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MEMORANDUM

July 19, 1996

TO: Our Clients and Friends

FROM: Grady & Associates

RE: Data Processing Outsourcing Contracts

Following personnel and physical facilities expense, data processing costs typically represent the single largest non-interest expense of a financial institution. To manage this cost and to harness advancing technology more effectively, financial institutions frequently consider outsourcing data processing operations to third party vendors. The selection of a data processor -- because it reflects the overall strategy of a bank and affects its day-to-day operations -- is one of the most important decisions bank management can make. While traditional contract review by an attorney is important for issues such as indemnification and limitation of liability, a data processing contract also reflects many issues requiring a specific knowledge both of technology and of the banking industry. Legal review of only the traditional contract issues would be superficial. Because the dollar values of these contracts can be enormous, every outsourcing contract should be thoroughly negotiated; every contract clause has potentially far-reaching and costly ramifications.

What is never stated by the marketing team of the data processing provider is that the vendor's contracting goal is to transfer to the financial institution user the risk of (i) vendor failure in data processing or (ii) vendor negligence. This vendor contractual goal remains unspoken because it is so fundamentally at odds with the vendor's marketing goal of persuading the bank customer that the outsourced data processing services will meet all the customer's needs and create a simple and effortless solution to back office administration.

The typical outsourcing contract is a one-sided document prepared by the third-party provider of data processing services. As an industry long accustomed to setting contract terms with customers, it is surprising how easily so many banks accept the one-sided terms and unfavorable risk allocation typically imposed in a data processing contract. Typical contract deficiencies we have encountered in legal review of data processing contracts include the absence of a contractual

obligation specifying proper disaster recovery by the vendor, minimal or no vendor liability for vendor mistakes in the delivery of data processing services, excessive charges (or liquidated damages) for premature termination of the outsourcing contract, the absence of vendor performance standards, the absence of penalties to be imposed against the vendor for nonperformance vis-a-vis required standards and vendor lien rights to customer information (i.e., the vendor's right to hold data files until the vendor is paid in full, even in the event of a fee dispute).

Contract review and negotiation need to address functional performance, technical performance, service support and cost. Functional needs should be clearly stated in a checklist so that both the vendor and the bank have no misunderstanding as to what the system needs to accomplish and for whom. Technical issues should be the subject of contractual commitment so that the bank can be assured of minimal, or at worst predictable, downtime in a relationship with a data processing vendor. In the case of in-house systems, system capacity, memory, response time of on-line terminals and peripheral hardware issues all need to be clarified. Support considerations should include the qualifications and availability of a specified customer service representative and the availability of training for bank personnel. Aside from per-item and other explicit costs, other cost parameters must be specified in the contract so as to minimize surprises which might arise in the event of bank expansion or a need for new or special reports.

As these issues may suggest, the easiest mistake to make in outsourcing contract negotiation would be to focus on explicit, item-by-item costs, while ignoring the performance issues, risk allocation or the bank's anticipated growth or expansion. Grady & Associates have considerable experience in negotiating and reviewing data processing outsourcing contracts, both in a facilities management context and in a service bureau environment. Contract negotiation and/or review with Grady & Associates would consist of more than strict legal review. There are as many bank regulatory and risk management considerations incident to data processing contracts as there are strict legal issues. Bank regulatory agencies will study carefully the business rationale of any bank entering into an outsourcing contract for the delivery of data processing services. The allocation of risks under such contracts are scrutinized by the regulators. We can advise a bank that outsources the data processing function of strategies to lessen the regulatory oversight and intrusions into the institution's decision making relative to the data processing contract.

Given our familiarity with the technology issues, bank regulatory considerations and risk allocation issues affecting data processing contracts, we are well positioned to advise any financial institution on legal review and contract negotiation of a data processing contract. Few lawyers combine all these proficiencies in their review of data processing contracts, and we would be pleased to assist your institution with protection of your vital interests in any written agreement.