to do, upon which promise the client reasonably relied.

We have had clients whose vendors promised certain system functionality, but the vendors (despite intense efforts) could not deliver the promised software modules. In one case, it was critical for the client's FDA compliance; in another, the system would never interface properly to financial and accounting systems and the client could not timely generate accurate financial reports. While the clients were not happy with the vendors (and the vendors were much less happy), the clients had their systems replaced or removed and they received refunds in full. Whatever the circumstances, we should ensure that the acceptance criteria are set out for separate modules within the system and for the system as a whole, and should reflect that although the system will change over time (upgrades, modifications, enhancements, new modules) it must continue to meet certain promised requirements.

In the beginning, vendors are trying to bring in a deal. Like other salespersons, they may say what they think the client wants to hear, and they might honestly believe every promise they make. In that case, they should have no difficulty accepting the terms and addressing the issues raised above. While we expect give and take in any negotiation, with the stakes as high as they are in IT contracts, we need to distinguish mere vendor bargaining from the early warning signs of a fundamentally unworkable business relationship. ◆

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