CHANGES

THERE IS NO FREE LUNCH

Few terms in outsourcing contracts arouse more interest than those governing change, both during negotiations and after contracts are signed and service begins.

Why? To begin with, scope is the single most important issue. In dynamic times, change is a given – in customer requirements, technology and regulations. Written documents must accommodate these changes while preserving the parties' expectations.

Costs of change concern both parties, and properly so. Too many changes for too much money and the customer's business case may suffer. For the supplier, elastic scope and uncompensated changes erode margins. Customers fret that suppliers may abuse the leverage of incumbency, as in the short run, the customer may have nowhere else to go. 'Therapeutic' change orders (designed to help a contractor 'get well') are a chronic customer concern. Suppliers worry about scope creep, around the edges and between the lines of their express obligations. Good change provisions, coupled with good change discipline, helps to protect both sides. Customers need not pay for changes unless they approve, and suppliers need not perform until the customer has approved. Good records matter.

For suppliers, it's useful to consider changes as points on a continuum that begins with requirements, documents scope precisely in a service description, then manages scope after signing. *Define, contain* and *manage* are key themes. When negotiating and managing contracts, it's equally important to see change control in context, and understand its interplay with other contract terms and documents – service descriptions, 'sweep' clauses, refresh or upgrade requirements, performance standards, or other obligations and constraints.

No Free Lunch

The essential principle is easily stated, but not always easy to apply: There is no '*free lunch*.' Suppliers may absorb trivial changes in contingency allowances but must be paid for net additional service performed (excluding anticipated changes that have been built into cost models and priced – such as scheduled upgrades, refresh or replacements). On this issue, as on others, insistence upon a principled, fair position can be an effective tactic – the more so when variable pricing links pricing metrics with cost drivers to serve both parties' interests by preserving expectations in changing circumstances.

Restrictive Terms

Customer-oriented forms attempt to shift risk to suppliers and compel them to absorb costs of change, without compensation. Common techniques include the following:

- Restrictions or prohibitions upon relief for certain kinds of changes, even changes in laws, regulations or the customer's own policies. These are risks outside the supplier's control, which it cannot manage and cannot be expected simply to absorb.

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- Peppering contracts with obligations to do this or that 'at no additional cost.' Individually, these may be trivial. Collectively, they add up. Hundreds of small cuts soon equal a hemorrhage. Occasional, minor requests are easily accommodated and absorbed; especially if a sensible materiality threshold can be agreed. Significant net increases must be paid for.
- Linkages that prohibit relief unless changes are also 'Projects' or 'New Services.' These are abstract, often debatable terms, which can often be clarified with examples (for example, by indicating whether or not anticipated initiatives are 'Projects' or 'New Services.') Expansion or extension of existing service may be priced at contract rates, but paradigm shifts (to robotics or the cloud) or wholly-new offerings should generally be treated as changes or perhaps new service lines under the umbrella of an existing agreement.

When restrictive terms are unavoidable, suppliers may protect themselves through contingency allowances and by making sure that all costs, direct and indirect, are covered by one or more rates, adjustments or other metrics.

Charges for Changes

If changes must be paid for, what should the customer pay? Charges can be negotiated when the time comes, but few customers care to leave the point open, lest an incumbent supplier enjoy monopoly leverage. Sophisticated suppliers understand that pre-determined rates and charges make it easier for customers to do business with them than to solicit bids from competitors. Where contract rates have been agreed, the rate table may provide convenient answers. Where no contract rate has been agreed, the supplier's usual rates for particular services may be the basis for discussion. In general, the customer pays only for the net increase in the supplier's level of effort.

Suppliers should beware of change provisions that merely assure payment of the supplier's costs — a term that may mean no more than compensation for out-of-pocket expenses or perhaps the cost of performing additional service, without any allowance for overhead or margin.

Change Procedures

These should be straightforward. Customers may request changes and suppliers may propose them, using in either case an agreed form or litany that includes scope, timing, charges and various other particulars. The customer need not pay and the supplier need not perform until a change order is signed.

Customers expect suppliers to absorb the cost of preparing change proposals, and suppliers are often willing to do so, up to a point. They may need to charge for very large proposals involving hundreds of hours of effort, such as preparation of detailed requirements that may be put out to bid. In such situations, suppliers may offer to preliminary or 'rough order of magnitude' estimates free of charge, together with a firm or not-to-exceed price for the full proposal. This assures the customer an opportunity to make an informed decision before authorizing significant expense.

Suppliers sometimes wish to reserve rights not to bid, for a variety of sensible reasons that may be awkward to express during the sales cycle. Suppose, for example, the customer proves laggard about payments? In practice, suppliers are usually keen to bid when opportunities arise, and can excuse themselves politely if uninterested.

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This publication is a summary of legal principles. Nothing in this document constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

Varieties of Changes

Classifications of changes (such as major, minor, operational and technical) can be a useful convenience but should not mask the reality that most such changes amend, at least slightly, one or more of the documents that, together, constitute the parties' contract. Contracts should allow suppliers latitude to make operational changes, so long as they do not adversely affect service quality or raise costs. (Changes should be distinguished from service requests – that is, requests for particular services selected from a pre-determined 'menu.')

Keeping Current

Customers prefer up-to-date solutions and expect suppliers to keep reasonably current, as suppliers do for competitive and other reasons. However, to avoid open-ended obligations, suppliers prefer to limit their commitments to (i) specific upgrades or improvements that have been proposed and priced, and (ii) evolutionary changes in the normal course of business and offered to all customers without additional charge. Paradigm shifts, acceleration of anticipated change, extra-cost options, wholly-new offerings or custom variations to standard solutions – all of these should be authorized as changes at additional cost.

Urgent or Mandatory Changes

What about urgent changes – the ones that absolutely have to be done before systems implode or regulators arrive with guns and badges? Customers have understandable concerns, especially in regulated industries. Usual negotiated resolutions include provision for performance of essential, urgent changes when needed and as required, provided the customer agrees to pay. If the parties are unable to agree on price, they can often agree on substantial but partial payment sufficient to cover direct costs, pending prompt, joint review by the parties' management.

Constructive Changes

These are compulsory but undocumented changes – work that the supplier is effectively compelled to perform, but without signed authorization from the customer. The doctrine, best known in government and construction contracts, may sometimes offer suppliers relief. Customers can be compelled to pay for that additional work, given the right facts, circumstances and record.

How might constructive changes occur? Suppose a customer provides deficient specifications; delays and disrupts performance; or breaches express or implied obligations to cooperate with the supplier; but refuses extensions of time or additional compensation. These kinds of situations, and others, may permit a supplier to recover, if the supplier can establish that the additional work was compulsory, outside agreed scope and inflicted damage upon the supplier. In order to prevail, the supplier must put the customer on notice – typically, by proposing changes or performing under protest – and keep excellent records of both customer compulsion and additional costs and performance, without which damages cannot be proved.