

SERVICE LEVEL AGREEMENTS

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1. The topic

To begin with, the following example shall serve to delimit the topic:

For operational and commercial considerations, a business enterprise has outsourced the operation of its IT environment. This IT environment consists of hardware, operating and applications software, as well as a local network. In addition, there are external connections, for example to the internet and to the bank for certain payment transactions. For organisational reasons, the program servers and data servers are physically located in the premises of the service provider (outsourcing provider).

The outsourcing provider's customer ("customer") is active in the wholesale trade. It supplies retailers in German-speaking Switzerland; with orders being accepted on working days during normal business hours. The majority of orders are received by telephone, with the goods to be delivered no later than the next working day. Each day 200 orders are received on average, which equates to an average of one order every three minutes.

Products of the type sold by the customer are also distributed in the sales territory by at least three other wholesale businesses. In other words, there is real competition. Since there is not much scope for flexibility in pricing and product presentation, speed and reliability of order processing are decisive factors in determining the success of the business.

Against this background it is imperative that the computerised order processing system is reliably available. To achieve this objective, of course the necessary measures relating to staffing, technology, and organisation as well as project-management measures have to be in place. This is primarily the domain of the IT professionals. On the other hand, the project also needs to be backed by contractual safeguards: this is where the lawyers face a challenge. To ensure a good contractual foundation, the lawyer should present a detailed outsourcing agreement. In addition to this, or as part of the agreement, certain measurable performance criteria will have to be defined. The role of these criteria is to determine whether the outsourcing provider meets its primary obligations to perform, for example whether it provides the agreed system availability. These measurable performance criteria or "service

levels” also serve as a basis for introducing remedial measures and for imposing any contractual penalties should performance be inadequate.

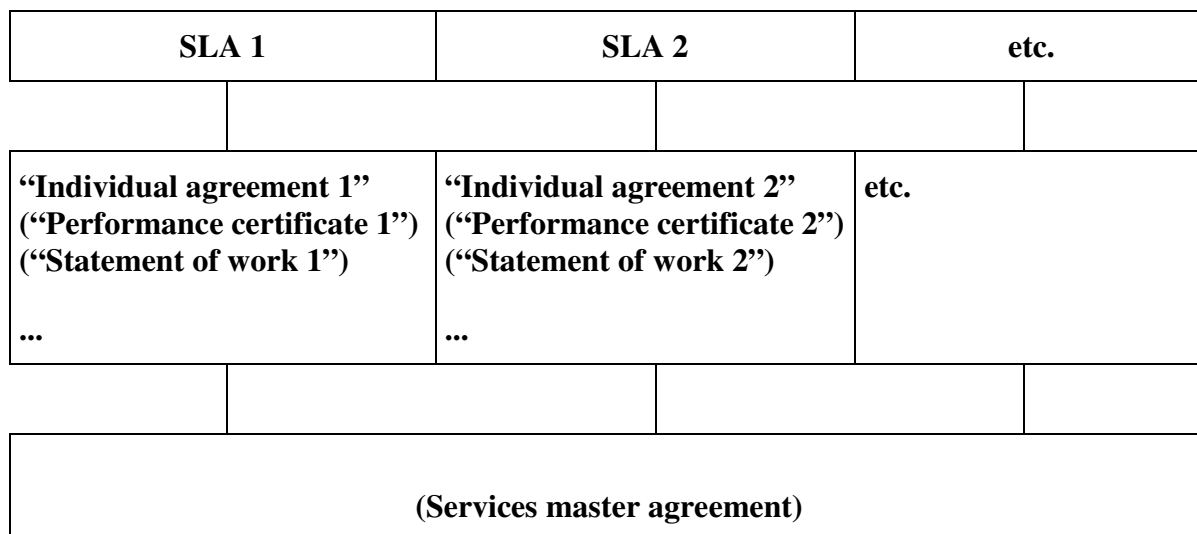
2. Main features and definition of a service level agreement (SLA)

A service level agreement (SLA) regularly has the following main features:

An SLA stipulates specific performance criteria which the outsourcing provider has to meet. The performance of the outsourcing provider is assessed and measured by means of these performance criteria (the “service levels”). Should the outsourcing provider fail to meet the service levels, it will face the consequences specified in the SLA.

In practical application, contractual arrangements of outsourcing projects are often drawn up along the lines of the following model: the basis is provided by a master agreement which sets out the fundamental rights and obligations of the parties. Based on this master agreement, concrete individual agreements concerning the performance of specific services are entered into. Except for setting out any ancillary obligations (such as e.g. obligations to maintain secrecy and/or prohibition to compete), the master agreement as such does not establish any concrete performance stipulations between the parties; such performance stipulations only come into existence with the signing of an individual agreement (in practical application often referred to as a service attachment, supplement, statement of work, or similar). With reference to these specific services, concrete performance criteria or service levels are then agreed to; this regularly occurs within the context of the service level agreements (SLAs) which are the subject of the present discussion.

The above information is summed up in the following diagram:



Against this background, a service level agreement in the sphere of outsourcing can be defined as follows:

“A service level agreement is an agreement between a customer and an outsourcing provider, by which the parties determine measurable performance criteria for a services agreement signed between these parties, and in which they stipulate the consequences of any failure to meet these performance criteria.”

3. Overview of the content of an SLA

An SLA that has been drawn up along the lines of the model presented in section 2 above, should set out at least the following points:

- a) *Subject matter of the agreement:* The provisions dealing with the subject matter of the agreement should describe the services to be measured. Preferably this description is prepared also with reference to the services agreement on which the SLA is based (individual agreement, supplement, statement of work, etc).

- b) *Specification of performance criteria:* After the services for which the SLA is to apply have been described, the concrete performance features are to be defined. This definition and the wording of the respective provisions of the agreement require great care and mutual understanding from the informatics professionals and lawyers involved. Determining criteria for measuring the performance of the outsourcing provider is naturally very demanding. In many cases it is therefore advantageous if the parties agree on relatively simple but practicable definitions, instead of attempting to seek an all-encompassing solution which involves highly complex criteria that are often no longer comprehensible.

- c) *Measuring procedure:* The best performance criteria are of no avail if the procedure for measuring the outsourcing provider's compliance with these performance criteria has not been defined. Such definition not only determines the measuring procedure per se, but also, and just as importantly, who, i.e. which party, is to carry out this procedure. Experience shows that this latter point leads to controversial discussions between the parties.

- d) *Consequences of the failure to meet the performance criteria:* The outsourcing provider needs to have a clear understanding of the consequences if it fails to meet the performance criteria. Apart from legal aspects, commercial considerations in particular are of great importance in this sphere. When determining a "penalty", the weighing up of earnings and risks is crucial to the outsourcing provider, while to the customer it is primarily a matter of having a means of applying pressure – even if often only light pressure – knowing full well that if a problem does occur, the often rather light "penalties" are unlikely to completely cover the expected costs or loss of income.

- e) *Further provisions:* Apart from the above-mentioned core provisions, service level agreements regularly lay down a number of other points, for example organisation structure, structure of operations, processes, physical environment, IT environment, the customer's obligation to cooperate, price, change management, period of the agreement, and general provisions. However, it should be noted that, depending on the solution selected in individual cases, some or all of the above-mentioned points

are either set out in the individual agreement and/or in the supplement instead of in the SLA. Suffice it to say that these points need to be stipulated in the agreement.

4. Specification of the performance criteria

4.1 Introduction

The specification of performance criteria is a central element of an SLA. This is about determining the scope of performance according to which the outsourcing provider's performance is to be measured. The definition of these characteristics and the way they are measured form the basis for introducing any improvement measures and – in the case of defective performance – for the payment of an agreed contractual penalty.

In the example of the wholesale business enterprise mentioned in the introduction, which outsources the operation of its IT environment, it would be sensible to stipulate the following performance criteria:

- a) Availability of the system;
- b) Fail-safe operation of the system;
- c) Speed or response times;
- d) Troubleshooting.

Below, these performance features are discussed in more detail.

4.2 Availability

Defining availability involves stipulating the time period within which the system has to be available for the customer's use. Naturally, stipulation of the respective attended times depends on the customer's requirements and wishes in each individual case. A wholesale business that accepts and delivers orders during normal business hours may not need availability around the clock (i.e. 24 hours a day, seven days a week); it might instead opt for

somewhat reduced availability (for example Monday to Friday from 6 a.m. to 8 p.m.; Saturday from 8 a.m. to 6 p.m.).

It should be pointed out that in principle, the attended times, i.e. the periods of time during which access to the system is assured, are to be specified with care by the parties and stipulated in the contract. It is imaginable that the outsourcing provider assures access only during a limited time (for example from 6 a.m. to 8 p.m. on working days), while the customer is nevertheless entitled to use the system also during the remaining time (in which case the outsourcing provider does not, however, provide any assurances in relation to this remaining time).

The following stipulation serves as an example of a respective contractual provision:

“The outsourcing provider assures the customer of the following system availability: Monday to Friday from 8 a.m. to 5.30 p.m., except for public holidays in [e.g.] Zurich (“attended times”). The customer is entitled to use the system outside these attended times too, but the outsourcing provider has no obligation to perform outside the attended times; the customer acknowledges and agrees that it has no claim to any use of the system outside the attended times and that any such use is its own responsibility.”

4.3 Fail-safe operation

While the criterion of availability serves to determine the times during which the system can be used, the definition of fail-safe operation serves to stipulate whether, and if so for how long, the system may be unavailable during attended times without the outsourcing provider facing the consequences stipulated in the SLA (or in the individual agreement or master agreement).

Fail-safe operation can be specified in per cent (for example 99%) or in periods (for example four hours per quarter). The extent of fail-safe operation that is to be assured by the outsourcing provider, too, primarily depends on the customer's requirements and wishes.

Time-critical applications, such as for example purchase order entry by the wholesale business mentioned in the introduction, require good to maximum fail-safe operation, while lower values may well be appropriate for applications that are less time-critical, for example a charitable organisation's accounts receivable and general accounting.

A corresponding contractual clause might be worded as follows:

“The outsourcing provider assures average minimum availability of 99% for each period of three months. Such minimum availability is calculated as an average during the quarter. Faults which are not the outsourcing provider's responsibility and contractually stipulated maintenance windows are not taken into account when calculating the lack of availability.”

The above example shows that two further points need to be determined: the parties would be well advised to specify periods of time during which the system is not available due to scheduled maintenance work (“maintenance window”), and to state clearly that the respective downtimes are not to be taken into account when measuring availability. In addition, outsourcing providers are likely to be interested in stipulating that access errors outside their responsibility too must not be counted. In order to ensure the best possible contractual certainty, the parties will have to carefully define the cases which are to be covered by such exceptions (for example failure or disruption of the telecommunications network, disruption in the customer's sphere of influence [e.g. in the internal network]).

4.4 Speed and response time

When the parties have defined the attended times and minimum availability, they will want to define the speed at which the system – which after all is now no longer under the direct influence of the customer – has to operate. Since experience shows that specifying operating speeds and response times is an extremely complex and difficult task, it is advantageous if the parties only define limits which are reasonably easy to measure, limiting themselves to a few processes or programs which are particularly time-critical. For example, the speed of data connections and data communications could be stipulated, as could the response

time of particularly important programs or modules (for example display screen buildup of the purchase order entry or inventory control module at the wholesale business) as well as the processing time of critical batch runs. When defining such processing and response times, particular attention should also be paid to finding out and contractually stipulating the data quantities involved, number of users, localities connected to the system, as well as other factors which have a bearing on time-related results.

As already hinted at, contractual parties often find it difficult to translate processing and response times into a contractual solution that can subsequently be verified and implemented. Therefore, a provision is sometimes used which specifies that response times have to be at least as good as the response times achieved so far, or at least as good as the response times measured at a reference installation. In such a case, the respective results are documented in an appendix to the service level agreement.

The wording of a solution in which this last case has been selected might be as follows:

“The outsourcing provider assures that the processing times and response times of the system are at least equivalent to the existing processing and response times measured at the customer's on [date] as specified in Appendix [no].”

4.5 Troubleshooting

In those cases where attended times, fail-safe operation, as well as processing and response times have been defined, it is advantageous to also determine in what way and how quickly remedial action in relation to any experienced malfunction or fault is to occur.

In this context, the following are to be specified:

- a) *Points of contact:* It must be defined who on the customer's side is to contact what office at the outsourcing provider (for example, the customer's project manager or his/her deputy is to contact the outsourcing provider's helpdesk).

- b) *Communication channels:* To ensure a smooth flow of information, communication channels are to be determined; in other words it must be defined through which channel the outsourcing provider is to be notified of any fault detected by the customer, or, conversely, through which channel the customer is to be notified of any fault detected by the outsourcing provider. The same applies to any further notification in connection with the fault notified. For example, communication by telephone, or with the use of special software are imaginable in this context.
- c) *Fault categories:* Since faults or malfunctions vary as to the seriousness of their consequences, and therefore not every fault requires the same degree of attention by the outsourcing provider, different fault categories are to be defined which are accorded different priorities for action.
- d) *Response times:* If fault categories have been defined, the required response time for each fault category is to be specified. In this document, response time refers to the time it takes between the notification or detection of a fault or malfunction and the recording of the fault by the outsourcing provider (this often takes place by initiating a so-called trouble ticket).
- e) *Reaction times:* In this document, reaction time refers to the time it takes from the time of recording a notification to preparing a fault report to handing the case over to the support organisation. Reaction times, too, vary in length, depending on the severity of the fault.
- f) *Problem solving times:* Problem solving time refers to the period of time between handover of the case to the support organisation and rectification of the fault. While the parties usually manage to agree relatively quickly on response times and reaction times, they naturally experience some difficulty in specifying problem solving times. On the one hand, from the customer's point of view it is desirable and understandable for the outsourcing provider to have to come up with a binding time within which a problem has to be solved. On the other hand, due to the multitude of possible faults or malfunctions and their complexity it is clearly extremely difficult to assure in advance binding times for solutions to problems which are not yet

known at the time an agreement is entered into. While reaction times and response times primarily depend on the internal organisation of the outsourcing provider, and corresponding assurances can be met with the use of corresponding organisational means, the situation is quite different in relation to remedying a fault or malfunction: the remedy not only depends on the internal organisation, but to a much greater extent also on the nature of the fault or malfunction.

In summary, the performance criterion of problem solving can be shown or specified as follows:

Category	Description	Response time ¹	Reaction time ²	Problem solving time
Category 1 Disastrous	• Total failure	1 hour	1 hour.	?
Category 2 Critical	• Important function not available	2 hours	24 hours	?
Category 3 Medium	• Other function not available	4 hours	48 hours	?
Category 4 Noncritical	• Minor fault	4 hours	48 hours	?
“Catastrophe”	• Total failure due to “catastrophe”	1 hour	1 hour	3 days ³

¹=Time between receipt of notification and recording the notification/trouble ticket

²=Time between recording the notification, preparing the fault report and handover to the support organisation

³=Solution involves the provision of a back-up system

5. Measuring procedure to establish whether the performance criteria have been met

Determining the performance criteria is of little use to the parties involved unless there is a clear stipulation as to how and when – i.e. at what time intervals – compliance with the performance criteria is to be measured. Without such measurements being carried out, it is

impossible to reliably determine whether the outsourcing provider has met the agreed performance criteria, whether remedial measures are indicated, or whether there is a basis for asserting any contractual penalty that may have been agreed to.

In connection with measuring the performance delivered, at least the following points should be specified:

- a) *Responsibility for the measuring procedure:* There is often quite some discussion as to which party is to carry out the measuring procedure and to record the results. Although the customer's suggestion of either itself carrying out the measuring procedure or at least being present during this procedure is quite understandable, nevertheless, at the end of the negotiations it is usually agreed that the outsourcing provider is to carry out the measuring procedure – because of its proximity to the subject matter and its experience and specific knowledge.
- b) *Measuring method:* This point deals with the question of how to determine whether the performance criteria have been met. Various methods are possible, for example purely manual measuring or the use of specific software.
- c) *Measuring interval:* Apart from determining responsibility for the measuring procedure and for the measuring method, it must also be specified at what time and over what period of time measuring is to be carried out. It is advantageous if the measuring interval spans several months (e.g. a quarter) so that reliable results are obtained.
- d) *Reporting:* The results obtained are to be communicated to the other party – as a rule to the customer – within a reasonable time. A time frame of several days would seem to be appropriate.
- e) *Review:* This refers to the results obtained during the measuring procedure being checked by the parties. Ideally, these results are discussed within the framework of joint meetings, in particular in order to determine whether remedial measures or change measures are indicated. If the outsourcing provider does not meet the criteria, identification of problem areas and specification of remedial measures are often

more advantageous to the customer than is the purely pecuniary measure of paying the contractual penalty.

Since the entire procedure of measuring to establish whether the performance criteria have been met is largely a technical procedure, details should regularly be arranged in specific appendices; the text of the agreement in a narrower sense should be confined to the basic provisions.

The wording of the respective text in the agreement might, for example, be as follows:

“Availability and fail-safe operation shall be measured by the outsourcing provider; for each month, the customer shall be advised in writing of the results obtained from the measuring procedure, in a form mutually agreed to by the parties, within five working days from the end of the month. The measuring method to be applied by the outsourcing provider has been defined in Appendix [no].”

6. Consequences of failing to meet the performance criteria

In cases where the parties attach specific legal consequences to any failure to meet the performance criteria, they frequently agree that the outsourcing provider has to pay a certain amount (hereinafter the “contractual penalty”). Ideally, this amount depends on the degree of failure to meet the performance criteria. Obviously, some slight deviation in performance should not have the same financial consequences as a serious one.

In cases where the parties agree on various performance criteria to be met, they should determine separate contractual penalties for each of these criteria, otherwise it would be difficult to determine the actual amount owed.

The extent of the contractual penalty can either be stipulated in absolute amounts or as a percentage of the fee for services. The parties can either agree that the outsourcing provider is to remit any amount owed, or – which in many cases is likely to be the more practicable

solution – that the customer can set this amount off against the next fee for services that is owed.

In cases where the outsourcing provider is to be rewarded for extraordinarily good performance, a bonus/penalty system can be agreed to. In such a system, the outsourcing provider has to pay a contractual penalty in the case of failure to meet the performance criteria, while conversely qualifying for an additional payment (a bonus) for exceeding the specified criteria.

The wording of a respective contractual provision for fail-safe operation might be as follows:

“If the assured fail-safe operation in an agreed measuring period is not attained, the outsourcing provider shall pay the following amounts to the customer:

<i>99% (assured)</i>	<i>CHF 0.00</i>
<i>98 – 98.99%</i>	<i>CHF [amount]</i>
<i>97 – 97.99%</i>	<i>CHF [amount]</i>
<i><97%</i>	<i>CHF [amount].</i>

If the assured fail-safe operation of 99% is exceeded in an agreed measuring period, the customer shall pay to the outsourcing provider the amount of CHF [amount].”

Incidentally, the parties should pay particular attention to making a clear distinction between the contractual penalty on the one hand, and claims arising out of general principles of the law of contract on the other hand. For example, the customer's claim for a contractual penalty must be clearly delimited from any claim for damages and cancellation of a contract (cf. 8.3 below).

7. Other provisions

7.1 Preliminary remarks

In the author's view, the points mentioned in 4 to 6 above are mandatory in every service level agreement. To round off the agreement between the parties, a number of other questions have to be settled. As already mentioned above, the respective provisions are either contained in the SLA or in the individual agreements or in the master agreement.

These provisions include not only arrangements of a predominantly legal nature, for example concerning liability, contractual period, the customer's obligation to cooperate, and general provisions (such as severability clause, governing law, place of jurisdiction), but also arrangements of a predominantly technical nature, e.g. concerning the organisation and the informatics environment. Below, we will briefly deal with some provisions of a predominantly technical content.

7.2 Organisation structure

In this section of the agreement it should be laid down who has to contribute to the outsourcing project and in what way. Particular attention must be given to specifying the employees (on both sides) who will be working on the project, and to specifying the project group or groups which are to be formed for introducing and then operating the outsourcing solution. In addition, the tasks of individual employees are to be defined. The latter requires particular attention to ensure that the specified basic obligations to perform, or the responsibilities which have been defined, are not diluted or changed in this step.

Nomination of the employees involved and formation of the project groups require special emphasis on the training and experience (skills) of employees and on determining cases in which the other party can demand replacement of an employee who, in that party's view, is underperforming. In addition, if employees are listed by name in the contract, the circumstances under which a party may withdraw such an employee from the project must also be stipulated. In the author's view, a customer is well advised to draw up the definition of this organisation structure just as carefully as that of any contractual penalty, since it is not least

the well-qualified and committed employees of the outsourcing providers who have a decisive effect on the success of the outsourcing project.

7.3 Structuring of operations / processes

In this section of the agreement, the various operational sequences or processes are to be defined which are necessary in the context of operating the system for the customer. This is primarily the domain of the IT specialist. For the lawyer, the important issue is that these areas are also covered by the agreement.

Areas that have to be specified are for example: processes for installation of new software versions, maintenance of hardware and the network (maintenance window), troubleshooting, backup procedures, and restore activities.

7.4 Physical environment

The heading of physical environment relates to the requirements regarding the premises in which the customer's system will be operated. This is primarily a matter of specifying interior furnishings and fittings, space requirements, security of the premises and the system, and any further operating resources that may be needed.

In this context it should also be stipulated at what times and under what preconditions the customer, i.e. its employees, has access to the premises in which the customer's system is operated. Such access may be necessary purely for control purposes. However, it is also possible that as a result of a contractually agreed division of tasks, individual employees of the customer have to carry out certain activities on site.

8. Specific legal questions

8.1 Preliminary remarks

In the context of outsourcing agreements in general, and service level agreements in particular, a large number of other legal issues arise, for example issues related to warranty,

liability, secrecy, or the use of persons employed in performing an obligation. A discussion of all these additional issues would clearly be beyond the scope of this overview. We will therefore only discuss two issues briefly which in the author's view are of particular interest: firstly, the relationship between limitation of warranty and liability and defining special performance criteria, and secondly, the delimitation of any contractual penalty from statutory claims.

8.2 Definition of performance criteria and limitation of warranty

The question of delimitation might arise in the following situation: In the SLA, the parties have agreed to fail-safe operation of 98.5%. After the first measuring period it turns out that there has been a failure of 1%, a failure which was however caused by gross negligence. If the general law of damages of the Swiss Code of Obligations (CO) were to apply, according to art. 100 para. 1 CO, a respective limitation of liability would be null and void (art. 100 para. 1 CO states that: “An agreement entered into in advance, according to which liability for unlawful intent or gross negligence would be excluded, is null and void”).

This problem of delimitation is correctly solved in that the definition of performance criteria is to be seen as an expression of the performance content in concrete terms, rather than as a limitation of liability. In other words, the performance criteria serve to specify and circumscribe the performance to be delivered by the outsourcing provider, instead of limiting liability for a performance obligation which might be more far-reaching. In order to find an appropriate solution in each specific case, great care is needed in this respect, both during the negotiations for entering into the agreement and, in particular, in the wording of the agreement.

8.3 Contractual penalty arising from non-performance or defective performance

In cases where the parties have stipulated that if the agreed fail-safe operation is not met, the outsourcing provider is to pay a certain amount (for example with underperformance by 2–3%, an amount of 10% of the agreed fee for services is owed) for the respective measuring period, the question arises whether the customer can put forward any additional claims as well.

The starting point for this is that, fundamentally, liquidated damages are due even in the event that the customer has not suffered damage (art. 161 para. 1 CO); from the customer's point of view this is the attractive aspect of a contractual penalty.

Beyond this, there are some controversial issues; they also require careful wording of the agreement. According to art. 160 para. 1 CO, if liquidated damages are provided for in the case of non-performance or improper performance of a contract, the obligee is only entitled to claim either the performance or liquidated damages in the absence of an agreement to the contrary. According to para. 3 of this provision, the obligor has the right to prove that he should be entitled to withdraw from the contract against payment of liquidated damages. According to art. 161 para. 2 CO, the obligee may only claim the excess to the extent he proves fault.

As far as the relationship between liquidated damages and other contractual or statutory claims is concerned, the law provides various dispositive standards which apply in the absence of provisions to the contrary agreed to by the parties in the service level agreement or in the outsourcing agreement. Accordingly, the wording of the agreement requires special attention in this respect too.

Finally, in this context it is worth remembering the – mandatory – provision of art. 163 para. 3 CO, according to which excessively high liquidated damages are to be reduced at the discretion of the judge. It is therefore advisable to exercise a degree of restraint when determining the extent of liquidated damages.

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