When Due Diligence Becomes Due Negligence

Due diligence doesn't stop on the 'go live' date. So how do you keep the relationship working?

"Keeping on top of the deal is critical to building a relationship that works for both parties."

Everyone entering into a long-term business relationship, such as an outsourcing or managed services deal, knows that "due diligence" is a box to tick. But that's often the problem, as too many organisations treat it as just a chore that bears no relation to the success of the ongoing deal.

We examine the vital exercise of due diligence with two aims:

- To emphasise how both parties should use the due diligence process to know what each is getting into.
- To show that due diligence doesn't stop on go live date. Keeping on top of the deal is critical to building a relationship that works for both parties and to ensuring that the customer continues to get the service it expects and pays the right price for it.

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You are invited to a seminar on 16th May, 11am – 3pm
The Lansdowne Club, London

RSVP: 020 7868 1901 or london@maturity.com

Before the live date

There is much that the customer can and should do to ensure that the deal is going to work – and our earlier white paper stresses the need for the deal to work for both parties. After all, if the service provider cannot make a profit or the customer doesn't see any business benefit or improvement in service, there is no incentive for either party to invest in the relationship.

The role of due diligence at this stage is to start the whole relationship off on the right foot, by making sure that both parties negotiate and sign the contract on the basis of a common understanding of what assets are being taken over and what is expected from the service provider. There is a risk of over-complicating the process and letting it become bogged down in details of warranties and penalty clauses to the detriment of the relationship actually working. Due diligence should involve:

1. Both parties having absolute clarity of the underlying purpose of the deal and the anticipated outcomes – what is to be delivered, when, where, and to what effect.
2. The customer examining its own existing operation, both as a sum of its parts (e.g. the contracts, people and assets that make up the relevant department or function) and as the sum of what it does (the services it provides and

the quality it achieves). This isn't just a mechanical process for external (or in-house) lawyers – both parties need to get under the skin of the existing processes and assets to work out how in practice these will enable the service provider to meet expectations on go live date.

"An 'everything but the kitchen sink' contract can risk blocking innovation and losing emphasis on the outcome."

3 The customer providing this information to the potential service providers – not least to make sure that they are all bidding on the same basis. The customer should bear in mind the bidders' costs of going through the material and preparing the bid. Demonstrating that the customer has put its own house in order is important, so the output of the process at (2) above is key. Again, though, the data is not the whole story: the bidders need to understand the customer's business requirements and what its future plans may be.

4 The customer understanding its current in-house costs and how these compare with best practice – how else will the customer be able to tell if potential service providers are offering value for money? A benchmark at this stage (a "proxy bid" for the defined service to be outsourced) can save time and add value, clearly defining service, outcomes and anticipated benefits.

An effective benchmark will confirm the price that the customer should expect to pay over the life of the deal, based on real prices paid by other organisations for similar services that they have outsourced.

After the 'go live' date

Setting up the deal properly is critical, but it is less than half the story. Some people – and some lawyers in particular – think that the longer and more comprehensive the contract, the better the relationship will be, but this ignores two vital points:

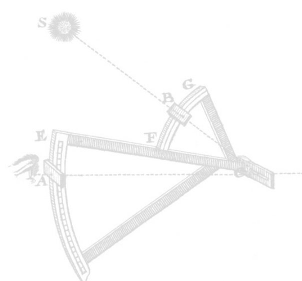
- The contract is there to support the relationship, not to stifle it. An "everything but the kitchen sink" contract that fills many shelf-feet of space with endless schedules of essentially operational material can risk blocking innovation and losing emphasis on the outcomes and outputs. In most cases, specify what is required and leave it to the service provider to decide how it runs the services effectively.
- No contract, no matter how bulky, can anticipate all the changes which could affect the parties over the life of a five or ten year deal – changes in economic climate, in the structure and needs of the user's business (perhaps something as substantial as a major merger, for

Traditional legal 'Due Diligence' often misses the mark

Lawyers use the jargon of "due diligence" to mean the extensive process (originally used in mergers and acquisitions) of going through all the contractual and other documents of a business, primarily to enable another business to decide whether it is worth buying, and on what terms.

The parties use these documents, giving and taking appropriate warranties and indemnities to allocate any risk between them and, if necessary, to adjust the purchase price retrospectively.

It is dangerous when lawyers try to apply a similar approach to transferring the in-house operation of a company to a service provider. Unlike in a corporate deal, when assets and people are transferred on a once and for ever basis, these assets and people may well, at least at first, be the core of what the service provider uses to provide the services. As such, they underpin the whole relationship. Warranties and indemnities to re-allocate money later will not cut it: the parties want the service to work!



example), in technology or in regulation will all have an impact. It is critical to be able to use the contract flexibly to manage change – and, of course, to ensure that the services are still good value for money.

Regular health checks should be undertaken as opportunities for both parties to assess the situation. These should not be judgmental or confrontational, and should form part of the overall process of governance which regulates the relationship between the parties. They should also be within the framework of the customer's strategy both for the relevant service and for how this fits within its broader business strategy. This leads to some key recommendations:

"Regular health checks should be undertaken as opportunities for both parties to assess the situation."

1 The customer must control the strategy – it is highly risky to outsource both the setting of strategy and the provision of the services to meet that strategy to the same organisation.

2 The customer must have the information and retain the skills not only to manage the outsourcing contract on a day to day basis (which is very different from managing the services in-house), but also to assess the bigger picture and to ensure there is input from the business as a whole and the users of the services.

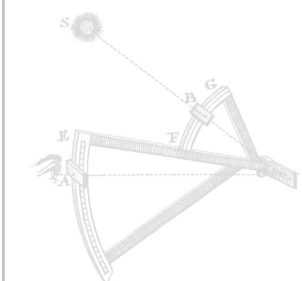
3 There must be an effective exchange of information between the parties about each other's perceptions of the way the deal is going and how future changes can be addressed. Again, this goes further than simply having good change control procedures in the contract – it involves more senior representatives being prepared to be open with one another, and this depends more on building trust than having a good contract.

4 There has to be a contractual mechanism for addressing concerns and making sure that, ultimately, the customer can ensure that business-critical changes can be made.

In order to achieve this, both parties need information about current service achievement and how both this, and the underlying contract, compares with good practice elsewhere. This is where outside help can be valuable to verify service levels, assess end-user satisfaction and assist in preparing reports and proposals for discussion.

On a more formal level, of course, comes benchmarking. The unit cost of commodity services, particularly in IT, is likely to fall, and the customer will want to share in any cost savings and/or see re-investment in service provision. The best way to manage this fairly is by exercising the benchmarking clause in the contract, measuring the real price recently paid for the service by other organisations for similar services – similar, that is, in terms of volume, complexity and service level.

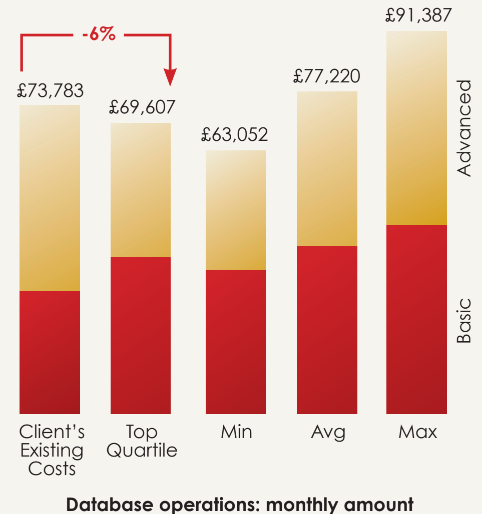
This does, of course, require the benchmarking clause to have been set out clearly in the contract, so that a meaningful exercise can be carried out. Too often these clauses are vague as to the scope of what it to be assessed, how meaningful comparisons can be made and the objectives – how the results of the benchmarking are to be used. Is the benchmarker's report merely the basis for discussion, or is the service provider required to implement the recommendations? Does this mean reducing the unit price or varying the service levels – or both? If these points are addressed properly, a benchmarking exercise – frequently paid for jointly by customer and supplier – can identify a fair price for the service and so often reduce the unit price that the customer is paying.



Exercising the benchmarking clause – what is the target?

The example opposite shows a 'target price' for the benchmark, as set out in the contract, of the peer group average minus 10%. In this example, there is a 12% difference between the current price being charged to the client and the target price.

But the benchmarking clause in the contract must set out clearly what action will now be taken. Is the supplier contractually bound to reduce its price? What other outcomes could be considered? This must be considered before the benchmark is carried out.



Conclusion

Money never sleeps, and neither should a contract for an outsourced service be left in a drawer after go live date. An organisation needs to focus its due diligence to ensure that it defines the service it expects to be delivered and the price it expects to pay, and must continue to be diligent about managing both service and price during the life of the deal. The contract (and supporting measures such as fair benchmarks) can support the relationship during the whole life of the deal, and an organisation that fails to plan properly beyond the live date is a negligent one.

MATURITY

A benchmark from Maturity enables our clients to plan future scenarios, ensure the right price for a new outsourcing deal and get value for money during the life of a sourcing contract. Our ability to carry out benchmarks based on actual deal price as well as cost is core to our business.

For more information contact:
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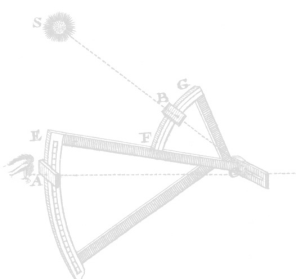

Authorship

Maturity works with a number of respected law firms, and this paper has been co-authored by Rory Graham, partner at Coffey Graham LLP, who specialises in complex technology transactions such as outsourcing and systems procurement. www.coffeygraham.com