

NEGOTIATING KEY TERMS OF THE OUTSOURCING DEAL

By

C. Ian Kyer

Fasken Martineau DuMoulin LLP

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An Overview

In essence, an IT outsourcing transaction consists of two distinct parts. First there is the acquisition by the service provider of all or part of the IT assets of the customer. Second there is a long-term service contract where the supplier uses those assets and others that it contributes to provide the service that the customer formerly provided internally.

The first part of an outsourcing transaction, namely, the acquisition of the customer's IT assets, is similar to the purchase and sale of a division of a company. The same legal issues arise with respect to transfer of title in IT assets as arise in any such IT acquisition. What assets does the customer actually own? What IT assets are licensed? What are the terms of the licenses? Can the third party licenses be assigned or even used by the supplier? How are the employees of the customer to be dealt with? What about the lease for the customer's data centre or network operating centre? Does it permit the supplier to assume the lease or share the premises? These are important issues but they are seldom the key issues in the outsourcing deal.

The more challenging aspect of an outsourcing transaction is the long-term service contract. Often these contracts run for a period of seven to ten years. Especially in the modern business environment, that is a very long period of time. Such a contract term is likely to entail significant changes to the customer's business. During that time period, there might well be a merger or a divestiture. There might well be some form of corporate reorganization or refocusing of the customer's business. Thus one of the challenges that is faced by the lawyer in negotiating and drafting the outsourcing agreement is how to deal with this inevitable change. Clearly there is a need for flexibility. There is also a need for the parties to deal effectively with each other over a long period of time. Communications and reporting become very important as does change control and problem solving. The lawyer's challenge, in part, is to facilitate this long-term relationship.

Putting the Issues in Perspective

The most difficult issues that arise in the outsourcing transaction involve pricing and service levels and how the parties measure performance and adjust for changes in the customer's needs and the business and technology environment in which they are operating. In addressing these issues it is important to understand the different perspectives of the supplier and the customer and their respective needs and wants.

The customer's needs and wants are more intuitive than those of the supplier. The customer is turning to the supplier for its expertise in providing service and dealing with technology issues in a professional, cost effective manner. Essentially, the customer wants the supplier to assume responsibility for the operation of all or part of its IT functions. The customer, however, is dependent upon those functions for the success of its business so it wants to be sure that it gets quality service and that it does not pay too much.

The supplier, obviously, wants a long-term, financially advantageous relationship. Given the current competitive environment this is no small feat. The supplier is often required to purchase the assets of the customer's IT operations, which means a potentially large out-of-pocket payment at the beginning of the contract. They also have to incur the cost of setting up the new IT operations, which will involve assuming some of the customer's current obligations to employees, licensees and landlords and adding people equipment and infrastructure as appropriate. These up-front costs constitute an investment by the supplier in the relationship. That investment needs to be repaid with an appropriate return from service fees over the life of the contract. This is one of the reasons why suppliers need a long-term relationship. At the same time the supplier has to be concerned about any threats to that return such as any financial penalties for failure to meet service levels and any re-pricing or re-scoping of the project based upon benchmarking during the course of the contract. All of these pose threats to the supplier's profitability and the return on its investment.

The Lawyer's Starting Point

In preparing for the negotiation of an outsourcing agreement it is essential that legal counsel know precisely what it is that their client needs and wants out of this relationship. It is not enough for legal counsel for the customer to be able to recite the ten principal reasons why companies outsource, he or she needs to know precisely why his or her client is outsourcing. Understanding the client's goals and its priorities has got to be the lawyer's starting point. This involves establishing a list of the client's goals and then ranking those goals in accordance with their priority to the customer. At the same time legal counsel for the supplier needs to understand the business model that the supplier is using to price the outsourcing transaction. Without this background it is impossible to do a good job in representing your client. Invariably an outsourcing transaction involves give and take. You need to know what you must have and where you can afford to give in order to achieve that with the other side.

Top ten reasons companies outsource

1. Reduce and control operating costs;
2. Improve company focus;
3. Gain access to world-class capabilities;
4. Free internal resources for other purposes;
5. Resources are not available internally;
6. Accelerate reengineering benefits;
7. Function difficult to manage/out of control;
8. Make capital funds available;
9. Share risks;
10. Cash infusion.

Source: Survey of current and potential outsourcing end users.
The Outsourcing Institute Membership 1998.

Once you understand what your client needs and wants, it is important to give some thought to what the other side needs and wants. This permits you to better prepare your client and your self for the negotiations that will develop around the friction points where the needs and wants of the parties clash. To the extent that difficulties arise over an issue that you did not anticipate would be troublesome, remember to ask WHY. You usually cannot solve a problem you do not understand.

Scope/Change Control

One very important area of concern to both customer and supplier is the scope of the work to be undertaken. It is almost impossible to properly price an outsourcing transaction until you clearly define what is the scope of the work to be done. Establishing what is in the scope and what is out of the scope is important to both parties. For the supplier, defining what is “in scope” clearly delineates what they are promising to do. For the customer, it is important to understand what they are getting for the agreed-upon pricing and what will be charged as out of scope, often at time and materials rates that are not as competitive as the agreed-upon contract prices.

Having established what is in scope, it is very important to put in place an appropriate change control mechanism to permit changes to scope over time. As noted above, over the course of an outsourcing contract it is likely that the business of the customer will change. In addition, technology and what the competitors of the customer are doing with technology will change. There needs to be periodic review of the services being provided. The parties need to put in place an agreed upon process to review any request for changes to what is in scope. This will allow them to know at any point in time what is to be done. It also will permit the parties to consider the implications of changes on pricing, service levels, etc.

One aspect of change is “repatriation”. This is the term used to describe a decision by the customer to itself assume responsibility for an in-scope service. The customer may well want this flexibility but it needs to be conscious of the implications of this change for the supplier. What portion of the supplier’s anticipated return on its investment is directly or indirectly tied to that service? The supplier will want to be compensated in some way for this loss.

Service Levels

Once you determine what is to be done, you need to consider how it is to be done. What level of service does the customer need or want? It is important to realize that pricing and service levels are closely linked. You can usually get great service if you are willing to pay for it. The challenge in outsourcing is to achieve price savings without sacrificing service. Depending on the circumstances, it may be possible for the supplier to achieve both better service and cost savings but suppliers are not miracle workers.

One important step in establishing service levels is to determine what level of service the customer has been receiving from their own internal IT group. Setting this baseline before the contract is resolved is good. The supplier may resist this and try to build this into the contract as the first deliverable. Customers will often accept this to get the project underway. It is, however, a less than optimal solution and it might work to the disadvantage of both parties.

Another important step is determining the consequences of failure to meet the service levels. Will there be credits against future fees? When will they be triggered? Will there be the opportunity to earn back lost revenue through rewards for improved service? This will be the subject of much discussion. Remember that the purpose is to motivate the supplier to provide better service.

Pricing

There are a number of different pricing models that are used in outsourcing transactions. This is where the use of outside consultants like the Gartner Group can be helpful because of their familiarity with different pricing models and their knowledge of going rates. While the customer will want to get the best price possible, it is important for the customer to understand that if the long-term relationship is to succeed the supplier must make a reasonable return upon the investment that it is making in the outsourcing. A supplier that thinks that it is being underpaid will try to find ways to reduce its costs or increase the customer’s fees. The goal is to pay a fee that fairly rewards the supplier but does not overly reward the supplier to the detriment of the customer.

Some customers have the leverage to insist on the supplier's best price. How does the customer know that is getting this? One way of trying to ensure this is the use of the "most favoured customer clause". The supplier certifies that its price is as good as it gives any other customer. This is often combined with a promise to adjust its pricing if it offers a better deal to another customer. This is a very dangerous clause from the supplier's perspective. First, how do you compare pricing from deal to deal when there are many variables? The assets of the customer may have to be replaced or supplemented more than another customer. The scope of the work or the service levels and penalties may be different or the term may be longer. Second, what do you do about the deal where the supplier gives a "loss leader" deal to a strategic new customer? Suppliers try to carefully restrict any such clause. They insist that the clause state that the variables be taken into account. They certify that this is the best price that they give to customers of similar volume in similar circumstances on similar terms and conditions.

Benchmarking

How does the customer ensure that its pricing and service levels remain competitive over a 7 to 10 year deal? There is need for periodic reassessment of the terms of the agreement to deal with changes in technology or the outsourcing market. Benchmarking is a tool that has developed to assist companies in ensuring that they continue throughout the term of the deal to get service and pricing in keeping with industry standards. Essentially, an independent third party is retained to report back to the supplier and the customer on current service levels and pricing. Suppliers are unhappy with this trend. They point out that their pricing is intended to permit them to offset their investment over the life of the project. If the benchmarking results in higher service levels it increases their costs and if it results in lower fees it reduces their revenue. Either way there is less money later in the deal to offset the expenses incurred at the beginning of the deal.

An alternative is to have an agreed upon reassessment of the service levels and pricing every few years.

Building in Flexibility

Given the fact that many of the issues discussed above are going to be contentious and that the outsourcing arrangement is a long-term agreement, mechanisms like audit, regular reporting, regular meetings and periodic re-evaluations can all be useful as "pressure valves." They provide a means for the parties to monitor and adjust performance as appropriate over the course of the agreement.

The outsourcing lawyer needs to be wary of being overly rigid and insisting on "control" mechanisms in the agreement. While it may be true that the agreement is very important from the customer's perspective, the customer has chosen to outsource this IT functionality because it has confidence in the expertise of the supplier. You do not want to develop an agreement where the hands of the supplier are tied thus preventing it from adapting to changed circumstances and the differing needs of the customer.

Conclusion

The most important thing to bear in mind in negotiating and drafting these key clauses is that you need to be aware of your own client's needs and wants as well as those of the other side. And you need to be seeking out solutions that maximize the satisfaction of those needs and wants for both parties.