REAP THE BENEFITS

THINKING OF OUTSOURCING CERTAIN ASPECTS OF YOUR COMPANY'S BUSINESS? NEVER FEAR, **ROBERT SUMROY** AND **DAVID WITTMANN** OF SLAUGHTER AND MAY ARE HERE TO SHOW YOU THE RIGHT WAY.

The outsourcing market in the UK continues to grow at a considerable rate. But as more companies nail their future business strategies to the mast of their outsource suppliers, stories of broken masts and shipwrecked outsourcing relationships continue to wash up in various trade press. Here, we will look at the potential benefits of outsourcing, and the risks that can turn a good business idea into a painful legacy for the future. We will explain how, through the use of appropriate legal provisions, the parties to an outsourcing arrangement can reap the many potential benefits of outsourcing by assessing and ultimately managing those risks.

WHAT IS OUTSOURCING? Outsourcing is commonly used to describe a commercial arrangement under which a company (the customer) transfers a business function to another company (the supplier), who then provides that function back to the customer under a long-term services arrangement. From a legal viewpoint, the arrangement involves a transfer of the customer's assets (and commonly also its employees) used to carry out the business function, followed by a services agreement governing the supplier's subsequent service provision back to the customer.

The outsourcing model is driven by the business principle that excellence comes from specialisation and that, by trying to do all functions, a company will be prevented from excelling at what it does best.

By outsourcing those functions at which a company is not efficient or market-leading, that company can free up capital for, and allocate resources to, its key revenue-generating functions. Historically, customers outsourced only ancillary or non-core functions such as security, canteen, cleaning and the like. However, in the past five years, the trend has moved towards outsourcing any function (even those core to the customer's central business), where there is a supplier which can provide that function more efficiently and/or to higher levels of service.

Customers are nowadays outsourcing front-end functions (such as call centres and manufacturing), back-office functions (such as mortgage processing, account settlement, fund management and custody arrangements), global services (such as telecoms backbone and helpdesk support) and in many cases the whole of the customer's IT function, retaining only a core IT management team to manage the relationship with the supplier.

ADVANTAGES OF OUTSOURCING. An established supplier of the outsourced function will benefit from economies of scale that come from spreading overheads across a large customer base. With these, the supplier can offer to the customer attractive cost reductions. The supplier will be seeking to maintain a competitive service offering to attract and maintain a large customer base. It will be investing in new technologies to maintain a market-edge over its competitors.

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Its commercial drivers will be the provision of improved service quality, while maintaining a competitive charging structure. By outsourcing to that supplier, the customer is exchanging its internal business function, which may have been operating almost entirely free of any true competitive pressures, for this continuously improving, market-leading service offered by the supplier. The customer can then free up resources to focus on its own market-leading services.

Outsourcing arrangements typically involve additional ancillary benefits for the parties. For example, if the supplier is developing a new technology solution for the customer, the customer may seek to receive benefits from the supplier's future offering of that

technology to its wider customer base (for example, by the customer receiving a share of revenues, a rebate on development costs, reduced service fees and the like). Ultimately, the customer and supplier may choose to formalise joint development and exploitation arrangements by establishing a joint venture to carry out the development work and to provide the outsourced services. The customer transfers its assets to the joint venture, as opposed to the supplier, and the joint venture will offer the services into the wider market, as well as providing them to the customer. As a shareholder in that joint venture, the customer will maintain an element of control over the direction and performance of the service provider and will share in any success of the joint venture from providing the services to other customers. Typically, however, these other customers will be competitors of the customer, and they will require legal or practical guarantees that the joint venture will be acting wholly independently from the customer.

RISKS OF OUTSOURCING. The main risks to the customer of outsourcing core business functions flow from the loss of control and accountability for the supply of that function. Before the outsource, the customer could bring to account any under-performing element of its service function. It could control the levels and scope of services and could make decisions to increase or withhold investment in its infrastructure without recourse to a third party. Now that the function has been outsourced, many of these issues will be legislated for in the outsourcing contract.

The contract will state the scope and levels of services beyond which the supplier is not legally obliged to perform. The supplier's annual obligations to invest in related technology will be fixed. Accountability for errors will be channelled through a fixed and formal project management process. If the customer wishes to change any of these contractual controls, they will be required to lodge a change request through the contract change management procedure – and to foot the bill for the extra incurred costs. This will be an acute concern where changes in technology, law, regulation or market conditions mean that the customer's requirements have changed fundamentally from those at the outset of the arrangement. With an in-house function, the customer is free to make unilateral changes to its business strategies to address these changes. As an outsourcing customer, he or she is now subject to the rigidity of the outsourcing contract.

Another risk of outsourcing is that, while the supplier may be a leader in its field, it may not fully understand the needs and culture of the customer's business. The cheapest or most efficient supplier is not always the right choice for a customer. Issues of corporate culture, brand values and employee concerns will also have to be taken into account when selecting the right supplier. In any event, there will always be an inherent conflict of interests between the supplier and the customer. The customer's aim is to get good service for a competitive price, while requiring little actual involvement for the customer's management or staff. The supplier needs to make a sufficient margin, so it will want to pass investment costs to its customer, and will have the interests of the customer to weigh against its own needs and those of its other customers.

There are further risks relating to the allocation of personnel following transition. The supplier will want to take the customer's best staff to provide the services back to the customer. While this will benefit the customer in the short term (because those staff will be available to provide the services back to the customer) they will need contractual comfort that those staff will continue to be available to the customer in the longer-term. It is a common customer complaint that their 'A' team has been re-assigned within the supplier company to provide services to the supplier's latest new customer, with the customer having to make do with a replacement and sub-standard 'B' team. However, the more control the customer seeks to place on the supplier's operations, the less the supplier will be able to impose its own skills and resources on the outsourced function to get the benefits for the customer that underpin the original decision to outsource.

Finally, there is the disruption to the customer's business. Both on the transition to the supplier's service provision at the outset and when the outsourcing arrangement comes to an end, when bringing the assets and employees back in-house or selecting and transitioning to a new supplier can disrupt the customer's ability to perform its core retained functions.

ADDRESSING THE RISKS. The challenge for all parties is to address these risks, while still meeting their respective key concerns. The outsourcing contract has an important role to play in achieving this.

ASSET TRANSFER. Part of the contract will deal with the asset transfer. This will define the assets and employees to be transferred and the price for that transfer. As the supplier is likely to recoup any transfer price as charges under the services arrangement (with an added margin) the customer is usually happy to accept little or no consideration for the asset transfer. The asset transfer agreement will also deal with the procurement of any third-party consents required to transfer the assets (for example, software licences, leased premises and equipment) and for the supplier's continued use of those assets. The pre-transfer due diligence process is key in ascertaining which assets and employees can and should be transferred, and which of them the customer will need for its retained business functions and what consents are required. There may be a need for transitional requirements under which the customer provides certain services or functions to the supplier (such as payroll, technical support, wide area network access and the like) for the supplier to use to provide the outsourced function back to the customer until such time as the supplier can make alternative arrangements.

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SERVICES. The key contractual terms will appear in a services agreement, which will act as an instruction manual throughout the term of the arrangement, directing the parties as to their rights and obligations throughout the various stages of the relationship, such as:

- transition of the services to the supplier;
- transformation to a better scope and level of services as the supplier imposes its skills and systems;

- stable state during which the customer continues to receive high quality services; and
- exit during which the parties effect an orderly transfer of the services back in-house at the customer or to the customer's replacement service supplier.

For each of these stages, the agreement must set out in detail the services to be provided, the service levels to be achieved and the charges to be paid. The charging structure will be bespoke to each deal, and may be constructed from various models: for example, fixed charges, floating and capped, costs plus a margin – although it is unlikely that a supplier will want to give details of its costs or required margin. Whatever deal is struck on price, it needs to work both for the customer and the supplier: a customer is unlikely to get market-leading services from a supplier which is constantly having to cut corners to keep within a tough charging deal.

During transition, the supplier is unlikely to accept any more onerous terms on services, service levels and charges than those applying prior to transfer within the customer, because there will be the same employees using the same systems to provide the same services. The agreement may provide, therefore, for an initial period of interim arrangements matching those applying internally within the customer prior to transfer. This highlights the importance of the due diligence exercise, prior to transfer, to ascertain what those pre-transfer services, service levels and prices were.

CHANGE MANAGEMENT. Once the service requirements and charges are fixed in the contract, the parties will need an appropriate change management process to manage changes requested by the customer or the supplier, or imposed by changes in law or regulation, and to legislate which party will bear the related costs. The customer will also want a right to benchmark the services and charges against the market, to ensure the supplier is remaining competitive. In practice, the benchmark process can prove difficult to define and enforce. How can it be ensured that the services, charges, customer and supplier are being compared against equivalents in the market? Is the supplier to be benchmarked against the best in the market, a mean or a higher percentile? If the supplier fails the benchmark test, will it be required to lower prices or improve performance, or will the customer be given a right to seek those services from elsewhere? Although fraught with these difficulties, benchmarking is often the customer's only effective way of keeping the supplier competitive over the term of this long-term arrangement.

CONFLICTS AND DISPUTES. The parties will be in contact on a day-to-day basis and, inevitably, differences of opinion, conflicts of interest and other disputes will arise. The parties will need a practical process for escalating and resolving those disputes that will avoid the need for either party to resort to the courts. If independent arbiters are required, the parties should seek an expert opinion on technical matters. Termination would require the customer to 're-insource' or replace the supplier, and the customer will want to avoid the disruption this can bring.

Instead, the parties will agree effective and practical remedies, such as service credits against future charges for failure to meet service levels, and 'step-in' rights to enable the customer to have a direct impact on management of the supplier's service provision while the breach is being remedied. These remedies will enable the customer to receive compensation for its loss and comfort that the breaches will end, while enabling the supplier to remedy the breach, with a view to maintaining the long term relationship. The supplier will not want to be 'haemorrhaging' service credits while in breach, and will want to negotiate an appropriate cap on these remedies.

If termination is required, the customer may want the option to terminate only those services that are failing to meet the contractual requirements. Such a partial termination may reduce disruption for the customer, but may not be acceptable for a supplier which has based its price and service offering on the whole proposal, and would not want the customer to 'cherry-pick' the best bits. The parties should agree at the outset which service portions (often referred to as 'service towers') may be terminated without terminating other services or the agreement as a whole, and any increases in the charges that will apply for the remaining services to ensure that the supplier can continue to make its required margin on the deal. It is common for the customer to negotiate a right to terminate (including partially) for convenience, so that an arrangement that is no longer fulfiling the parties' expectations can be ended or curtailed without the need to wait for breach. The supplier will have built a charging model in which its overheads are recouped in the early years, with the later years bringing its margin. There is therefore likely to be a charge for the customer to 'buy' an early exit from the arrangement for convenience.

Whatever the reason for the arrangement coming to an end (including simply the expiry of the term), the customer will expect the supplier to continue to provide services and assistance for a limited period to support the customer while it brings the function back in-house or selects and outsources to a new supplier. Periods of a year or more are not uncommon, reflecting the time it takes to select and transition to a new supplier. There are a number of issues to be addressed:

- for how long will this support continue;
- who will pay for the assistance;
- will service credits and other remedies continue to apply;
- will the new supplier be given access to the supplier's systems and methodologies; and
- who will control the development and implementation of an exit plan?

As the parties may be in dispute at the exit stage, the exit principles should be agreed and inserted in the contract prior to contract signing.

RISKS AND BENEFITS. The risks for a customer of outsourcing its core business functions are clear. These are driven mainly by the loss of accountability in respect of the outsourced function and the inherent conflict of interests between the customer and the supplier. However, it is also clear that outsourcing as a business strategy can deliver substantial benefits to customers in terms of lower costs, improved service offering and access to market-leading technologies. The challenge for both customers and suppliers is to assess, manage and ultimately reduce those risks, through due diligence, and the adoption of clear and detailed contractual provisions.

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