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Cloud Financing: Come Hell or High Water

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Cloud computing is completely reinventing the IT business model. Companies are electing to replace large, expensive corporate data centers with highly efficient cloud-based solutions that distribute applications using the Internet or corporate intranets. Instead of heavy investment in hardware, software, infrastructure and staff, companies can reduce costs and save space by utilizing what is now referred to as the “cloud.”

Cloud Computing — The Future of IT

Service providers offering cloud-based solutions may require a customer to acquire new hardware and software to be maintained on the customer’s premises so that the service provider can meet the customer’s needs. Often, the service provider will offer a bundled solution which includes its services together with the hardware and software costs. Although the customer needs to acquire the hardware and software at the outset of its engagement, the service provider may wish to make these costs more palatable to the customer by financing it and spreading the customer’s payment for these upfront costs over a period of several years.

A typical cloud solution includes three separate elements — hardware, software and services. Hardware includes the servers that are used to provide applications to users, along with printers and other related peripheral devices. Typical cloud configurations also include the technology equipment used to provide both data communications and the network infrastructure that facilitates user access and system administration. As in more traditional equipment leasing transactions, the hardware is pledged as collateral for the transaction and remains on the customer’s premises. As a part of the cloud financing transaction, the customer acquires this equipment, which is essential for all of the subsequent services that are delivered by the service provider.

In terms of software, two types are typically required. First is the system software that creates the network itself and facilitates data and message communication. The second type of software includes the actual applications that address specific business needs and that are provided on demand when requested by authorized users.

Funding software poses slightly greater risk for the financing company since it cannot serve as collateral. Even if a software license is revoked or software services are discontinued in the event of a default, the finance company cannot resell the software to mitigate its losses.

Services include planning, designing, installing, implementing, managing and supporting a cloud computing environment and represent a complex, demanding, and time intensive set of tasks. A cloud-based solution requires substantial professional expertise in many different disciplines in order to function effectively and sustainably. Finance companies might occasionally fund a portion of the upfront services required to accomplish necessary tasks, while accepting the risk posed by a lack of tangible collateral. Most legal experts recommend however, that the ongoing services required to support and maintain the cloud solution should be paid for as rendered.

Role of the Finance Company

In a cloud financing transaction, the finance company plays two important and essential roles. The first is to finance the hardware and software components of the transaction. Some finance companies will also agree to finance the upfront service costs that are required to plan the installation, prepare the site, and then actually install the solution. Even though the value of the equipment itself will not be sufficient to fully collateralize the transaction, the financing agreement should be constructed in such a way as to ensure that the finance company is made whole in the event of a default.

The second role of the finance company is to administer the monthly billing and collection process. This includes not only collecting the equipment and software lease payment — along with any upfront services that were bundled into the initial agreement — but also collecting any ongoing payments to the individual service providers. For the customer, all of these payments will appear on one monthly invoice.

Choosing the Right Partners

An important aspect of funding the cloud is the underlying relationship between the finance company and the service provider who is providing the cloud services. In the best case scenario, this relationship will be in place long before a cloud computing solution financing opportunity is even considered. Furthermore, the financing company should be very selective about the equipment vendors that it chooses to do business with, particularly when funding the cloud. Discretion is paramount and should include a rigorous process of reference checking and vetting before any projects are undertaken.

This is a key point because dependable service providers can have a major impact on the ultimate success — or failure — of a cloud computing project. Substandard service or bad business practices can impact the entire cloud solution, far beyond the relationship between a particular provider and the end user. For example, if payments are based on a monthly minimum plus a variable cost based on usage, an unexpected spike in the monthly invoice amount might trigger an adverse customer response. The same holds true for a buried escalator clause that significantly inflates the monthly payment when it takes effect. Another potential cause of end user dissatisfaction is the failure of the service provider to meet service requirements and the related performance obligations.

Any of these occurrences, if severe enough, can cause an end user to refuse to pay, despite the provisions of the legal agreements. Legal recourse — along with all of the attendant costs — then becomes necessary. The best way to avoid these kinds of problems is to preempt them completely by first having a trusted relationship with the service provider, and then by carefully reviewing the provisions of each service agreement.

It also helps to identify a particular type of cloud computing solution — a specific market niche for example, targeting a particular industry in which the finance company can develop internal expertise. This helps to ensure that the right compilation of products and services is brought to the table and that the right vendor is in place to deliver them.

As with virtually everything else in business, the quality and value of any given cloud computing solution are derived to a large extent from the relationships that combine to deliver it. By working with proven and trusted service and solution providers, a finance company can significantly enhance the overall quality and reliability of the cloud solution it is funding. Just as importantly, the right team will also minimize the risk of customer dissatisfaction over time.

As important as they are however, relationships alone cannot ensure a problem free cloud solution. Furthermore, relationships will not provide a remedy in the event of a default or system failure. As in any complex financial transaction, documentation that clearly defines the transaction and that addresses any contingencies associated with it is an essential element of funding the cloud, and the finance company should have a detailed understanding of every component agreement.

Hell or High Water

The inherent complexity of a cloud solution makes it essential that there is no ambiguity about the terms and conditions of the monthly payments due pursuant to the lease agreement. This is where the classic “hell or high water” clause should come into play. This clause requires that the monthly payment for the products that have been financed be made irrespective of any other factors including dissatisfaction with the service provider. Regardless of the situation, once the agreement is in effect with a hell or high water clause in place, the customer is obligated to continue making its lease payments.

The hell or high water clause should be absolute; leaving no doubt that the bill must be paid. If the payments for ongoing services are made directly to the service providers and have not been financed as a part of the overall transaction, the argument of unsatisfactory service metrics cannot impact the payment of the monthly lease payment itself. On the other hand, if services have been bundled into the total transaction—perhaps for work performed during the setup and installation of the cloud solution — they should be considered to be a part of the master agreement, and should also fall under the hell or high water clause.

Customers may, in the event of problems, want the ability to cancel services if they are not satisfied with them. However — and this is a critical point — it is imperative to make it clear that the customer has an obligation to pay their monthly lease invoice and that the agreement cannot be cancelled.

Circumstances under which a customer might dispute a service contract should be addressed in the service agreement as performance contingencies, along with the remedies to be followed. Standard lease documentation often does not address the issue of customer dissatisfaction which, when dealing with cloud solutions, should not be unanticipated.

One way to address a performance contingency is through a separate agreement between the service provider and the customer, setting forth service metrics and establishing who is responsible for what. The optimal configuration of the documentation should provide for all servicing agreements to reference the lease agreement. They should also clearly spell out the remedies for performance contingencies.

Proceed With Caution

The opportunities for financing the cloud are substantial—as are the potential risks. Financing the cloud requires an entirely new paradigm for finance companies that must now contemplate funding transactions that include a large component of intangible — and unrecoverable — assets in the form of software and services. The multiple layers of complexity make it essential that cloud transactions are carefully structured to protect the finance company and its capital.

The fact that cloud solutions inherently include a large component of intangible assets that cannot be collateralized presents a major challenge for finance companies that are unaccustomed to funding transactions without collateral. Because this is an atypical approach to business, finance companies seeking to become involved with funding the cloud should first rationalize their willingness to accept the potential of greater risk, and then adapt their business models accordingly. This is an important point to consider because despite the fact that funding the cloud offers tremendous opportunities, it might not be a market that interests everyone.

The very complexity of cloud computing projects is another thing that must be carefully considered by the finance company. Even a moderately comprehensive cloud transaction may have multiple vendors supplying a wide variety of equipment and services over a relatively lengthy period of time, typically on the order of several months, at least. These transactions will often include upfront funding for much of the equipment as well as interim progress payments for services rendered. The end user on the other hand generally does not start paying until everything is complete and the cloud solution is deployed.

Furthermore, most customers will demand that those payments are made once a month to a single point of contact. The responsibility for distilling the inherent complexity of a cloud solution down into a single, usage-based invoice is almost always the responsibility of the finance company. Companies that are not properly configured to administer a cost-per-usage based billing system, or those that lack the administrative infrastructure to satisfy the billing requirements of multiple vendors should carefully consider the implications of financing cloud solutions.

Conclusion

Cloud computing offers many opportunities, but requires careful planning, meticulous legal review, and seamless integration between vendors, service providers and the finance company. Solid documentation along with granular, non-cancellable service agreements and well established business relationships are all essential elements of successfully funding the cloud.

More importantly, cloud computing is not only reinventing IT, but it is also forcing a change in the way finance companies structure and collateralize transactions. Because cloud solutions combine both tangible and intangible assets, a perceived increase in risk may become a significant barrier to entry for many finance companies.

Finally, there will inevitably be a number of moving parts to every cloud funding transaction. Equipment vendors will place hardware and software; service providers will set it up and install it, and then keep it working. Along the way there may be potential issues in terms of equipment maintenance and continuity of service. With these ongoing issues notwithstanding, the transaction should be structured so that the finance company gets paid … come hell or high water.
