Customer Audit Rights in Technology Agreements
Jim Steinberg and Lance McCord
Daily Report

July 1, 2015

Many of the articles in this series have focused on negotiating for strong commitments from suppliers of technology services. In this article, we focus on a tool available to buyers who wish to verify that those commitments are being met: audit rights.

Audit rights give the buyer an opportunity to pull back the veil and view the evidence of the supplier's performance. Buyers should think carefully about the scope of their audit rights.

First, what aspects of the services does the buyer want to audit? Most audit provisions in technology agreements give the buyer a right to verify the amounts being charged by the supplier. This right is especially important when the supplier's fees are based on factors that may not be known to the buyer (e.g., number of hours worked, number of resources used, or third-party charges being passed through).

But charges are not the only process typically hidden from the buyer's view. A buyer may wish to verify compliance with data security commitments, specific legal requirements (e.g., compliance with laws regarding labor practices, obtaining consents from data subjects, or corrupt business practices), or employee screening requirements.

The most buyer-favorable audit provisions will give the buyer permission to audit all aspects of the supplier's compliance with the agreement. The buyer's negotiator can prepare to respond to the supplier's resistance to broad audit rights by asking what aspects of the supplier's performance are hidden from view and too important to go unverified?

Second, what access will the buyer have during an audit? Audit provisions typically grant access to books and records relating to the audit scope. But access to books and records may not be sufficient when the scope of the audit extends beyond verification of the fees charged by the supplier.

Audits of the supplier's compliance with data security commitments, laws and policies may require access to the supplier's facilities, networks and personnel. Buyers should ensure that the access granted will be sufficiently broad to fulfill the audit's scope, and the contract should spell out the level of access to be granted.

Suppliers are generally not eager to grant broad audit rights. Accordingly, buyers can expect suppliers to shy away from broad audit provisions. In addition to narrowing the scope of the audit and the auditors' access, suppliers may seek to restrict who can perform the audit and when the audits can occur.

Restrictions on who may conduct an audit can undermine the effectiveness of an audit. The buyer may not have resources with the skills necessary to sort through another company's books, records and other assets to assess whether the supplier is complying with the contract.

It is important for the contract to state clearly that the buyer has the right to engage a third-party auditor. The use of that third-party auditor should not be conditioned on circumstances within the supplier's control. For example, a supplier may insist that a third-party auditor agree to protect confidential information disclosed as part of the audit.

If the audit language in the contract requires auditors to sign a nondisclosure agreement that is acceptable to the supplier, then there is a risk that the supplier will undermine the audit process by requiring the auditor to agree to unreasonable terms. Instead, the contract can address the supplier's concern by requiring the auditor to agree to written confidentiality obligations that are substantially similar to those in the contract, but which may be contained in an agreement between the buyer and the auditor.

The supplier may suggest additional limitations on the audit process. For example, suppliers prefer that audits not be performed by outside auditors on a contingency basis. Auditors who get paid only when they identify problems may be more likely to identify problems.

Suppliers may also seek assurances in the contract that they will not be required to share information on the underlying costs of the products or services they are supplying. The supplier will argue that its profit margin has no bearing on the supplier's compliance with the terms of the agreement (except, of course, where the supplier has given pricing commitments based on profit margins).

In addition, suppliers may wish to specify that the audit not be performed by competitors, who might derive an unfair advantage from their look under the supplier's hood.

In assessing the supplier's proposal to limit third-party auditors to noncompetitors, consider both the scope of the restriction and its context. It is best for the buyer if the term "competitor" is limited to a defined group of business entities. If the supplier itself is unable to provide such a list, how could the buyer ever hope to know who it may engage as an auditor?

Even where "competitor" is clearly defined, consider whether the market context for the contract is such that a noncompetitor can effectively conduct the audit. For highly specialized products and services, competitors may be the only third parties with the experience and skills necessary to evaluate the supplier's performance.

Restrictions on when an audit can occur are customary, with buyers typically being required to give some reasonable amount of advance notice. Suppliers may wish to cap the frequency of audits (for example, at one per calendar year).

It is important to specify that an audit conducted to verify the correction of problems that were identified in a prior audit does not count as a new audit when assessing whether the frequency cap has been reached. In addition, buyers who are subject to regulatory audits cannot directly control the timing or frequency of such audits. If suppliers may be required to support regulatory audits, there should be no limit on the number of such audits or how often they occur.

The out-of-pocket costs of an audit are usually borne by the buyer. However, the buyer may wish to negotiate an audit clause that shifts these costs to the supplier when the supplier is found to have engaged in significant breaches of the contract (such as overbilling that exceeds 5 percent of the fees or failure to comply with an important regulatory requirement). In these cases, the supplier has derived a benefit from its noncompliance that has not been passed along to the buyer, and the buyer should not be doubly penalized by having to pay for the audit.

When our clients have audited their vendors, they frequently discover compliance failures. Revenue share formulas may be incorrectly implemented in accounting software; service level calculations may be based on the wrong measurements; services or products may be double billed; or the supplier may fail to obtain or keep important regulatory consents.

A buyer seeking to exit a contract may use its audit right aggressively to encourage the supplier to agree to an early termination.

Even when an audit reveals that all is running according to plan, it serves an additional purpose by signaling to the supplier that the buyer is paying attention and is likely to monitor the supplier's performance proactively throughout the life of the contract.

Buyers are not the only parties with a reason to verify compliance with a technology agreement. In our next article in this series, we will focus on audits by suppliers, the risks posed by such audits, and how buyers may preserve their ability to protect against such risks.

Jim Steinberg, a partner at Kilpatrick Townsend & Stockton, focuses his practice on complex commercial transactions and general corporate matters for telecommunications, financial institutions, health care providers, technology and other companies. **Lance McCord**, an associate at Kilpatrick Townsend & Stockton, focuses his practice on outsourcing and commercial agreements, technology licensing, advertising data and targeting agreements, joint ventures and strategic alliances.