Vendor-side Contract Strategy and Negotiation

Gary Brown

Daniel Runt

Kazi Russell

Rebecca Traina

Northwestern University, 03/13/15

Introduction

The Mind Hive, Inc. (TMH) considers four primary criteria when executing contracts with all of our clients. In this analysis, TMH will identify the importance of these items and explain how our current contract with Sunt Community Physicians (Sunt) for the Lab Integration for Efficiencies (LIFE) project can and should be negotiated to protect and improve on these criteria. This contract also has other items of lesser importance that can be addressed. Negotiating strategies are noted along with a discussion of anticipated challenges from Sunt. The contract does not yet include a service level agreement (SLA) so this paper will discuss approaches for adding an SLA along with alternative operational environments.

Primary Criteria

Every TMH contract must first consider profitability and cash flow. Compared to many healthcare organizations, we have lower revenue and smaller cash reserves. Any contract that causes a financial loss or ties up cash flow will be felt immediately leading to potential staff reductions or violations of covenants with our lenders. The Sunt contract has several areas of possible contention related to profit and cash flow. Our bid has a decent margin built in, but could be eroded by project delays, an anticipated client need for greater support, failure to deliver ROI to the client and certain penalties if we cause a breach in the contract. Cash flow can be slowed in this contract based on the loosely defined milestone payment schedule. Sunt could easily be the cause of delays which would hold up payments.

TMH’s second concern is liability. We cannot be on the hook for any Sunt loss of revenue and especially any adverse patient outcomes. We can control how our software operates, but we are not a medical company and we make no claims in that regard. We cannot be held accountable for how our software is used or misused.

TMH's third primary concern is the protection of our intellectual property. Should our source code or even our extensive documentation get in to the wrong hands, our systems could be copied and our market position can become jeopardized.

Our fourth primary concern with every contract is client satisfaction. Any successful contract must work for TMH but it also has to solve client needs both now and in the future. "The highest level of healthcare consolidation since the turn of the millennium occurred during 2012 and it is expected to continue" (Andrews, 2013). Sunt is a prime example of this trend and TMH's future growth is predicated on participating in this market segment. We do not "win" this contract simply by having Sunt agree to all our terms. We "win" when we can use Sunt as a reference knowing that they will give a glowing report to our next prospective client. And we "win" when Sunt comes back to us for future business.

Contract Analysis related to the Primary Criteria

In the book, *Getting Past No*, author William Ury provides several negotiating strategies that will be deployed as we negotiate with Sunt. Ury offers this advice to any negotiator: don't react, don't argue, don't reject, don't push, and don't escalate (Ury, 2007). Step back from initial reactions, put yourself in their shoes, understand and reframe concerns, give the other side a way out, and educate the other side.

Our proposal is higher than Sunt's stated budget in the RFP. We can anticipate that the client will seek to reduce the cost to $500,000. Our first interest in this area is to protect our profit margin. We have some room to discount our rates which will lower the price, but a better solution is to work their problem from a different angle. We know they have an IT staff and it would be possible for us to work with their programmers to show them how to convert their own data into a format that we could load. This can significantly reduce the $168,750 Data Conversion and Historical Load item. From our perspective, this frees up our programmers to work on another project and it lowers our bid price to be much closer to Sunt's budget.

TMH is also at risk for profit erosion because the contract - while not explicitly saying this - can be considered to be a fixed price bid. Our risk comes from any delay, regardless of reason, that causes us to put in more hours without any additional compensation. We need to indicate that any additional request by the client will flow through a change management process and any additional hours, explicitly approved by the client, will be billed at our standard rate. The client needs to understand that this is to their advantage, because without this language, TMH would be able to say no to the extra work which will not cause a breach, but it may cause an unworkable problem for the client.

Cash flow is a potential problem with this contract. We are exposed initially, considering we will have worked 45 days before we get our first payment. Furthermore, we have a payment due based on the "first productive use" of the system, which is undefined. Optimally, the milestone 3 payment should be made at the completion of Acceptance Testing and the final payment should occur when the first production lab test is completed and reported back to the ordering physician, or 30 days, whichever comes first. We do not have to hesitate to show our vulnerability in this area. Sunt is capable of understanding our need to pay our people in a timely manner. This will be an appeal to fairness. If that does not work, we need to at least tie milestones to things either under our control, or tie them to the calendar so that we can determine a worst case scenario for cash flow and plan accordingly.

Our licensing strategy will probably be challenged too. At one place in the contract, we have put a cap of 1000 users but later, in Schedule __, we say unlimited users. Furthermore, the limit of 30 computers will be hard to take for Sunt since they operate 28 different facilities. Our best strategy here is to have them give us a count of anticipated users and workstations. Without touching our price, if their numbers are reasonable, we agree and then build in a price structure whereby we derive more license income from their growth. This shows a compromise on our part, but also a win for us. We need to demonstrate that our software will help enable Sunt's growth and these additional license fees will only be paid after Sunt wins.

Related to cost, our annual maintenance fees are quite high. Three months at $25,000 is $100,000 per year. Even at a high market rate of 20%, the client would likely expect to pay only $65,000 per year ($325,000 * .2). We have also built a limit of 20 calls the first year. Sunt will probably point out that this is equal to $5,000 per call. The second year, it goes to 10 calls or $10,000 per call. While we can see them doing this math, we will need to educate them on what else this fee includes; specifically, software updates. As an Agile development shop, we have a new patch/product release approximately every month. Many of these updates are made based on customer feedback where they are looking to improve operations. Sunt will get these benefits, ultimately helping them reduce costs and/or improve patient outcomes. Ask them how much an adverse outcome costs them in comparison and our cost will probably seem trivial.

In this same area, we've limited the support period to business work days. Their business works 24 hours a day, including weekends and holidays. Our system is critical to patient care and the client will probably insist on 24x7x365 support. We will certainly agree that they need that much support without any argument. We will then explain that we cannot afford to staff our technical resources and the management of those resources at that level. They should understand that to get after hours support, we will have to incentivize our employees. This could lead to some agreement that yes, we can offer after hours support and we will need to charge extra for these calls.

As we are negotiating these elements of costs, we can afford to discount our fees, but this is something we will hold on to until we work out other points in the contract. Along the way, we should find a way to eliminate clause 4.6 which provides a return on investment warranty clause of 25% per year for 5 years. This clause does not state what happens if the ROI is not attained. Furthermore, our software is a tool and we put that tool in the hands of the client. We really have no control over how that tool gets used. Yes, we educate as best we can, but this is potentially a huge trap for us. Return on investment is a complicated statistic that stems from proper usage, business practices, and business environment, all of which fall outside of our ability to monitor and control. For example, if within the next five years, Medicare lowers reimbursement rates or coverage for specific lab functions, this will no doubt cut into the potential ROI of the LIFE project. Client ROI is worth discussing in the sales cycle, but it does not belong in this contract. As part of any concession anywhere else, we need to trade off the removal of this clause.

The contract may be problematic for the client around Acceptance Testing. We know that our software has been thoroughly tested so that when delivered, it is virtually free of any bugs. However, the client may not want to just take our word on this. We have given Sunt 30 days to accept, but from their point of view, if our code is "buggy", they will miss the window and it will be our fault. They would see this as unfair, and we should not argue this point. Since we are confident in our code, it costs us very little to extend the acceptance testing period by the time it takes to fix defects in TMH code. In fact, we should be happy to do this because identifying and cleaning up defects only makes us better in future engagements.

Liability exposure in the present contract is favorable to TMH. We should anticipate a challenge from Sunt regarding their potentially large penalties for contract breaches. The most costly breach by Sunt would be early in the contract before we have collected the first milestone payment. Any later breach by Sunt would not be highly costly for TMH so we really do not need to profit from their breach. As such, we can relax the penalties and in return, get their initial payment upon the start of the project, not 45 days later.

Finally, the protection of TMH's intellectual property cannot be understated. Contract Section 7.6.1b states that source code may be temporarily released if a number of factors are not met by TMH. Intellectual property is the core of TMH's business, and the potential of it being left unprotected through this contract is objectionable. The permanent release clauses are acceptable, as they only apply when TMH (voluntarily or involuntarily) ceases to support our software. The only real TMH-created situation that could cause significant software outages for 30 days would be if we had fully abandoned a client and that would be a material breach subject to a permanent release. The potential temporary release of intellectual property should be taken out of the contract. A member of Sunt's IT department could glean trade secrets from our source code, and then he or she could potentially take that information to a competitor. This is too much risk.

Best Alternative to a Negotiated Agreement (BATNA)

The contract under negotiation right now has several areas where TMH can bend; but we must protect the aforementioned critical needs and be prepared to walk away from this deal to focus on other customers as our BATNA. This should not be taken lightly, and if we do walk away, it should not occur "empty handed." Because this potential client represents a lucrative industry segment for our business, we will need to fully understand where our proposal fails to solve the client's true needs.

First, we would like to find out who else has bid on this project. This can be uncovered in negotiations. Let's say for example that the client asks for a warranty period greater than 30 days. Our reply could be that "We believe 30 days to be the industry standard. Do you have other proposals that provide a greater warranty?" If they say yes, ask more by indicating that we might be willing to extend our warranty to be more competitive if we know who we are competing with. If they say no, then you may have just helped them see that their request requires you to exceed industry standards. Either way, we both learned something in this process.

If we are not able to reach agreement with Sunt, it would be beneficial to know how they ultimately solve their original requirements. If they go with another vendor, what was given up or gained by the customer over our offering. It will be especially useful to know if they settled for a less favorable contract than ours because this tells us that we missed an opportunity based on relationship factors more than content offerings. Ultimately, any failure to close this deal should at a minimum provide us with market intelligence about our competitors and focused insight on what mistakes we are making that can and will be corrected in the future.

Analysis of Non-Critical Contract Issues

Several additional contract items either favor TMH, needlessly confuse or cause no benefit to either party, or simply do not belong in the contract. Here is TMH's list:

- 1.15. TMH can extend the warranty without incurring cost (our software is tried and true) so this can be a trading option
- 2.3. Terms like File A-Master and File B-content are undefined. References can be removed.
- 3.2.1. Licensor Trainer Deluxe. This is more of a sales pitch.
- 3.5. TMH is not concerned about a physician becoming a subject matter expert as long as our liability is limited to client fees paid in.
- 4.2. TMH can raise renewal fees based on add-on software. We should build increases based on the Consumer Price Index and offer add-ons as optional cost items.
- 4.4. TMH has yet to discover a client abusing their license count. If the client wants softer language around auditing, we can easily comply.
- 11.6. Need to resolve potential jurisdictional conflicts.
- 11.9 Before final signatures, TMH needs to double-check these sections for survivability.

Service Level Agreements

The current contract has no language to define Service Level Agreements (SLAs). This is a problematic area for both sides. Sunt needs assurances that their system will be highly available and perform at all times. TMH would normally offer this, but Sunt has chosen to run our software in their environment. We cannot promise something we have little or no control over. According to Ury in “Getting Past No”, going to the balcony is a powerful negotiating tactic which involves taking a moment to pause, to collect your thoughts, and most importantly to not react in a difficult situation (Ury, 1993, p. 37). This approach will be beneficial for TMH to use during negotiation of SLA terms with Sunt, as it helps us to view the situation objectively rather than emotionally. In fact, Ury (1993, p. 38) states that the balcony "is a metaphor for a mental attitude of detachment…you can calmly evaluate the conflict almost as if you were a third party. You can think constructively for both sides and look for a mutually satisfactory way to resolve the problems." In addition to enabling TMH to utilize objective thinking that is free from frustration or other negative emotions, the time spent waiting for a response may have the same impact on representatives from Sunt. .

One alternative approach that TMH could take in SLA negotiation includes stepping to Sunt's side of the discussion (Ury, 1993). Stepping to Sunt's side entails actively listening to their concerns, acknowledging those concerns to be valid, and agreeing with their points wherever possible (Ury, 1993, p. 54). Active listening requires a focus on what the other party is actually saying, rather than "reacting immediately or plotting your next step" (Ury, 1993, p. 56). As part of this approach, TMH should also ask questions and restate what Sunt has requested to ensure that their points are thoroughly and accurately understood. Perhaps a workable solution would be to offer separate infrastructure management services whereby TMH establishes and manages SUNT on-premise infrastructure and thus could provide a more complete SLA.

Another alternative, "Building a golden bridge," is a phrase coined by Ury which would involve drawing Sunt towards a solution that is more workable for both parties (Ury, 1993, p. 109). We want Sunt to see that they need to hold the right individuals accountable for problems and that they will need an escalation process for support levels that starts with internal IT when a problem is identified. If TMH does get a call, it should have already been identified as an application level issue. Sunt needs to see that this is actually the quickest and least expensive option because if TMH gets the first call, we will have to try and diagnose the problem remotely, requiring Sunt IT cooperation anyway.

Alternative Operating Environments

Currently the new lab interface software will be installed and maintained on a server located in Sunt's data center. Consequently, Sunt will be responsible for system software, database, networking, and hardware maintenance along with application upgrades. Alternative operational models exist such as cloud-based Platform as a Service (PaaS), Software as a Service (SaaS), and the Application Service Provider (ASP) models. Cloud platforms can be provided at 3rd party sites or at TMH's data center. In these environments, TMH and/or a 3rd party are responsible for managing the entire infrastructure for Sunt. The idea of a near-zero maintenance requirement on an already busy Sunt infrastructure team could be very appealing. The PaaS solution is a hybrid where Sunt retains infrastructure control at a management level while the physical layer is safe and sound in the hands of TMH or the 3rd party. A primary benefit to cloud computing is that when demand warrants, new servers can be brought online in minutes, rather than the days required when a business such as Sunt maintains its own data center.

In an SaaS platform, instead of having the application running on server and data storage located in Sunt's data center, it will run on a server located in TMH's data center. Sunt users will access the lab application through the Internet. SaaS platform provides lower cost solutions because it will enable Sunt to avoid the costs of purchasing expensive hardware and software. SaaS deployment requires Sunt to pay a fixed monthly subscription cost. On site deployment requires Sunt to pay for ongoing costs to support and manage on site data servers. With SaaS, you are limited to the features and capabilities written into the software, but cloud computing offers the ability to increase server capacity or storage space on demand. Application Service Providers (ASPs) platform is a more traditional client-server application environment which requires installation of software on user's devices. One of the major advantages of an ASP platform is that Sunt can implement its customized lab application as a single instance of the application on TMH's data center. The client-server model allows for a richer user experience and can be more performant that an internet-based application.

All these alternative platforms simplify security by reducing individual maintenance responsibilities reducing Sunt's workload. Furthermore, both the PaaS and the SaaS platforms enable better data exchange as data from many healthcare organizations can be stored and processed in a more uniform way. Thus Sunt can be better prepared to share information with other providers and healthcare organizations. The downside of such an arrangement is that more responsibility is placed on TMH. Services cannot experience any unexpected downtime, or else TMH will be in breach of any applicable SLA, which would also be required in such situations.

TMH wants to build a strong partnership with Sunt. Since the LIFE project will be an integral piece to Sunt's operations, they would like some form of guarantee that it will always be around. So, while not preferable, placing TMH's intellectual property in escrow with a trusted, neutral, third party escrow service will help TMH build a long term relationship with Sunt. TMH recognizes the need of maintenance and upgrade obligations to Sunt. We also recognize that Sunt needs access to the intellectual property, in the event that TMH is unable to satisfy the obligations set forth in the license agreement.

Overall, the contract between Sunt and TMH has issues to be negotiated for both sides. These negotiations hold the promise to create a workable contract for both that can lead to a long-term relationship. Ultimately we can turn this in to a win-win scenario with respectful dialogue that follows the guidelines for effective negotiation.

References:

Andrews, J. (2013). Hospital Consolidation Rising. *Healthcare Finance*.

Funken, K. THE PROS AND CONS OF GETTING TO YES: Shortcomings and Limitations of Principled Bargaining in Negotiation and Mediation

Overly, M., & Kalyvas, J. (2004). *Software agreements line by line*: Aspatore Books.

Ury, W. (1993). Getting past no: Negotiating in difficult situations. New York, NY: Bantam Books.