

Get It Right the First Time

Seven Rules for Making Your Outsourcing Successful

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Outsourcing—once an obscure idea considered to be the domain of information technology professionals—has now arrived as a mainstream business strategy that is on the agenda of all senior management.

Industry analysts continue to predict explosive growth in the outsourcing marketplace—not only in the number of deals and dollars spent on the outsourcing of information technology, but, more recently, in the breadth of services outsourced, extending beyond information technology to business processes, application development and, increasingly, even to strategic business functions.

Companies outsource for a variety of reasons, including a desire to reduce costs, obtain better levels of service, improve core business focus, provide access to state-of-the-art technology and offload the less stable portions of their workforces.

But how often does an outsourcing arrangement deliver on its promise? Formal statistics are difficult to come by, but the figure typically cited by industry experts is that at least 50% of outsourcing arrangements fail within the first year, and that a much higher percentage are renegotiated prematurely because the relationship is not meeting the business objectives of either the customer or the vendor.

The risks associated with most outsourcing arrangements are significantly greater than those associated with other transactions, even large-scale technology development projects. Outsourcing means turning over a critical technology resource or business function (or sometimes both) to a third party with business objectives that are distinct from, and not always compatible with, those of the customer. An outsourcing relationship is like a marriage—relatively easy to get into, but once fully implemented, highly complicated and difficult to undo.

What is the key to a successful outsourcing relationship? Executive support, ongoing management and control over the vendor, appropriate vendor selection, a detailed and workable plan to transition operations, assets and employees to the vendor and a viable exit strategy are all important factors. But discussions of key success factors often overlook a critical component of the outsourcing relationship: the process of negotiating the outsourcing contract with the vendor.

Surprisingly, the contract negotiation process, a fundamental part of the outsourcing transaction, is rarely identified as a significant stage in the establishment of an outsourcing relationship. But from the perspective of the company engaging the vendor, effective contract negotiation

has three important benefits. It enables the company to (a) clarify its expectations of its relationship with the vendor and to identify early on any significant discrepancies between its expectations and the vendor's expectations, (b) negotiate the best business deal possible with the best vendor and (c) minimize risk by taking steps to protect itself in the (not unlikely) event that the outsourcing relationship fails to meet the company's expectations.

This article sets out seven rules that a company should follow when negotiating an outsourcing arrangement. Following these rules will assist in reaping the benefits that the company identified as the reasons for deciding to proceed with the outsourcing. Ignoring these rules will increase the likelihood that an outsourcing relationship will end up in divorce or, at a minimum, that marriage counseling will be required.

RULE #1: PREPARE A DETAILED TERM SHEET BEFORE VENDOR SELECTION AND NEGOTIATION

Once a company has made the threshold decision to outsource certain of its operations or business processes, the next step is to establish and set out in detail the business terms upon which the company has decided to proceed with the vendor it eventually selects. This requires a greater level of detail than was contained in the outsourcing proposal presented to the executive team for approval.

A great deal has been written about the need for a company to define its functional, performance, technical and operational requirements before embarking on an outsourcing initiative. Detailed requirements should be established in advance to ensure that both parties understand what is expected. The first step in being able to do this is for a company to understand its existing operations—the functions performed by the business unit to be outsourced; the technology, human resources and other resources used by the business unit; the service levels achieved; the unit's operating costs; and the relationship with other business operations within the company, to name a few. Without an understanding of a company's current state, it is next to impossible for the company to understand its own business objectives, define appropriate requirements for the vendor or evaluate the success of the outsourcing initiative. In addition, the process of establishing detailed requirements often reveals issues that can easily be addressed when the relationship is being structured,

but that become more costly to address later on.

But a description of detailed requirements with corresponding pricing is only one piece of a much more complex business deal between a company and an outsourcing vendor. There are many significant business terms that are relevant to the company's business needs and to the vendor's ability to commit to a price. The company should address terms such as

- the proposed term of the arrangement;
- the process for the transition of the operations to be outsourced from the company to the vendor;
- the remedies, financial or otherwise, that the company would require if the transition to the vendor is late;
- the vendor's obligations to retain transferred employees, and who bears the risks associated with employee termination;
- the project management, reporting and other governance mechanisms that the company requires to maintain control over the outsourced operations;
- the company's requirements for technology support;
- the company's requirements for updating and refreshing the technology platform;
- the service levels that the vendor must meet and the company's remedies should the vendor fail to meet the required service levels—and whether the company expects the service level requirements to increase over the term of the agreement;
- whether the company expects the vendor to deliver and pass on to it cost savings over the term of the contract;
- the rights of the company to benchmark the vendor's performance, and the remedies available to the company if the vendor's performance falls short;
- the ability of the company and the vendor to change the scope of the services, and how those changes will be priced;
- the circumstances in which the company can terminate the outsourcing relationship, and the financial consequences of termination;
- the ability of the company to reacquire the transferred assets and human resources upon the termination of its relationship with the vendor;
- the ability of the company to continue to use the technology or make a transition to an alternative service provider upon the termination of its relationship with the vendor;
- the privacy, security and intrusion standards that the vendor must meet—and the extent of the vendor's obligations to perform third-party security and business process audits and testing;
- whether the company requires the vendor to maintain a disaster recovery facility, and if so, what the company's requirements for testing and recovery time are;
- what will happen and what access the customer will have to the vendor's technology, should the vendor go out of business;
- the steps that the company requires the vendor to take to protect the company from the possible insolvency of the vendor;
- who owns the technology developed by the vendor;
- if the vendor is to own the technology, the scope of the company's rights to use it and/or license it to others;
- whether the company requires the vendor to agree to a non-competition provision;
- whether the company is bound to use the vendor

- exclusively for any present or future services; and
- which party is liable for intellectual property infringement.

These are just some of the significant business issues that may affect a company's choice of vendor or decision to move forward with an outsourcing. For example, a company may decide that it will not outsource a particular technology function unless the vendor will commit to provide minimum annual increases in cost savings to the company, or to achieve minimum increases in service levels in each year. A company may decide that it is not willing to restrict itself to a single vendor on an exclusive basis. Some companies may not be willing to outsource services that involve a development component unless they will own the technology developed.

Some companies do not take the time to reach an internal consensus regarding the business terms upon which they are willing to proceed with an outsourcing arrangement before sending out a request for proposal ("RFP") to vendors (see Rule #2 below) or before negotiating with a selected vendor. This can lead to unpleasant (and sometimes insurmountable) surprises as the negotiation unfolds, resulting in wasted time, resources and money. A company that sets out its requirements in a detailed term sheet will be much less likely to encounter surprise "deal breakers" that can affect the company's expectations relating to price, schedule or other business requirements.

An experienced adviser can be a real asset at this stage in the process. Having been involved in many similar deals, he or she will

- know the important issues to consider;
- be able to help the company identify a range of creative approaches that address the company's needs;
- know what is commercially reasonable and what positions specific vendors will take on issues; and
- know through experience which approaches are likely to work.

While company staff know the company's business best, they may not have the experience that comes with participating in many outsourcing deals.

RULE #2: USE THE RFP PROCESS EFFECTIVELY

Company procedures often require the use of an RFP for the vendor selection process. Only a few use it to full advantage.

Many RFPs do not set out the company's requirements for the outsourcing relationship at a level of detail that enables a vendor to provide a firm commitment on timing and price. Still fewer RFPs include details of the other significant terms of the business deal proposed by the company.

Ultimately, RFP responses will be as meaningful as the contents of the RFP. Although an RFP may contain a detailed set of the technical or operational requirements for an outsourcing, if it does not also include the other significant business deal terms required by the company, the vendor will quickly shy away from any commitments contained in its RFP response once negotiations commence; the unarticulated business terms affect the vendor's cost to provide the services and the degree of risk that the vendor must assume to provide the services.

In an effort to prepare an RFP that sets out the key terms of the business deal, some companies include their standard form agreement and ask vendors to indicate their willingness to

agree to each provision of the agreement. The rationale underlying this approach is at first glance persuasive: vendors are likely to be more willing to make concessions in favor of the company while bidding for the project, and less likely to do so once the project has been awarded to them. But unless the agreement has been customized to accurately describe the business deal that the company is seeking to enter into, the inclusion of the agreement might do more harm than good by binding the company to contractual terms that are not appropriate. Outsourcing contracts describe unique deals that do not lend themselves to the use of a standard contract. Even if the parties begin with a standard form, they will likely need to customize it substantially before contract negotiation is complete.

A customized term sheet can achieve the desired goal because it clearly sets out for the vendor the business terms that are the most important to the company. While it does not stop the vendor from attempting to renegotiate terms once contract negotiation is underway (or stop new issues from surfacing during the negotiation process), a detailed term sheet will reduce the number of surprises following vendor selection, paving the way for a smoother, quicker contract negotiation.

RULE #3: GET THE RIGHT PEOPLE TO THE TABLE

This rule might sound easy to follow, but in an outsourcing, getting the right people to the table (to represent both the company and the vendor) is one of the biggest challenges to a successful contract negotiation.

Outsourcing contracts must articulate the technical and operational details of the business relationship. Many of the company staff who have the expertise and knowledge to determine the company's business requirements are responsible for the company's day-to-day operations and may not be available to take part in contract negotiations. Even if these individuals can be spared for the contractual process, they may not have the experience or skill required to draft or negotiate contracts.

Assembling the right negotiating team also presents a second challenge unique to outsourcing. Frequently, the employees who have the requisite technical or operational knowledge of the business required to negotiate the deal are the very ones to be transferred to the vendor once the deal is complete. So, for example, the company employees in the best position to negotiate appropriate service level commitments are the ones who will be responsible for meeting those commitments on behalf of the vendor.

What should a company do to address these challenges? While there is no foolproof answer, there are steps that a company should take to involve the right people. First, the company should identify the people within the organization who have the expertise needed to negotiate the contract—avoiding, to the extent possible, using individuals who will be placed in a conflict situation. Next, the company should determine when and how to involve these people in the process. The right approach will vary, depending on the company's needs. In some cases, the individuals should assume responsibility for preparing documents or should participate in the negotiations; in other circumstances, it may be necessary to retain the assistance of external advisers, such as consulting engineers with experience drafting contractual documents. Here, too, an experienced adviser with an understanding of the company's business and the technology involved can make a

valuable contribution by identifying and drafting the business terms.

RULE #4: ALLOCATE ENOUGH TIME FOR CONTRACT NEGOTIATION BEFORE IMPLEMENTATION IS SLATED TO BEGIN

"We sent out the RFP last week. We will be making a decision by the end of this week, and we want the contract signed by the end of the month".

This is a statement I frequently hear from clients, and these timing imperatives have become increasingly shorter in recent years as the Internet has skewed perceptions about the importance of speed to implement to a company's success.

In many respects, the relationship between a company and an outsourcing vendor is like a marriage. The relationship is a long-term one, it is critical to the happiness and success of the parties involved, and its termination would be traumatic and costly. The parties must be compatible and their goals must be aligned if the relationship is to succeed. Most people would not rush into a marriage without first getting to know their prospective spouse. Why, then, do companies often rush into relationships with vendors?

The answer lies in part in the fact that, to most of the people making decisions about the outsourcing, the technology or operational details of the business being outsourced are unfamiliar. Just as most of us have no idea what is involved in performing renovations on our house or fixing our car, most of us are not in a position to fully appreciate the complexity of an outsourcing or to assess the capabilities of prospective vendors. Add to this the natural excitement that tends to surround new strategic alliances and their potential for breakthrough results, and we have a dangerous combination that often leads to unrealistic expectations and commitments.

Taking time to select a vendor and negotiate a detailed contract will reduce the total implementation time and increase the likelihood of success. The time required for contract negotiation depends on the nature of the outsourcing and the resources available. An experienced adviser can help to identify the steps and map out the contract time line. Typically, negotiations for a major outsourcing may take several months. But it will be time well spent, ultimately resulting in time and money saved.

RULE #5: BEWARE OF THE LOI!

Many companies that will not permit a vendor to begin work on an outsourcing implementation without a contract in place will resort to a letter of intent ("LOI") in situations where the company wants the vendor to start before contract execution. In most cases, however, any protection that the company believes it has by virtue of the execution of a letter of intent is largely illusory.

The LOI means different things in different contexts. In most cases, it is little more than an expression of the parties' intention to attempt to negotiate a business deal and enter into a legally binding agreement if the parties are able to reach an agreement as to the business terms. In many cases, an LOI will set out some terms of the business deal that the parties agree should form part of the agreement they intend to negotiate. In some cases, an LOI contains binding terms, such as an obligation to negotiate on an exclusive basis for a specified period of time or an obligation to keep confidential any

discussions and information exchanged during negotiation.

Regardless of the exact form, however, a letter of intent is little more than an unenforceable agreement to agree; it does not provide assurance that a business deal will be successfully negotiated. A company that permits a vendor to commence an outsourcing implementation on the basis of a letter of intent is no less exposed than the company that permits the vendor to commence the implementation without any documentation in place. Although the parties may have clarified their expectations for a few of the key terms of the business deal in a letter of intent, the parties do not have a business deal that governs the work that is already under way.

As an outsourcing implementation advances without a contract in place, the consequences of breaking off negotiations become more severe: the company loses both the ability to "walk away from the table" and the leverage to negotiate its desired business terms that accompanies this ability. Often the company ends up with a contract with the original vendor on business terms that are much less favorable than what the company had desired.

RULE #6: NEGOTIATE AS A PACKAGE

The value of a business deal should be assessed in its entirety, and negotiation should be a process of give and take: where one component of a deal's value is conceded, an element of corresponding value should be gained. But while most vendors seem to be adept at assessing and negotiating a business deal as a package, many companies negotiating outsourcing transactions with vendors often find themselves resolving each issue separately, arriving at a result in which the company has conceded on virtually every point and has received almost nothing in return. While each concession may have seemed small, the incremental effect often sees the company in a worse position than it originally anticipated.

Vendors are often better at negotiation because negotiation for the vendor is a simpler mathematical exercise than it is for the company engaging the vendor. There is a cost to the vendor for each commitment it is being asked to make. The vendor can add up the cost to perform its obligations, compare the total cost to the fees that it will receive and judge whether or not the deal is sufficiently lucrative. For the company engaging the vendor, however, the analysis is rarely this straightforward. It is difficult to attach a dollar value to the receipt of strong service level commitments. But the company should do its best to determine whether the total package it is receiving from the vendor is worth what it is proposing to pay for it.

RULE #7: TREAT ALL ISSUES AS BUSINESS ISSUES

It is common for business executives and lawyers to view a contract as being composed of business terms and legal terms. In some cases, companies may go so far as to split negotiations, excluding lawyers from the discussion of what are perceived to be business issues and confining the role of the lawyer to the negotiation of the legal terms with the vendor's counsel.

While it is true that some contractual terms are more legal in nature than others, all contractual terms are ultimately business terms that affect the value of what the vendor is committing to provide. Moreover, decisions relating to the perceived legal terms of the contract affect the meaning and scope of the perceived business terms, and vice versa. For example, the definition of *force majeure* is typically left to the

lawyers to negotiate as a legal issue. But the definition can have far-reaching business implications, as it lists the circumstances under which the vendor will not be responsible for failing to perform its obligations. Many vendor standard forms will include as part of this definition a failure of third-party suppliers. But a company may take the reasonable position that a vendor should take responsibility for managing its supplier relationships in a way that enables it to meet its obligations to its customers, and that therefore the failure of a vendor's supplier should not excuse the vendor's failure to perform its obligations to the company. Whatever position the company decides to take on this issue, the issue affects the value of the commitment that the vendor is making. It is therefore a business issue that should concern the company—not just the company's lawyers.

CONCLUSION

When your company embarks on an outsourcing initiative, keep in mind the following points to help avoid surprises as the project unfolds:

- Prepare a detailed term sheet before vendor selection and negotiation and include it as part of the RFP.
- Use the RFP process to set out the key terms of the business deal.
- Involve the right individuals in the contract negotiation process from the beginning.
- Take the time to select the right vendor and negotiate a contract before the implementation begins.
- Don't rely on a letter of intent to begin the implementation.
- Negotiate all terms of a business deal as a package and decide whether the package is worth what the company is proposing to pay for it.
- Treat all contractual terms as business terms that affect the value of what the vendor is committing to provide.

The process of contract negotiation is key to the success of an outsourcing relationship. By following the seven rules discussed above, a company can minimize the time, money and effort it expends in managing its vendor, and increase the likelihood of success. ■
