



## **Analyzing and Managing Risk in Services Contracts**

White Paper

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**James River Consulting**

Better IT Contracting

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## **Introduction: Looking At Services Contracts In A Different Light**

### **MEDIEVAL DEFINITIONS OF CONTRACTS IN THE MODERN BUSINESS WORLD**

In the common law, contracts are defined as an “exchange of consideration,” a “meeting of the minds,” and a “mutual assent to terms.” These definitions focus on whether or not a legally valid contract has been formed.

In the real, everyday world of business, classic legal definitions of contracts are not much help. Business people honestly don't care if a contract is legally valid. They want to conclude their transactions quickly and efficiently, with minimum discussion, and under terms that will support practical business goals, such as increasing revenues and maintaining customer satisfaction.

Neither do business people look to argue with each other or treat each other with suspicion. Good will is the bedrock of business. Business people expect some friendly negotiation about price and due dates and other terms that directly impact the bottom line. Anything beyond that, though, is disturbing to them because it can undermine good will and threaten to derail the deal.

At the end of the day, most business people look at contracts as nothing more than legal documents that require signatures. They often don't see any

meaningful connection between contracts and the business at hand.

What business needs is a new and different way of looking at contracts, one that meaningfully describes contracts, defines their role in business transactions, and leads to a more effective and positive use of contracts.

### **CONTRACTS ARE STATEMENTS OF RISK, NOT LEGALITIES**

Contracts are not business goals or ends in themselves, but rather the means to achieving business ends. Contracts manage risks in order to produce rewards, i.e., the completed work and the compensation.

A contract is in essence a memorandum of a risk/reward proposition.

Any individual contract term, regardless of its subject or how it is written, is an expression of a particular risk. Since there must always be at least two parties in a contract, contract terms work to allocate risk between the parties. The more risk one party takes on, the less risk there is for the other party.

And since risk is fluid, reducing risk of one kind for a party to a contract can lead to that same party assuming greater risk of another kind under the contract.

To summarize about contract risk:

- Any term in a contract is a risk.
- Risk can be relative to the world or it can be an allocation between the contracting parties.
- Reducing one risk may increase another.

## GHOST IN THE MACHINE

Contracts manage risk in numerous ways. By developing a better understanding of how risk is embodied in contracts, business parties can use contracts to manage risk and improve their chances of attaining business goals.

Risk can be the disputes that most often arise between buyers and sellers. For example, in the IT business, innocent but nevertheless unauthorized use of software in customer companies is a common problem. Software licenses include audits to manage the risk of unpaid use.

Risk can be the costs associated with the contract. Costs include the vendor's cost of doing the work, the cost savings that will be realized by the customer because of the work, and the costs of ensuring quality in the work. In IT, for example, the business case for a new quote generating system might project that the fully operational system will reduce sales support staffing requirements by 20%. Contract payment terms sometimes include targets for achieving cost savings as a determinant of how much is paid.

Risk is the nature of the relationship between the parties. A customer who outsources its entire IT operation makes itself highly dependent on the services company replacing the IT department. Outsourcing contracts use service level agreements to guard against poor operational performance.

## JAMES RIVER CONSULTING'S FIVE CONTRACTING RISK SPECTRUMS

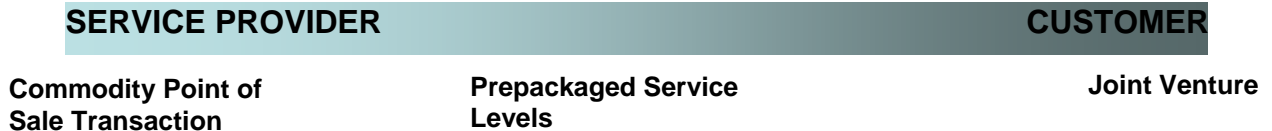
James River looks at contracts as business documents—particularly as sales tools, account management systems, risk calculators and value generators—not just as legal documents. Analyzing contracts in a broad, business oriented and flexible manner enables James River to employ effective methods of writing and managing contracts.

In this white paper, James River will discuss risk in contracts on five spectrums (value in contracts is a separate discussion). The spectrums are:

- 1) Transaction: Commodity Sale versus Business Partnership & Investment
- 2) Payment: Cost Plus versus Fixed Price
- 3) Management: Vendor Program Management versus Customer Performance Measurement
- 4) Market: Bargaining Power versus Competition
- 5) Impact: Personal Services versus Corporate Profits

The analysis will not champion the interests of either the buyer or the seller in an outsourcing or services transaction. We will look at why risk favors one party or the other. Examples

of situations confronted by business people, taken from everyday business life, will be used to illustrate the discussion.



**Figure 1. Transaction Risk Spectrum**

## 1. Transaction: Commodity Sale versus Business Partnership & Investment

### iPODS

When you buy an iPod you are buying what is known as a “good.” You are buying associated services, too, in the form of a warranty on a little booklet in the box. If you have problems with the iPod, you go online or call a technical support number and access the resources that Apple has dedicated to supporting iPods.

No negotiation takes place for buying the iPod, and you don’t sign a contract (state laws set the terms). The iPod isn’t customized for you in any way: Apple didn’t ask you if you listen to more hip hop or country and then redesign the circuitry. The majority of the transaction is completed at the time of sale. Otherwise, Apple doesn’t know you from Adam and you never meet Steve Jobs or anyone else at Apple.

Now compare the iPod purchase with a corporation outsourcing its IT operations.

The executive management team has approved a business case setting out the benefits that it believes the outsourcing will achieve. A competitive bid notice is put out to the major outsourcing vendors. The service providers interested in bidding on the opportunity expend a great deal of time learning about the corporation’s requirements and writing their proposals. The corporation enters into non disclosures and shares confidential information with the bidders.

The contract will last 5 or more years and will consume most of the winning providers’ administrative resources and talent. To gain a competitive advantage, some of the bidding

providers offer to take responsibility for achieving the targeted benefits from the business case, knowing that the targets may be too ambitious or that the customer and outside factors will largely influence their outcome.

The contract award is highly publicized both by the winning provider and the customer. Upon award, the provider moves its personnel into the customer's offices and works with the customer's upper management on a daily basis. The work is unpredictable and often changes following the meandering decision making of customer management. When the customer company misses sales targets and managers receive poor performance reviews, blame is placed on the provider.

What is the point in comparing the purchase of an iPod with a corporate outsourcing contract? It's almost silly.

The point is that the dollar amount is not the primary differentiator between the two transactions. In the iPod example, the transaction is completed at the point of sale and the buyer and the provider are strangers to each other. In the outsourcing example, although the two companies are legally separate, in practice they have become something very close to partners in a joint venture that will last several years.

The level of personal interaction between the parties, the high level of response to needs, their necessary reliance on one another to be successful, the length of their

interaction, how the parties identify themselves in relation to each other, and the impact of the results on both party's overall business are what really set the two transactions apart.

Sometimes services contracts involve actual investment. This is common where a small, young company offers innovation to a large company with abundant working capital. The large company pays the small company a large lump sum which is characterized as an advance payment for services. Or the large company may simply invest in the start up and request services as it would from any supplier. Investment may run the opposite way as well between service provider and customer. A service provider may provide business assistance to a startup customer in return for a long term contract.

Illustration: Highflyer Internet outsources its internal IT operations to Reading and Waites Group. The contract is for seven years. The required effort is much greater than Reading and Waites has provided in the past, and the draw on resources created by the Highflyer contract threatens to overwhelm Reading and Waites' corporate capabilities.

Two years into the contract Highflyer finds itself running out of capital. It asks Reading and Waites to postpone invoicing for its services. Reading and Waites has been turning away other business so that it can service Highflyer, leaving the provider with few other sources of income. Also In addition, Reading and Waites has

redirected its marketing towards larger companies, with Highflyer serving as its flagship.

Reading and Waites has no choice but to postpone the invoicing, however, it demands that Highflyer transfer 5% of voting stock to Reading and Waites and that Highflyer give partner Endicott Reading a seat on its board.

## SERVICE COMMODITIZATION

Among all types of business deals, commodity sales pose the least amount of overall risk to contracting parties. At the same time, the majority of the risk that accompanies a commodity type transaction is placed on the buyer.

A transaction like outsourcing is the antithesis of commodities: Partnership-like transactions such as outsourcing afford the opportunity for parties to level the allocation of risk between buyer and seller. They also present the greatest amount of overall risk among all transaction types, and overall the risk that accompanies these transactions is unpredictable.

In between commodity sales and quasi-partnership services contracts lie numerous alternatives for parties to reshape risk. Doing so can enable business people to succeed where they otherwise might never have reached agreement, and to conduct business with fewer disputes and a higher rate of success.

Illustration: Windjammer Consulting Group is a small firm that manages the

outsourcing of enterprise application management to third party firms in India. It markets itself as a boutique firm that caters to its corporate customers.

Despite tremendous growth in the outsourcing industry, Windjammer has been getting itself caught in the middle between corporate customer demands and the inability of the Indian firms to adapt their processes to a particular customer. Customers have walked away from Windjammer, and Windjammer has incurred many unbilled hours ironing out differences.

Windjammer makes a strategic decision to commoditize its management services. It settles on a few predefined levels of service that are within the demonstrated capabilities of the Indian firms. The services are sold on an annual fee basis with payment due up front. Its new services contracts describe in detail all aspects of the service. Windjammer strenuously resists any attempts to change the terms. All of Windjammer's customer dealings going forward are handled in strict accordance with the service levels.

Windjammer's commoditized services model is more reminiscent of the iPod sale. Customer expectations are set at the time of sale. Defining the service reduces Windjammer's overall risk by making the services predictable. Windjammer's services are less susceptible to mismanagement on the customer's part or on the part of its Indian partners. Windjammer's success

or failure ultimately is dependent on Windjammer.

The effect of commoditizing services on risk may not be appealing to customers. Gaps between service levels and customer operations may cause problems for the customer. Commoditization also may create other risks for providers. Annual agreements

are subject to non-renewal by customers, and service descriptions provide clearer grounds for customer terminations. And the opportunity to gain a competitive advantage by going the extra mile in providing service to customers is foreclosed, which especially hurts smaller providers and recent market entrants.



**Figure 2. Payment Risk Spectrum**

**2. Payment: Cost Plus versus Fixed Price**

**GOVERNMENT MANDATED CONTRACT TYPES**

The U.S. Government follows a set of laws called the Federal Acquisition Regulations (FAR) when it purchases services. The FAR directs all aspects of Government purchasing including which contract types may be used in given procurements. These contract types range from “cost plus” to “fixed price.” The rationale behind mandating contract types is precisely to allocate risk between the Government and the contractor.

Cost plus contracts pose minimal risk for contractors. In a cost plus contract, the service provider is assured that its costs

will be reimbursed, and a formula is used to determine a profit. The contractor is only responsible for controlling costs. In return the contractor provides services that are hard to define and may not achieve results. For example, the FAR requires the Government to use cost based contracts when purchasing military research and development services. Carrying over this example to the commercial world, cost based contracts would be appropriate for work such as the development of new encryption technologies.

Fixed price contracts, which are at the opposite end of the spectrum from cost based contracts, pose the greatest risk

for contractors. In fixed price contracts, the contractor is paid a fixed amount for completing a defined project or delivering a finished service “deliverable” to the Government, subject to acceptance testing. The contractor does not get paid until the Government accepts the product, regardless of how much effort it expended.

## PHASING AND TASKING WORK

Essentially, contract types are about “When do I get paid?” They are also about defining “What am I getting for my money?” Contract types shift risk between companies in answer to these two questions.

Just as fixed price contracts shift risk to the service provider, modifying contracts so that they somehow resemble cost based contracts works to balance out risk between provider and customer.

Illustration: Amanda Starr writes custom reports on the customer relationship management (CRM) software industry. She gains access to executives at Fortune 100 companies through various means and interviews them on whatever issues her customers request.

Sometimes Amanda travels to conferences to hear executives speak. At the outset, Amanda never knows how many executives she will get through to or whether they will be willing to provide with the desired information. Yet Amanda’s customers expect her to quote them an all inclusive price for writing the report.

Quoting a figure is tantamount to throwing darts, and often Amanda loses business because the price is too high, or she wins the business but is barely able to meet her monthly expenses.

After some thought, Amanda decides to approach her projects in phases. In the first phase she works to successfully schedule and conduct 30 minute to one hour interviews with a VP or higher level executive at half of the Fortune 100 companies. She charges only for necessary travel, meals, and lodging, and a low hourly rate for her expended time. The rate is based on what she could make spending the same amount of time as an ad writer through a staffing company.

If Amanda fails to secure interviews with half of the companies, she turns over her receipts and time sheets and compiled notes to the customer and is reimbursed for her costs. If she is successful in meeting the threshold number of interviews, then she charges an additional fixed price for the second phase, which is writing and delivering the final report

Using the concept of contract type, Amanda has altered how she charges for her work in three different ways to reduce her risks in doing business.

First, Amanda employs cost as a basis for contracting for her services. Her quotes become less of an all or nothing proposition, and she guarantees that she will not end up out of pocket due to

things outside of her control, i.e., the cooperation of the interviewees. Also she avoids sacrificing income during the first phase. She uses an objective basis—what she could make doing work that is readily accessible to her but doesn't pay well—to calculate her rate.

Second, Amanda divides the work into phases that are interrelated but nevertheless separate. The first phase is cost based and determines the feasibility of the second, fixed price phase. Amanda's incentive to finish the project is not diminished by contracting for the work in phases, so customer risk does not grow. If Amanda's customers are concerned about excessive costs, they can ask Amanda to decrease the threshold number of interviews used for phase one or to place a cap on total costs.

Task orders issued under umbrella contracts are another version of dividing work.

Third, Amanda employs an hourly rate for some of the work.

In reality, in commercial business, dividing a project into phases and charging an hourly rate are a much easier sell than asking customers to pay costs in return for an unfinished product. Commercial businesses assume that any quote includes a built in profit of some kind. Also commercial businesses are not in the habit of sharing financial information with each other. Nevertheless, they are proven methods of shaping risk in services contracts.

## TIME & MATERIALS FALLACY

In the Government, hourly rates are known as time and materials contracts or "T&M." T&M is the dominant contract type for services in both the Government and in commercial business. All professional services and temporary staffing contracts are T&M. Most if not all management consulting services are on a T&M basis.

On the surface, T&M contracts appear to minimize the amount of risk on both parties for several reasons. Either party can end the contract at any time or replace individual workers. T&M contracts ensure that service providers will have enough cash flow to cut pay checks and pay other operating expenses. Customers avoid the overhead expenses of employment including pensions and defending against discrimination suits. Little to no administrative costs are imposed on the customer other than time sheets.

In reality, the risk in time and materials contracts greatly favors service providers and disfavors customers.

First, there is nothing inherent in T&M contracts to ensure that work is being directed towards producing meaningful results, or that prior completed work can be leveraged to perform future work. Second, there is nothing about T&M that vets the quality of the work unless the customer is going to look over the contractors' shoulders every day. Third, there is nothing in T&M that ensures the creation of business value for the customer.

As if T&M did not do enough to shift risk on to customers, management consultants place even more risk on customers in their T&M contracts by requiring a lengthy termination notice period, sometimes called a “ramp down.” The argument made for the notice period is that the service provider must have time to place personnel on other projects and avoid carrying the costs of employing unassigned personnel.

Illustration: Worldcon hires 3 programmers from Undele LLC to integrate its new ERP system with its purchase order system. The project is estimated to take no longer than 3 months. Worldcon pays an hourly rate for the programmers. Worldcon does

not hire a manager from Undele and Undele does not manage the programmers’ work in any other way.

Programmer 1 is hard working and responsible. He discovers after several weeks that the integration will require middleware and will take much longer than 3 months to complete. Programmer 2 is good at looking busy and otherwise spends his time running a free share FTP site from his cubicle. Programmer 3 spends half of his time networking with the employees in hopes of landing a full time job at Worldcon. Programmers 2 and 3 pressure Programmer 1 not to rock the boat by raising his concerns. After 6 months no progress is made.



Figure 3. Management Risk Spectrum

### 3. Management: Vendor Program Management versus Customer Performance Measurement

#### DUSTY FILE CABINET SYNDROME

Contract terms are meaningless unless they are enforced. Contract negotiations in business receive a great deal of attention and resources. But contract management is mostly ignored. Very often companies even forget in which

file cabinet they placed the physical contract document.

In reality, management of a contract is more important than the negotiation. Regardless of how well a party made out in negotiation, if the hard won terms are not enforced, then risk can fall back

on that party. Similarly, if the contract is managed in a way contrary to the terms, then the terms may be waived and literally replaced with other terms.

Illustration: Wholesome Foods operates a chain of 35 stores in 19 states. The company's boilerplate contract terms include an indemnification clause and state that all vendors must provide copies of insurance policies covering errors and omissions up to \$3 million.

Arrowdance, a vendor of Wholesome Foods, is in the business of certifying food products claimed to be grown using organic American Indian farming methods. Arrowdance fiercely fights including an indemnification clause in the contract, pointing to what it says is Wholesome's unusually high and expensive insurance requirement. Wholesome capitulates and leaves the clause out. After signing the contract, Arrowdance readily provides a copy of its policy which, it turns out, only covers claims up to \$50,000. No one at Wholesome Foods catches the shortfall and the contract commences.

Over the next several months, several medical cases of enlarged prostate glands are traced back to an organic brand of goat cheese sold by Wholesome Foods and certified by Arrowdance. Law suits are filed and the use of steroids by the dairy that makes the cheese is uncovered. Arrowdance is only liable to Wholesome Foods for \$50,000 under the contract. Further there is no indemnification clause.

Lack of contract management does not increase risk exposure for customers alone. Service providers run the risk of exceeding customer budgets, falling behind schedule, improperly staffing projects, losing customer data, and eventually losing customers because the providers presented too many problems and because they failed to deliver value.

#### FOUR COROLLARIES OF CONTRACT MANAGEMENT

Contract management is a large subject. For purposes of our discussion, James River has identified four corollaries of contract management that are critical to understanding how contract management can shape risk.

1. If—The first corollary, discussed in the illustration above, is “if” contract management is being performed. Without management, any risk profile negotiated in a contract can become completely meaningless.
2. Who—The second corollary is “who” is managing contract performance, the service provider or the customer. If the service provider is managing performance, more risk is placed on the customer, and vice versa.
3. How—The third corollary is “how” work under a contract is being managed.

Program management is the traditional method of contract management. It tracks work progress indicators such as how many hours were expended and whether project milestones are on

schedule. It does not directly address quality or business value in services. For these reasons, while program management reduces risk for both parties, it is less effective in reducing risk for customers than it is for providers.

Customers are better served by outcome-based performance measures and metrics, which look at the impact of the work on the customer's business or organization. Examples of performance measures include increased sales in the year following completion of services, or increased customer satisfaction while services are being performed.

4. What—Finally, the fourth corollary is “what” is being managed in the contract. This corollary speaks to management of sources of risk other than the work itself, such as: provider financial condition; provider insurance coverages; certifications of provider companies and personnel; provider facilities leases; data security procedures; human resources practices; and many other items that require continuous proof on the part of providers.

## CONTRACT MANAGEMENT MAKE OVER

Administrative burden and a natural human desire to avoid conflicts are the motivations not to manage contracts. How can contract management be made more attractive?

The Government drives contract management by offering incentive awards to service providers for identifying more efficient ways of performing work, or for coming up with more innovative ways of working. Incentives are also used in the commercial sector, although not as frequently. Another way to facilitate contract management is to implement management practices done jointly by the provider and customer, so that both parties compile and assess the data.

**SERVICE PROVIDER**

**CUSTOMER**

Major Provider

Multiple Vendor Contract

Competitive Bidding

**Figure 4. Market Risk Spectrum**

**4. Market: Bargaining Power versus Competition**

**BARGAINING POWER**

In a negotiation between two sophisticated enterprises, the question of how much the final contract terms allocate risk in favor of one or the other comes down to one thing: bargaining power.

Service providers may have superior bargaining power because they offer technology or expertise not matched in the marketplace. Or the provider may have superior bargaining power due to other strengths like brand recognition and market share.

Customers hold superior bargaining power when the technology and services they are buying are generic and available from many providers.

The personalities and negotiation skills of the individuals conducting contract negotiations is also, in reality, a major determinant of bargaining power. If you had to sit across a table from Donald Trump, your bargaining power would immediately be diminished simply because he is the “Donald.”

Bargaining power comes into play not only during contract negotiations, but also during the life of the contract.

In high dollar, long term services contracts between prominent businesses, the first year is a “honeymoon” period during which the deal is ballyhooed by management in both companies. If problems occur, responding to them is a function of the relative strength of the management teams. If the provider’s management team is stronger and more dynamic than the customer’s management, then chances are the problems will be dismissed or quietly resolved. A stronger customer management team means that the problems will be highlighted and used to get concessions out of the provider. If both management teams are strong and cancel each other out, problem riddled contracts are often allowed to continue until they expire. This dynamic between management teams can play out regardless of any dispute or other terms in the contract.

Secondly, terminating service contracts is usually a very expensive and administratively difficult proposition. The bigger the contract, the more power

providers enjoy. Providers can passively resist the termination to the point that the customer gives up. Or providers can make a financial case that it is less expensive for the customer to allow the contract to continue than to terminate.

Thirdly, over time, service providers become privy to a customer's internal politics, trade secrets, and management shortcomings. Information is power.

Lastly, services from a provider may act indirectly to implement new business processes without documenting them, so that reducing the scope of services or terminating the provider threatens to effectively stop the customer's day to day business. Similarly, services may directly or indirectly create intellectual property that is not assigned to the customer, and when the provider walks out the door the intellectual property goes with them.

Illustration: Wauwatosa Distribution's warehouse manager comes to the conclusion that he must fire the Minnehaha Facilities Management Company, which provides security and maintenance services. Shipments from the warehouse continue to go missing despite complaints to Minnehaha personnel.

Minnehaha was hired without soliciting competing bids because it is the best known facilities management firm in the Great Lakes region. Their hiring is a selling point made by Wauwatosa to its own customers.

When the Wauwatosa sales department hears about Minnehaha's pending firing, they contact Minnehaha management and give them forewarning. Minnehaha's aggressive CEO calls Wauwatosa's CEO and tells him that Wauwatosa must increase Minnehaha's staffing levels to combat thefts at the warehouse. Wauwatosa's CEO, who is good at numbers but a passive personality, agrees to the request. He then calls Human Resources and directs them to fire the warehouse manager for not properly managing the situation.

## COMPETITION, THE GREAT EQUALIZER

The only means of shifting bargaining power away from service providers and towards customers (other than hiring Donald Trump as your negotiator) is through competition. Closed competition always favors providers. Open competition always favors customers.

There are several methods of employing competition to shift risk that is created by unequal bargaining power.

1. Competitive Bidding. This method is the process of issuing a request for proposals (RFPs), holding vendor conferences, conducting tours of the customer company and meeting with management and users, and evaluating bids using common criteria.

Competitive bidding is well known but not widely practiced in business due to its associated costs for both sides.

Competitive bidding draws significant administrative resources both from the customer and the provider. Sales teams are taken off line to write the proposals. Customers may alienate providers and in effect reduce competition in future procurements. Requirements may change, diminishing or completely obviating the premises of the original competition. There are some features of competitive bidding, unrealized by most business people, that reduce the administrative burden of negotiation. Requiring providers to write proposals, and including contract terms in the RFP that providers can accept or take exception to, eliminate negotiating terms and mutually writing and agreeing on a statement of work.

2. Multiple Award. The Government shifts risk away from itself and towards contractors by using “multiple award” contracts in which several contractors are awarded separate but identical contracts, then given the opportunity to bid on individual projects within the contract’s general scope. Pricing and

other terms are set in the initial contracts, and contractors are free to improve on these terms in their project bids. There are varieties of multiple award contracts. In some, contractors are required to bid on all project proposals. In others, contractors are guaranteed a minimum amount of work over a period of time as an incentive for them to continue actively bidding. Any of these contracts would work very well in the commercial business world.

3. Service Provider Teams. Another approach is to hire several providers and require them to work together on projects. Providers take turns filling the management role on project teams, with the other providers working under them. The thinking behind this approach is that the several providers maintain equal knowledge of the work, are given work on a steady basis, and can step in for each other if needed. Because each contractor’s success is dependent on the success of the others, it is thought, any motivation for the contractors to sabotage each other is removed.

**SERVICE PROVIDER**

**CUSTOMER**

Personal Services

Advice and  
 Recommendations

Corporation and Profits

Figure 5. Impact Risk Spectrum

**5. Impact: Personal Services versus Corporate Profits**

THE INTERNAL CUSTOMER

Illustration: John Self is EVP of Marketing at St. Johnsbury Health Services, which operates a PPO network for corporate health plans. He recently attended a seminar on meditating to make better executive decisions. The seminar was taught by Rohit Shamparwal, an Indian business professor and mystic. John wants to hire Shamparwal as a consultant to teach him meditation and act as a counselor. Company policy prohibits using the budget for personal services. John makes a case to the CFO that by enhancing his ability to make decisions, Shamparwal's services will serve the interests of the entire company, making the services allowable under the policy.

Executives often hire consultants who help them improve their public speaking, or hone their interpersonal skills, or help them stay fit. These "personal" services directly benefit the executive but only indirectly benefit the corporation. Like Self, most executives would argue that by benefiting their job performance the services also benefit the company they lead.

Let's look at another example.

Illustration: Bryce Newbury is a change management consultant brought in by Sudoku Engineering to support the consolidation of redundant operations created by several recent acquisitions. The redundancies are among sales, accounts payable, and human resources offices at the former company's. Newbury's statement of work calls for him to study the new organization charts and information systems created by the reorganization plan, then sell the effected groups of employees on the changes by conducting a series of team building sessions with all the employees in attendance.

Newbury's change management services directly benefit designated groups of employees within the companies. Less directly, his services also benefit the company at large in that the effected employees interact with other employees outside of their group. How much the company at large benefits from the services depends on the functions the employees perform. If the employees are in sales, there is a clear benefit to the entire company

because sales drives profits. If the employees are in accounts payable, on the other hand, the benefit to the remainder of the company is less clear.

Let's now look at an example at the other end of the spectrum, where the company as an entity, not individuals, is the beneficiary.

Illustration: Mokepon is a Japanese toy maker that has turned in poor sales numbers for the last several years. The company's new product lines have not been well received by consumers. Mokepon decides to hand over its product development function to Barbie and Associates. Mokepon's own product development staff is told to fully cooperate with the consultants but is otherwise left in the dark about their future, either as a group or as individuals, with the company. Barbie and Associates overhauls the entire product line and targets a different market segment.

The product development services in the above example are not directed towards individuals. They are directed at products. If any individuals can be said to benefit, it is Mokepon's owners and investors who are not workers at the company. Also, Barbie and Associates is clearly being hired to boost profits, which absolutely benefits the company at large.

A lot more is at stake for Barbie and Associates than for Newbury.

In the product development example, bad decisions would very probably put

Mokepon out of business and create bad publicity for Barbie and Associates that would continue for years.

In the change management example, failure to fully convince the sales people that the reorganization is good for them might impact revenues but the impact would be very limited. Sudoku upper management's expectations that the change management will completely allay the employees' concerns about the reorganization are probably low, so some continuing unhappiness among the employees is expected and will not reflect negatively on Newbury.

What the examples are meant to convey is: Services that are either intended to benefit the corporation at large and/or to directly impact profits carry the greatest risk for the provider. Services that benefit individuals and/or impact non-revenue producing functions carry the least risk for the provider.

Note: Descriptions of services in contracts do not necessarily identify who in a company is the beneficiary of services. The risk involved in the work is identified by who actually benefits. Sales people recognize the concept of intended beneficiaries when they talk about "internal customers" and "champions" for their projects.

## ADVISE, FOLLOW AND GET OUT OF THE WAY

As with the previous principles discussed in this white paper, we can shape risk by defining who in the customer company we intend to benefit

and whether or not we intend to impact profits.

Let's go back to our examples. Instead of taking over complete responsibility for Mokepon's product development, what if Barbie and Associates convinced Mokepon to retain their existing product development staff and advised the staff on how to improve the product line. Barbie's consultants would work closely with the staff but would not replace them. The shift in risk away from the consultants back to the company becomes immediately apparent. Mokepon's product development staff becomes the primary customer. Further, the consultant's services have a less direct impact profits because the staff is still involved in making decisions.

In the change management example, Bryce Newbury could focus not on selling the whole reorganization plan to the employees as a group, but rather on individual employees and how they fit into the new workplace. Newbury might conduct one-on-one sessions with the individual employees in each of the offices, then report back to Sudoku on the employees' most frequently expressed concerns (keeping the responses anonymous) and recommend ways to address them.

By changing the way they provide their services, Newbury and Barbie and Associates reduce their risk in the two ways we have discussed—individuals and less impact on revenue—and also in a third way. Services are a human business. Service providers who serve individuals have the opportunity to

become more intimate with their customers and consequently to manipulate their customers. Dealing with corporations as bureaucracies does not give providers this opportunity.

As with other discussions in this paper, we must recognize that in real business the changes in our examples might not be what the customer wants, or they might be professionally unsound or outside the service provider's business model. We are not concerned about how to best provide any particular kind of service, only on how contracts can shape risk.

Changes in service delivery like the ones in our examples also determine risk for customers. Looked at from the perspective of serving a need, the changes create more risk. Looked at from the perspective of relying on outside companies, they might be said to create less risk.

By contracting for services from an outside provider, customers are admitting that they have needs which either cannot be adequately addressed internally or that the company's status quo needs to be changed. Advising instead of taking over perpetuates the status quo in a way. The adage "We can't solve problems by using the same kind of thinking we used when we created them" (Einstein) applies to business as well as quantum physics.

Also advisory services are not a readily measurable service because they do not make final decisions or deliver final service products other than

recommendations and reports. In the original product development example, measurement of the value of Barbie and Associates' services would be a simple matter of looking at Mokepon's revenues for the coming year. But with Barbie and Associates in the role of advisors, the question of whether the staff properly carried out the recommendations would remain, making measurement hazy.

Finally, let's use intended beneficiaries to equalize the risk between provider and customer.

By commissioning parallel and competing product development projects between the staff and the consultants, Mokepon corporate

leadership could equalize risk, at least initially. This approach would not increase Mokepon's costs, either, given that in the example the product development staff was sitting idle. Mokepon, possibly with the help of another consultant, would then review the recommendations and decide to accept some or all of them or in combinations. Either Barbie and Associates would take over product development, or Mokepon would continue to use its staff, or the company might create a new product development organization comprised of both the service provider and the staff. This approach would also address the alternative view of customer risk, that risk is actually increased by placing work in the hands of providers.



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