



Outsourcing: Key Issues

Outsourcing (and its younger sibling, offshoring) is a maturing business practice. Yet all too often – especially in turbulent economic times – it is still seen as a panacea for all management ills and a way to realise a quick win by slashing costs.

It is important for any organisation contemplating outsourcing any of its functions to be clear about:

- what it expects to achieve from the outsourcing
- how it will measure the benefit, and
- how it will manage the process and the ongoing relationship to realise that benefit.

What is "outsourcing"?

As good a definition as any is:

The transfer of an in-house function to an external service provider for the on-going provision of those services, typically involving the transfer (often for value) of physical, real and intangible assets and people...

... and then moving the services to another provider or back in-house

The sting in the tail - the need to plan at the start for the ending of the relationship - is commonly forgotten in the flurry of activity involved in setting up the deal in the first place.

So outsourcing involves an organisation - be it a company or a government agency - deciding that a function it currently carries on itself could be better run by a third party. The reasons given generally include cost saving, the desire to obtain a more flexible service or to avoid having to manage the service directly. The range of services which are outsourced is vast. It used to be said that organisations should only outsource peripheral functions - such as catering, security, cleaning and technology - but this maxim is now ignored in practice. Organisations are increasingly outsourcing what would once have seemed to be core or business-critical functions - for example their back-office activities.

The risk implications of this have been picked up by various regulatory bodies, particularly in the financial services sector, where the regulators generally impose obligations on institutions to maintain adequate control over outsourced functions – but are often vague as to what constitutes an appropriate level of control. There is frequently tension between the need to allow a service provider to get on and provide the service in the best way it can and the need to impose adequate regulatory control to satisfy the financial institution's own obligations, which it cannot of course simply delegate to the service provider. In the light of the recent momentous changes in the banking world, it remains to be seen whether the global regulators' attention will move to other aspects of the banks' behaviour or whether how they manage their risk in outsourcing deals will remain an issue.

What is "offshoring"?

Many deals, particularly technology related ones, have a multi-jurisdictional element. Typically, the parties agree a master agreement for their global relationship and then have country specific subordinate agreements. However, the term "offshoring" tends to be attached to the situation where an organisation transfers the provision of a function - such as call centre services or application development - from its domestic jurisdiction to a much cheaper one. Cost is not the only issue, although it tends to be the principal driver. India has been one of the biggest recipients of call-centre and applications development work (at least from the English-speaking world), with the Philippines, Malaysia, China and Russia amongst the other countries vying for this work. US-based organisations have looked to other NAFTA countries for off-shoring, with Caribbean nations such as Jamaica also looking to benefit.

Concerns over the management and risk issues of off-shoring to distant jurisdictions has given rise to a variation on the theme: "near-shoring" where a more proximate, but still cheaper, country is chosen. As the former Eastern Bloc countries accede to the European Union treaties and invest in infrastructure and training, they have become popular venues for "near-shoring" from Western Europe.

Another reaction to the issues of off-shoring has been the tendency (as least as regards maturing markets such as India) for providers of services to set up "onshore" establishments in their target customer countries, such as the UK, to provide both a level of comfort and a method of communicating issues in the same time-zone.

The key issues to be considered, from a legal point of view, in relation to an off-shoring include:

- Deal structure: does the customer wish to establish its own, dedicated facility in the relevant jurisdiction? If so, will it own this directly (or via a local subsidiary) or simply provide in the contract with the service provider that dedicated facilities must be established? Are there local legal restrictions on the ownership of such subsidiaries/facilities by foreign entities? Would a "BOT" (Build Operate Transfer) model be better, so that ownership of the facility would pass to a local company after a set period of time?
- Assuming that there is to be a services contract with an indigenous service provider rather than the creation of a local subsidiary, should this be under local law or the law of the customer? Are there mandatory provisions (such as the hours which female staff may work, as was the case in India) which need to be taken into account? Should the contract be with a (say) Indian service provider or its European or US counterpart, with a sub-contract "behind the scenes"?
- Whichever structure is adopted, will there be tax issues for the customer? For example, there was at one point considerable uncertainty about whether having a call centre in India could amount to the establishment of a taxable presence there.
- Data privacy: are there restrictions (as in the EU) on the transfer of personal data to the chosen off-shore location? If so, can these be addressed by contract or by consent from the individuals concerned (eg the customers of a bank wishing to off-shore its data processing)?
- Regulations: do regulations (such as apply to financial institutions) prohibit off-shoring or impose requirements on the parties? These could relate to business continuity, security,



audit and reporting, exit provisions and other key issues.

- IPR: does the off-shoring location give adequate protection to the intellectual capital of the customer, to the extent that valuable IPR or know-how is to be transferred to the off-shore facility?
- People: are there employment law issues which may affect the ability of the customer to shut down its domestic facility and "export" the jobs? In EU countries there may be requirements as to consultation and the payment of compensation which will affect both the timing and the economics of the deal.
- Changing supplier: how, practically, will the customer deal with the termination of the contract and the transfer of the services to an alternative service provider - which may be in another country?

Of course, many of these issues have a commercial and political element to them. There have been moves in the US to impose restrictions on off-shoring which would inhibit the growth of this practice. In the UK, the government view is that it should not act to restrict trade by blocking off-shoring. However, union pressure has led to one major bank agreeing that it will make additional payments to employees made redundant as a result of off-shoring. Two other large UK financial institutions have stated that they will not consider off-shoring, seeing it as being an issue which worries their depositors.

Commercially, the savings from off-shoring need to be off-set against increased management and communications costs and the risks involved in delegating what may be a business-critical function to a distant service provider. Of course, the economic and political stability of the off-shore location, and the future availability of a low-cost workforce, also have to be considered.

What are the principal issues?

1. Who writes the contract?

Generally, the customer (ie the organisation with the in-house function it wants to outsource) issues the draft contracts to the potential service providers. This puts an onus on the customer to be reasonable: an outrageous contract will not attract realistic bids. The customer also has to be aware the bidders' cost of bid will be high and that legal costs incurred in the early part of the process will be seen as very speculative investment by the bidders.

2. What needs to be done up front?

Due diligence is the key:

- the customer should do its own homework on the assets it has which may transfer to the successful service provider. These could be the equipment and contracts (eg software licences) it uses and (particularly in the EU) the human assets - the people who may also transfer. The customer needs to collate and control the dissemination of this information, so as to be clear about the basis of any decisions the bidders are making as to the pricing of the deal and the service levels they can commit to, and to protect its own confidentiality. Many third party contracts will have prohibitions on transfer to (or even use by) an outsourcing service provider and suitable consents will be needed. The earlier this process is started, the less scope there is for last minute hitches.
- the prospective service provider (or bidders, in a competitive situation) should of course also be clear about what they are

taking on. There is an argument that this can be left till after service transfer, but our view is that this can lead to misunderstanding and disputes.

3. Structuring the deal

Generally the parties enter into two agreements - a Transfer of Assets agreement and the on-going Services Agreement. However, where (as indicated above) the deal is multi-jurisdictional, this simple structure may be replaced by a master agreement with country-specific local agreements, perhaps between the principals' local subsidiaries or sub-contractors.

Where there are multiple service providers, perhaps where each is providing an element of the services, the parties also need to consider whether one service provider should take on the role of prime contactor or whether a more complex consortium arrangement should be entered into.

Sometimes the parties will create a joint venture with a special purpose vehicle to act as repository of the transferring assets and as primary provider of the services. This is usually only where there is the need to create a tax efficient structure or where a provider of external finance insists on this approach.

4. Agree the services and the service levels

Timing pressures can make it tempting to go live on the deal on the assumption that the parties can agree the services to be provided and the standards to be attained after the event. In practice, this is a dangerous approach for both customer and service provider. Although an outsourcing is not a "partnership" in the sense of two parties having identical interests, it is a long term relationship and, like most relationships, works best when the parties understand what is expected of them. This means the services and service levels should be clearly and precisely expressed by the time the deal goes live.

5. Allocate risk and reward

Coupled with setting out what the parties' obligations are is the need to address what happens if one of them - usually the service provider - does not meet its obligations. Generally, the parties will agree a mechanism for avoiding such issues leading to major disputes. The contract should contain provisions for the payment of service credits for service failures and for escalating and resolving disputes. Given the increasingly business-critical nature of outsourced services, the parties will also need to consider what happens if service credits do not sufficiently address the consequences of service failures. Short of terminating the agreement or suing for damages, the parties may want to agree other specific remedies, such as the repeating of services or the provision of free consultancy, as well as more direct financial compensation.

Allied to the issue of risk allocation in the context of business-critical services is the question of the degree to which the service provider will accept liability for business losses, such as lost profit. This is always a controversial subject for negotiation, as is the issue of what the financial cap on the service provider's exposure should be.

The opposite side of the debate is reward: where the service provider adds demonstrable value to the customer's business by the provision of service improvements, it would be usual to agree a mechanism for some element of this benefit to be shared. Similar considerations apply where the service provider makes cost savings through greater efficiency.



6. Address continuing value

Outsourcing deals typically last for several years, and 10 year deals are not unknown. Over the life of a contract, not only will the customer's circumstances and service needs change (see below) but it will also be keen to ensure that the charges it pays are reasonable. Of course the service provider has an equal concern to ensure that it makes a profit over the life of the contract, especially if it has to make a heavy up-front investment in taking over and improving the customer's in-house operation.

In these circumstances, long-term fixed-price deals are rare and the parties are likely to agree a means of dealing with inflation and other pressures. The simplest mechanism is to link the charges to a verifiable external index. Care needs to be taken to make sure that the index (or basket of indices) reflects the costs of the service provider - particularly if some of these may actually decline over time.

A more complex way of measuring value is to compare the service provider's charges with those available in the market-place, a process known as benchmarking. This usually involves appointing an independent benchmarker to analyse the service provider's charges and services and compare them with comparable charges and services. Clearly, the more specialised the services, the more difficult it becomes to obtain valid comparators and the parties need to take care to agree what is to be benchmarked and on what basis - and to specify what is to be done with the results of any benchmarking exercise.

7. Provide for change

As the customer's requirements will evolve over the duration of the outsourcing agreement, the parties must agree a mechanism for recognising such changes and implementing them - and the basis of charging for such changed services. This is reasonably straightforward where the change is simply one of scale - more or less of a particular service - as this can often be linked to a variable unit cost. More complicated is where the customer requires the provision of new services, and the contract usually specifies a more formal procedure for this, often involving an element of competition with third party service providers.

The contract should also cover what should happen should there be a significant business change for the customer - for example the acquisition or disposal of an affiliated company.

8. Deal with re-tendering and exit

A pre-requisite for a successful outsourcing relationship is that the parties acknowledge that at some point it will end, and make provision in the contract for this to occur with the minimum of disruption to either of them. This includes considering the circumstances in which either party can terminate, whether this be after an agreed minimum period or on default. The customer may also seek a right to terminate for convenience before the anticipated minimum term, in which case the contract should set out whether there should be a termination payment to reflect any un-recovered investment of the service provider and un-realised profit.

The customer will typically expect to have a right to terminate for poor service or if the service provider is in financial difficulties. However, it should also consider whether it would need the right to terminate (in whole or in part) where there is, for example, a change in ownership of the service provider. The service provider will want to ensure that such rights cannot be abused or used as a pretext for terminating early without paying a termination charge.

Whatever the circumstances of termination, the contract must set

out how the transfer of services to a new service provider (or back to the customer) will be managed. Not only is this best practice for both parties, but it is increasingly required by regulators and others looking at corporate risk. The user should also think about the process of re-tendering, which will take place before the right to terminate is exercised in order to assess whether changing service providers is feasible. To do this exercise in a meaningful way, the customer will need access to information held by the existing service provider.

On termination, the contract should set out the parties' rights and obligations and where the risk and cost of exit are to fall. The customer may wish to have the right to buy the relevant assets of the service provider and to require the transfer of key third party contracts. It will always want to see an orderly transition of service provision.

The detail of how exit will be managed should be set out in a separate, detailed exit plan. The contract should oblige the parties to keep this up to date and to test it periodically, so that both understand what to do should the contract terminate.

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