

insights

Why service level agreements are key for provider longevity and customer satisfaction

SLAs – or “service level agreements” – are agreements between a service provider and a customer that provide objective standards of performance for the specific services. SLAs are widely used in virtually all procurement arrangements, from business process services, hosted software platforms, and the provision of goods.

Depending on the services or commodities to be provided, SLAs can be based on objective metrics (e.g., error rates, response times, uptime) or subjective factors (e.g., customer satisfaction derived from user surveys). SLAs can benefit both providers and customers by tying contract terms to concrete performance standards and avoiding a total termination of the contract due to a fixable problem.

In this article, we will describe the unique features of SLAs, the typical structure of service level credits, and why and how SLAs are a good option for providers and customers.

SLA vs. warranty

SLAs are widely used in contracts related to the purchase and use of technology and SaaS (software-as-a-service) arrangements. In these types of agreements, performance warranties typically provide that the SaaS service will perform substantially in accordance with the functional, technical and business specifications of the service. SLAs, on the other hand, offer objective performance metrics and the specific consequences of a provider failing to meet those standards. Two SLAs are typical for SaaS services: (i) response times during which the SaaS provider is required to address reported problems with the service depending on the level of severity of the issue; and, (ii) uptime during which the SaaS service must be available to users.

Both the warranty and the SLAs are designed to ensure compliance with expected performance standards. The key difference is that the remedy for breach of a warranty is for the customer to deliver a notice of breach to the provider, which is typically followed by a cure period in which the provider has an opportunity to remediate or correct the condition that gave rise to the breach. If not cured, then the customer's remedy is to terminate the contract and sue for damages.

“Off ramp” before breach

The unique feature of the SLA rubric is that it provides a remedy short of termination to address performance shortcomings within the scope of the SLAs. This remedy typically provides financial credits – often in the form of a reduction in monthly or other periodic fees – to reflect diminution in the value of the service to the customer. In this way, the customer does not face a binary choice of suffering subpar performance or terminating the agreement (which it may be depending on to provide a long-term business solution). Additionally, the service provider does not risk losing the customer's business and revenue stream for non-catastrophic and correctable failures.

There is, however, an important relationship between SLAs and the performance warranty. Truly dismal performance under the SLA may indicate a fundamental problem with the service and an overall failure by the service provider to provide the expected value (even if any one of the failures by itself does not amount to a breach). If there is an accumulation of SLA credits over a period of time, or if performance falls below minimum standards over that period, this may be classified as a “material breach” for which the customer can terminate the agreement. For example, a material breach could be declared if the service provider becomes subject to more than a certain dollar amount of credits over six months, or if performance is in the “poor” category in any three months of a nine month period.

Quantifying the credit

The service level credit should approximate the loss of value to the customer for the failure of the service to meet expected performance standards. While it is tempting to refer to the credit as a “penalty,” a service level credit should be characterized as “liquidated damages” and not a “penalty.”

Penalties are generally not enforceable under contract law. Instead, liquidated damages are a pre-determined amount to compensate a party for breach of contract. As a recent Illinois appellate court stated, liquidated damages “must be for a specific amount for a specific breach; they may not be a penalty to punish nonperformance or as a threat used to secure performance.”

Three factors are generally required for an enforceable liquidated damages agreement:

1. The parties must have intended to agree in advance to the settlement of damages that may arise from a breach;
2. The amount of liquidated damages agreed upon must be reasonable at the time of contracting and bear some relationship to the projected damages the aggrieved party might incur; and,
3. The amount of actual damages would be uncertain and difficult to prove.

Some state courts have held that the liquidated damages provision should not give the customer an option whether to receive actual damages or the liquidated damages amount, or actual damages plus a liquidated damages amount since the option indicates that the parties had not intended to establish a specific, fixed amount of damages in the event of a breach. As to the second factor, the amount of liquidated damages must not be grossly disproportionate to the customer’s actual loss. Such a large disparity would be a windfall recovery to the customer and thus would function as a penalty.

Key takeaways

It is worthwhile and important for both providers and customers to consider developing SLAs:

- SLAs help to focus the parties on the important elements of the business relationship and align the parties on the objectives and performance.
- Objective SLA standards enable providers and customers to better manage their own relationship rather than going to court or arbitration for a decision from an adjudicator with little expertise in the substance of the dispute and no stake in the financial and business impacts of the outcome.
- SLAs facilitate continuous improvement: they assist the service provider in allocating resources to key performance criteria, give the service provider an incentive to maintain performance, and SLA breaches typically require the service provider to undergo a root cause analysis and engage in a dialogue with its customer about the situation in order to improve services.

Both providers and customers put enormous resources into the RFP and procurement process, negotiating the service agreement, and building and training human and technological resources. Accordingly, both can undergo reputational damage and disruption from the termination of a services agreement. Investing time and energy in the procurement process to develop SLAs up front will pay dividends in the future success of the transaction.

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