RENEGOTIATING SUPPLIER CONTRACTS TO BRING NEW VALUE TO THE CLIENT
A lot has been written about preparing for the restructuring and renegotiation of supply relationships. It is an important topic. Most of these writings focus on maximizing leverage — through the existing contract, through price benchmarks, by using competitive bidding pressure, etc. But many of these articles miss the crucial opportunity that renegotiation provides for learning from the current deal — what works, what doesn’t — and using that knowledge, and the experience of the people involved, in delivery for innovation and transformation.

A restructuring or renegotiation is different from a first-encounter sourcing relationship. There is a shared history, a much better understanding of each other’s culture and business, and a much better understanding of scope than in a first-time outsourcing. Parties to a renegotiation should take advantage of that shared experience when preparing for a restructuring event.

Of course, especially in this economic climate, savings can be generated just from being well prepared to renegotiate based on comparative leverage. Parties can often “earn” discounts that way. For pure commodity transactions, that may be the best source of additional savings. For complex managed services, information technology and business process outsourcing transactions, however, focusing exclusively on leverage positions may cause the parties to miss out on opportunities for innovation, shared benefits and transformation-level savings.
Organize

The first step in renegotiating your sourcing contract is to assemble the right team. You will want to include renegotiation experts, pricing and financial experts, and experts from the business unit affected by the renegotiation. But make sure you are also talking with the individuals involved in managing and operating the existing sourcing relationship. They will have the best and most current information on the relationship. Identify who these people are, schedule time to talk with them and be prepared to listen.

Ask them to share:

• What is working?
• What is not working?
• What problems have they overcome with the supplier?
• How did they overcome those problems?
• What prevented other problems from being resolved?
• Have there been any changes in the relationship or in delivery that were good?
• Any changes that were bad?
• What would they do differently?
• What would they make sure they kept?
• Do they see any opportunities to change the delivery model or the relationship to make it better? In other words, how would they innovate? (Having some examples here can help open up the conversation. E.g., Would the relationship be better if you and your counterpart had more authority to change things?)
• Are there any ideas regarding changes to the delivery model or the relationship that have been rejected or tabled?
• What are those changes? Who initiated them?
• Why were they rejected?
• Who are their main contacts at the supplier?
• How comfortable are they with those contacts?
• How regularly do they communicate?
• What do they anticipate is working well from the supplier’s perspective?
• What changes to the relationship and/or the contract would be meaningful to the supplier? And, which of those changes, if any, could be made at little or no cost to them?
• Are there parts of the relationship or transaction that, if run independently of the other portions, would be successful from both their and the supplier’s perspective?
• Will they and the supplier agree about which portions of the relationship are not working well? Can the unproductive or challenging portions of the relationship be discontinued without adversely affecting the balance of the relationship; or are they all interdependent such that no part of the agreement could be changed without changing the entire relationship?

The purpose of this communication is threefold. At a minimum, the process will help establish who really has knowledge of the existing relationship and who does not. More important, though, this process may help identify how supplier management and governance is working, and may showcase opportunities to improve those processes. Improving supplier management and governance processes may be a useful outcome of the restructuring.

Also, these questions may help identify whether the parties are appropriately incented to innovate. If you find that there has not been any real focus on innovation, you know there is a problem in how your deal is structured. Even if your solution was cutting-edge when it was implemented, if it is time to renegotiate and there have not even been any suggestions for innovation, then your contract structure may not be properly aligning the parties’ incentives to make improvements. That information may be helpful in determining whether you need to look more fundamentally at your contract as part of the restructuring.

There are a lot of reasons why a relationship may inhibit innovation. The contract terms that govern the relationship may make the risk-taking too costly. For example, a contract that includes many complex provisions regarding how services must be performed might stall good opportunities for improvement simply because navigating the contract is too complex. Alternatively, the incentive structures in the agreement might make a party better off not innovating than they would be if they did innovate. For example, if fees are based on transaction volumes, a supplier is not incented to find ways to reduce the volume of transactions — even if there may be collective savings that could be shared to both parties’ advantage in the event of such reductions.

Alternatively, you may find that while the parties have come up with interesting ideas, none of those ideas ever make it through governance. In that case, you may have the right incentive structures in place to incent idea generation, but your governance structure is preventing those ideas from
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being realized. The restructuring may be an opportunity to review and improve your governance structure so that those ideas can be realized more successfully.

Also, if you identify innovative ideas prior to renegotiation, you may have an opportunity to use the restructuring to ask the supplier to make a fresh assessment of those ideas, and to recommend whether they should be implemented. For example, you may find that one party has suggested that portions of the solution currently managed on dedicated servers be migrated to the cloud. Balancing the risks and rewards of such a change may have been cost-prohibitive for the last year of the initial deal, but may make sense in the context of a restructuring for a longer term.

Interviewing the people who have been actively involved in the transaction may help you identify those opportunities for change that can help both parties make a better deal. As opposed to merely using your leverage to take a bigger piece of the pie, you can use the restructuring to make the pie bigger. Of course, you may find that the parties have been innovative. That information will be crucial in determining whether your current contract structure is effectively rewarding desired behaviors. It can also be useful in determining whether or not the parties are properly sharing the rewards of innovation.

Understand

In preparing for your renegotiation, it is critical to understand what the existing deal is. In many situations, that can be more complicated than it sounds. Often, even when fairly straightforward sourcing contracts are subject to only a handful of change orders, the cumulative impact of those change orders can have a big impact on the actual deal. To understand how you might restructure your relationship to improve it, first and foremost, it is critical to have a good understanding of what the relationship is.

As part of your preparations, retrieve all the change orders and other contractual changes that impact the relationship. Organize these change orders in context and determine how they affect one another. This may be a complex task, and may shed light on potential issues with the structure of the relationship. Question how these change orders alter the relationship. Also, if there are a lot of change orders, why are there so many? Does it reflect innovation? Does it reflect responsiveness to change? Or does it reflect something else, like an overly cumbersome governance process or contract terms that force the parties to be adversaries instead of partners?

If the change orders are significantly complex, you may decide that it makes sense to consolidate the change orders into a conformed agreement. We’ve done that recently for clients who have determined that the contract structure was sound, and the change orders properly reflected innovative responses to changing market conditions. In that case, the restructuring can be a good opportunity to implement a conformed agreement that incorporates all the change orders into a straightforward contract restatement.

In addition to the documented changes, confirm your understanding of the relationship with the team. Are there any undocumented changes? How are they captured? What are the deviations from the contract? Undoubtedly, there will be differences between what is reflected on paper and what people actually do. Try to understand what these differences are — not because you want to have a good list of “breaches” to use against the other party, but because it will be important to know what is actually happening so that you can best determine the advantages, disadvantages, risks and rewards of restructuring.

Explore

In preparing for the restructuring, identify opportunities for new, additional or reduced scope. Ask the supplier to consider those opportunities in its proposal. One advantage of a restructuring is that the parties are familiar with each other. A supplier involved in mainframe management and support may have significant residual knowledge of the network infrastructure surrounding that mainframe. Perhaps there are opportunities for expanding the relationship that could generate additional savings? Allow suppliers to demonstrate their expertise and include these additional service components in their restructuring proposals.

Also consider whether there are opportunities to transform how the services are provided. For example, an input-based application maintenance and support agreement priced on a time and materials basis, may be ripe for transformation into an outcomes-based, managed services relationship. Replacing the resource-based structure of the time and materials contract with an outcomes-based contract structure may allow the supplier to take greater control over service delivery, and the resources used to deliver such services. It may also provide greater incentives to the sup-
plier to implement process improvements. As a result, the supplier may have a greater opportunity to generate savings than may be generated simply by carving those “savings” out of its resource margins. In this example, if the supplier has developed a comfort level with the systems being maintained, and the customer has developed a comfort level with the supplier’s ability to maintain those systems, the parties may be able to mine greater savings opportunities by transforming the delivery model. By allowing for delivery transformation, the parties may be able to use the opportunity to restructure in a manner that makes both parties better off.

In addition, when restructuring a supply relationship, the parties should look for advantages that may be available outside of the delivery model. For example, in today’s world of “extended enterprises,” supply relationships between global buyers and sellers can become highly complex — with global enterprises buying and selling goods and services back and forth to each other, across different geographies and at various levels of the supply chain. Simplifying those relationships through restructuring can provide immediate benefits through lower contract management costs. In addition, there may be tax advantages to restructuring those relationships, including opportunities to repatriate foreign source income without adverse tax consequences. These benefits of contract restructuring are generated “outside the contract” but may offer additional benefits that can only be realized because the parties are able to look at the restructuring process holistically. As part of your renegotiation preparation, do not be so focused on a narrow objective — like price reductions — that you lose sight of the potential for improvements outside the contract that may lead to opportunities for both parties. Also, it does not hurt to include experts in your preparation who can help you identify and take advantage of those opportunities.

Ask your supplier for ideas about how you might transform your own organization to take even greater advantage of the sourcing relationship. Suppliers have the opportunity to look across multiple customer implementations. If your solution has been in place for a number of years and your organization has not made any transformational improvements, there may be many opportunities. Challenge your supplier to present you with them. Talk to your counterparts at other organizations about changes they have made. Ask your intermediaries about what they are seeing in the marketplace. Use the restructuring as an opportunity to generate savings, not just from your supplier, but also internally with respect to your own processes. Don’t fail to consider those opportunities.

**Analyze**

Once you have identified the opportunities that are available to you, it is important to analyze the risks inherent in any restructuring opportunity. In our experience, that is fairly well heeded advice when parties are considering true transformation. Often, one could argue that parties tend to underestimate the need for risk analysis more often when they are merely extending deals than when they are actually restructuring them. Why? When a deal is being restructured, the need for risk analysis is evident. For example, a party that decides to transfer the performance of a set of tasks to an offshore location must determine: a.) if the transfer permitted by law; b.) if so, what requirements must be met to permit that transfer; and c.) what

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**Ten Renegotiation Tips**

1. Get organized.
2. Assemble the right team with the right people.
3. Ask questions from the internal team about the current arrangement: What has worked, what has not worked and how do the parties work together?
4. Involve the right people from the vendor’s team.
5. Challenge the vendor to propose suggestions for improvement based on what it has learned.
6. Ask whether those suggestions have already been provided, and if not, why? (It could tell you something about your own governance structure.)
7. Involve outside experts to critique the status quo; they may see new opportunities for innovation.
8. Don’t undervalue the risk of failing to take advantage of opportunities for change.
10. Be prepared to share the risks and rewards of change.

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The consequences are if something goes wrong. Generally, the answers to these questions depend on the task that is being performed, where the task is being performed and the nature of the information that is used to perform the task. There are many resources available to help identify, manage and mitigate these risks, and this is an area where parties are not shy about asking for help.

However, where parties are simply extending a deal, risks are much more subtle. Are you failing to take advantage of opportunities to innovate? Are your suppliers’ incentives properly aligned with your need to reduce overall sourcing costs, not just your hourly rates? These types of risks might be missed if you move forward with a traditional restructuring focused just on term extension and price reduction. If there is a better way to structure your sourcing relationship and you fail to identify it through your renegotiation preparation, you may be missing significant opportunities that you won’t reconsider for another three, five or ten years. Those risks should not go unheeded.

**Share**

Finally, and obviously, be prepared to share the rewards of restructuring with your suppliers. If you have good sourcing relationships that have been delivering value, and through your restructuring, you (collectively with your supplier) generate an opportunity for even more value creation through transformation and shared investment, do not destroy that positive development by claiming all of the benefits. Be prepared to share. You will be rewarded with a much more motivated supplier and a much more motivated team.

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**ACC Extras on…**

**Renegotiating Supplier Contracts**

**ACC Docket**

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**QuickCounsel**

**Quick Reference**
- Top Ten Key Questions (and Answers) for Dealing with Financially Distressed Suppliers (June 2008). [www.acc.com/quickref/top10_findistsup_jun08](http://www.acc.com/quickref/top10_findistsup_jun08)

**Top Ten**

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**NOTES**

1 Technology Partners International indicates that there were almost $30 billion worth of sourcing supply contracts restructured in 2010. *TPI Index, 2Q11, 2011.*
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