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Outsourcing Business Processes: Building Successful Contracts

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Introduction

During the last dozen years, outsourcing of technology has become widespread. Now, companies show growing interest in outsourcing other operations: payables and receivables, logistics, HR and other labor-intensive, back office functions. Rationales and objectives vary. Outsourcing is supposed to save money, and introduce faster, more accurate, automated processes, allowing management to focus on products, services, research and the like. Better processes may reduce inventory, cut delivery times, improve customer satisfaction, and otherwise benefit the bottom line. Consulting powerhouses, computer services companies, affiliates of financial institutions, and well-funded, sophisticated new companies are pursuing these opportunities with talent and imagination. Commentators predict explosive growth during the next few years.

Lawyers earn their keep by helping clients achieve their goals, and attempting to keep them out of trouble—in part by worrying about, and providing for the consequences of Murphy's Law. We do this not only by writing remedies into contracts (termination rights, audit clauses, service levels and the rest), but by attempting to craft sensible allocations of risk, responsibility and incentives that give both sides incentives to perform, while protecting them against the worst risks—mindful that legal remedies are cumbersome, disruptive, uncertain and expensive.

Before Taking the Plunge

Socrates taught that wisdom begins with the maxim "know thyself." It applies here. Companies considering outsourcing should evaluate their own operations, understand their strengths and weaknesses, know their costs (which may or may not correspond to historic budgetary categories), and understand the web of internal and external relationships affected by relevant operations. Solutions devised for others, even in the same industry, may not necessarily fit a particular company's needs and objectives. Above all, management must understand what it hopes to achieve: cost savings, competitive advantage, process improvements, reductions in inventory, or a variety of other objectives that vary from one situation to the next. Outsourcing can be part of a good strategy, but it is a tactic, not a strategy, or a substitute for strategy.

Strong internal consensus is vital. Outsourcing business processes may require a wider consensus than the familiar IT contracts, which usually proceed when blessed by the CFO and CIO. HR, logistics, customer care, fulfillment and other functions involve wide constituencies throughout an organization. As with IT contracts, maintaining that consensus after signing is crucial, so that the customer speaks to its supplier with a single, authoritative voice. Wise management begins to build that consensus long before any contract is signed.

Management must also understand whether affected functions are peripheral support functions, or at the core of the business. Are they commodity services? Do they involve operation of whole functions, such as IT or HR? To what extent do they involve interaction with employees and customers? Design, development, policy and strategy? Providers of commodity services look very much like vendors of parts. Competition means price competition. Substitutes are readily available, so disengagement may be fairly straightforward. Move closer to the core of the business, however, and the picture changes. The supplier may be a strategic partner, who knows the customer's business intimately, and if successful, can deliver great value—even if that value eludes easy or precise measurement. Disengagement and replacement may be messy and time-consuming.

Companies must also examine their attitudes, culture and dealings with suppliers. The hard-nosed, adversarial tactics common in some industries are not necessarily effective when dealing with suppliers who think of themselves as, among other things, providers of professional service. They are part of the household, rather than household help.

Sound preparation includes assembling a team dedicated (often, exclusively) to the process for an extended period, in order to analyze current operations and costs, develop requirements, then oversee selection, negotiation and eventual transition to outsourced operations. Preparation should of course include examination of relevant intellectual property issues and rights—for example, protection of existing software, processes and methods that may be shared with an outsourcer. Often, companies engage outside consultants and lawyers, unless they already possess this experience. Outside advice can help to assure a level playing field, because of the advisers' prior experience with outsourcing and, often, particular suppliers.

There's much to do—so much that preparations to manage outsourced operations may be overlooked. Managing complex contracts and relationships requires capable and effective oversight, as well as recognition that contract management calls for skills that differ in many respects from management of internal operations. The team that manages the relationship is at least as important as the team that makes the deal. They may overlap, at least to some extent. Both should be identified early.

Selection

Competition generally assures the customer the widest range of choices, and the most favorable terms. However, in immature markets, where service offerings vary, conventional requests for proposals that compel suppliers to match specific, pre-determined requirements (often based on current operations) may not always be in the customer's interest. One attraction of outsourcing is the opportunity to consider diverse solutions. To find the best solution, it may be wise to forego the usual tightly-drawn RFP (which tends to focus competition upon price), and engage in preliminary discussions with a limited number of suppliers who offer varying services and technical solutions. To get the best possible terms, it is prudent to keep at least two competing suppliers in play, as well as internal solutions, until the principal economic terms are agreed, through a written term sheet or letter of intent.

Legal counsel can help management frame these issues, and be sure that the terms include essential protections that must be written into the final contract. However, legal protections are secondary, since they are difficult to enforce; and enforcement is rarely attempted unless the relationship founders. It is far more important to engage the right supplier, on terms that give both sides every incentive to perform. No antenuptial agreement can prevent or fix a bad marriage.

Risks

Contract negotiation is largely a matter risk allocation. Before engaging a supplier, the customer must consider what can go wrong. The risks identified will drive contract negotiations. Common risks include the following:

- Transition may be botched, at either end. In the beginning, some grumbling and stumbling should be expected. Change always attracts opposition. Inevitably, something will go wrong, however well the parties prepare. Transition away from the supplier, when the contract expires, is especially challenging if the outsourcer replaces old ways with wholly new processes, and absorbs the customer's former staff.

- Then there may be security and competitive risks. Inviting a contractor inside the tent may raise ticklish questions concerning confidentiality, intellectual property and dealings with competitors. Intellectual property, skills and talents are the service company's stock in trade, which it guards jealously, just as the customer will guard whatever competitive advantage it derives from the arrangement, to say nothing of secrets concerning its business strategies.

- Service may be poor. Apart from the obvious risks of major disruptions (the "meltdown" scenario) there may be widespread minor but irritating problems ("epidemic" failures), clashes between corporate cultures, or isolated problems in particular business units or locations. Legal and regulatory compliance are essential, especially in such sensitive spheres as HR.

- The customer may pay too much. No one cares to be taken, and in tough competitive markets, excessive costs spell competitive disadvantage. It is also possible to pay too little. The restive supplier with minuscule (or nonexistent) margins may be inclined to let change requests fly like confetti, work to the letter of the contract, or shave its own costs in ways that detract from good service. Remember the astronaut who, strapped in his capsule, paused to reflect that everything on which his life depended—space suit, capsule, rocket and the rest—came from low bidders.

- Finally, in long-term service contracts, uncertainty about contract scope is the most common source of friction, especially as services and processes evolve over time, so that they no longer correspond with words written long before.

Managing Risks

What, then, should a customer write into the contract to mitigate financial and performance risks? Many of the familiar protections in IT outsourcing contracts apply, but their details, priorities and importance may vary.

To help assure smooth transitions, the customer should insist upon detailed plans for the initial transition and provisions for an orderly transition when the contract expires or, worse, terminates. However the relationship ends, the customer may want a right to hire staff dedicated to its account, purchase hardware used to support the customer's operations, take over subcontracts and leases, and license software and other intellectual property so that the customer may carry on itself, or with another contractor. The outgoing supplier may have to carry on for several months or more, and may demand ironclad assurances of payment (whatever disputes may then be pending).

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Paying the bill may be a small price to pay for uninterrupted service and an orderly transition.[1]

To minimize scope disputes, both sides should want clear and specific descriptions of services, with specific qualifications, limitations and exclusions, where appropriate, as well as written change procedures (reinforced by the discipline to use them). Customers fear change requests (not without reason) as the supplier's preferred way to "get well" at the customer's expense; but good change discipline can actually help the customer, who generally has no obligation to pay for additional work, unless authorized in writing. To forestall scope disputes, responsibility matrices, specifying each party's responsibilities, are excellent supplements for the usual narrative statement of work.

To preserve security, both sides will want tight confidentiality provisions. These are rarely controversial. Suppliers understand that the customer's business, methods and records are confidential. Customers recognize that the supplier's software, methods and processes may be the "crown jewels" of its business.

Intellectual property rights pose challenges for both sides, especially at a time when the law is uncertain, business processes and software can be patented, and the software, web-sites and other means of delivering of service may blend the supplier's methods with aspects of the customer's business. This is an area where the attorneys on both sides add value with creativity. Both sides are usually well advised to look past sterile debates about "ownership" to think of intellectual property as a bundle of rights and obligations, upack the bundle, and consider what rights each side needs to carry on its business. Both sides should recognize the uncertainties, as legislators and courts attempt to adapt traditional intellectual property concepts for cyberspace and a networked economy. No legal language is airtight or bulletproof, and in this sphere, more than most, management should consider carefully with whom they wish to do business, the compatibility of corporate cultures, and other intangible factors that contribute to successful business relationships.

Specific licensing and intellectual property issues may vary a great deal, depending upon the context, but common issues include the following:

[1] Sophisticated customers also consider what options exist, if the supplier is sold or experiences financial difficulty. With recent "dot-bomb" experience in mind, the importance of investigating the supplier's resources, bench strength and staying power is difficult to overstate.

- *Supplier use of customer intellectual property*. Suppliers are continually refining their solutions, including software, based in part upon what they learn from customers. Customers are anxious to protect intellectual property that gives them advantages in the marketplace, especially if they believe the service company hopes to build a practice in their particular industry. Suppliers may wish to adapt or incorporate some of the customer's methods, processes and software in their software and service offerings.

- *Customer use of supplier's software after expiration*. Some software may be essentially inseparable from the supplier's service offering. Other software may be usable without the service, at least for a transitional period, and available on commercially reasonable terms for operation of the customer's business. This may be a more challenging issue with business processes than with conventional IT outsourcing, where many competing suppliers can capably operate commercial applications on standard computing platforms and networks. Business process customers fear becoming trapped, and desire the rights to carry on independently, and effect a smooth transition to some other internal or external service. If the supplier cannot or will not make its software and methods available after the contract expires, a prolonged transition period, and more elaborate transitional arrangements, may be essential.

- *Rights in new developments*. Customers reflexively request all rights in new developments, for which they believe they pay in service charges or project fees. Suppliers fear parsing out rights in their core systems among various clients, each with conflicting rights in systems on which the supplier's business largely depends. Moreover, development projects often draw upon experience and work product accumulated in prior work for other customers. There are no pat answers. Some developments are authentic custom work, developed entirely at one customer's expense, for its unique requirements, and should not to be shared with others. Some enhancements or extensions of the supplier's systems are really opportunities for the supplier to undertake developments of value to its customers generally—developments that may fairly belong the supplier, and be licensed to customers, so long as the particular customer's unique processes, methods and other confidences are protected. Price figures in this discussion, of course. Custom work, meant for just one customer and no one else, will cost more. Here again, solutions often require the parties to look past metaphysical arguments about ownership.

To minimize financial risks, the customer should consider, among other things:

- Audit rights;
- Pricing metrics that adjust charges based on outputs (rather than mere costs, to give the supplier the best incentives);
- Gain-share provisions, which align incentives through participation in cost benefits;
- Equitable adjustment of charges, based on objective criteria when unforeseen circumstances arise;
- Periodic benchmarking of charges against the market (although suppliers dislike these arrangements, and in immature markets, with wide variations among service offerings and scant data, the exercise may be impractical);
- Clear, objective criteria for pricing of changes (erasing an incumbent's temptation to charge whatever it can);
- "Most favored customer" clauses, assuring the lowest charges offered to any other customer for the same kinds of services (although these may be difficult to enforce, given the wide variation among a supplier's clients, for which any analysis must adjust in order to assure "apples to apples" comparisons); and
- Where there are similar, competing solutions, rights to "benchmark" charges and quality against the market, and require adjustments or else permit early (and inexpensive) termination. Benchmarking, however, may be less useful than in the mature IT outsourcing business, where competitors offer very similar services, and there is a good deal of accumulated market data.

To help assure quality, well-advised customers require:

- Objective service levels, measured and reported monthly or quarterly, with appropriate incentive and disincentive payments, based on performance (although here again, market benchmarks may be elusive, at least for the time being);
- Regular surveys of customer and executive satisfaction;
- Approval rights over subcontractors and key personnel (such as the account executive and his or her immediate subordinates); and

- Strong executive oversight from both sides, through regular meetings between the account manager and his or her counterpart, and (equally important) an executive level governing board or management committee, to meet periodically, review outstanding issues, set policy and oversee performance.

It is difficult to overstate the importance of good communications and good contract management on both sides. Contract terms for meetings, committees and executive oversight are rarely controversial, and have more practical than legal significance. Good communications help to avoid or at least manage problems when they arise. Executive oversight, which should focus on the health of the relationship and its future prospects, as well as immediate tensions, can be an excellent “trip wire” and help to deter over-reaching or other abuses, because everyone knows the bosses are paying attention.

Difficulties often arise when these mechanisms are neglected. When the lawyers are called in, they are often surprised to learn that neither side has taken advantage of mechanisms written into the contract that, if used regularly, help to keep routine differences of opinion from becoming serious misunderstandings. Frequent, occasionally intense and animated, discussion of ongoing issues is usually an indication of health. Marriage counselors say that couples who never argue, because they never talk, are the likeliest to run into difficulty. The same principles apply in long term service contracts.

To protect itself against serious deficiencies in service, the customer should require the usual remedies, including:

- As noted elsewhere, service levels, regularly measured and reported, reinforced by an obligation to pay credits for unexcused failures.

- Extensive termination rights, including the right to terminate particular classes of service, service to particular business units, or the entire contract, for the customer’s convenience, as well as in case of default. Convenience termination typically involves a termination payment, but customers need the flexibility to withdraw if their needs change, or make a clean break (without litigation) if service is mediocre.

- Disaster recovery protection, including access to redundant facilities, a detailed plan, and regular testing, so that essential services are restored after an earthquake, hurricane, fire or other calamity. Payroll, shipments, payments and the like must continue, without fail, or the customer's business is in jeopardy.[2]

Much more could be said about the details of these and other provisions, and many of the essentials resemble familiar terms from IT outsourcing contracts. The differences may be subtle, but important points of detail, because the services and functions are different. For example, a financial institution outsourcing its Internet banking operations may legitimately require (and have to pay for) more redundancy, and more stringent service levels than others require, because interruptions in service effectively shut down its business. Legal remedies such as termination are all very well, but pointless, if they only benefit the receiver, trustee in bankruptcy or FDIC. If contracts to outsource IT and some other process were laid side by side, the tables of contents and headings might be very similar—but because the service offerings and purposes differ, the details buried in the language may also differ.

Communication, regular measures of performance, well-balanced incentives and disincentives, consistent executive attention and other measures calculated to prevent trouble may be far more important, and far more useful, than anything in the lawyer's bag of tricks.

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[2] Depending upon the technical solution, and the extent to which these plans rely upon internal or third party capabilities, they may provide the basis for contingency planning if the supplier runs out of money and ceases operations on short notice.