

By Eric Esperne, J.D.

Outsourcing and Contract Law

Knowing the dynamics between contract doctrines and the numerous constraints placed on contracts by outsourcing is indispensable.

Outsourcing presents a very different and sometimes dangerous kind of animal for supply management professionals, contract managers and legal professionals responsible for negotiating and managing business-to-business (B2B) services contracts. The dilemma of finalizing outsourcing contracts — capturing the whole of an outsourcing transaction in a legally enforceable set of written terms before commencing services, without negotiating while standing in midstream — stems from a tension between the nature of outsourcing relationships and the most fundamental doctrines of Anglo-American contract law.

Bounded Rationality

At the very root of Anglo-American contract law lies the simple concept of a “bargain.” What is a bargain, known in modern business as a “deal”? Two men walk into town, one from the East, with a bag of coins, the other from the West, with a pig in tow, and they meet at a barrel in the town common. One says, “I have this pig to sell,” and the other lays some

coins on the barrel and says, “I’ll buy it. Bring it here an hour before sunset.” That is a bargain.

In the world of outsourcing, transactions aren’t so simple, because the bounded rationality (an economic concept referring to the constraints that the real world imposes on even the best decisions) of the parties — the ability to make fully informed and voluntary decisions — doesn’t allow them to enter into an agreement, at least not completely. If a customer agrees to outsource its IT operations but hasn’t commissioned any kind of assessment of its operations, such as taking inventory of IT assets or mapping business processes, even though the operations are transitioned to the provider under a nominal description of the scope of work, a legal contract containing enforceable terms for the services can’t exist — at least not until the assessment is made and the parties agree on commercial terms such as pricing, required service levels, service demand and audit rights. Until then, the parties have only agreed that they will transition the scoped services and do an assessment.

They have yet to agree on essential terms that describe what is being exchanged, and such an exchange of value is necessary for a legal contract to exist.

Industry Coping Skills

Outsourcing advisers often talk about the need for flexibility in outsourcing contracts and the use of governance to manage outsourcing transactions. In reality, these services are simply ways of coping with bounded rationality in outsourcing. They have limitations, though. Contracts with scope and pricing terms left open, or those that describe processes for agreeing on terms instead of the terms themselves, are ultimately not enforceable services contracts because they don’t contain a bargain (for example, “this pig for those coins”).

Bounded rationality is also why so many different approaches to negotiating outsourcing contracts have come into practice, such as framework agreements, structured negotiations or contracts entered into with the intent of renegotiating the terms. These various approaches

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are attempts to perform a tightrope walk between the realities of outsourcing with the universal business practice of protecting one's interests by signing a contract.

Relational Contract Theory

The idea that contract laws conflict with modern business transactions such as outsourcing is not new, but has garnered a surprisingly small amount of attention in professional and academic literature. In the 1970s and in later years, a U.S. law professor named Ian MacNeil wrote several law journal articles and lectures on the subject, which he coined "relational contract theory." MacNeil reached the conclusion that contract law was not only "useless" but also "misleading" to parties entering long-term relationships, such as outsourcing, that require a great deal of cooperation, and where gains and losses are not a zero-sum game.

Complex Modeling

The difficulty of fashioning outsourcing contracts is compounded by outsourcing's complexity. Differing outsourcing models intended to achieve business goals, such as reduced costs and alignment of services and providers, add to the constraints on the managerial effectiveness of outsourcing contracts.

1) *Provision of global outsourcing services involving multiple jurisdictions with inconsistent legal frameworks.* Outsourcing services may require many "localized" contracts that resolve conflicts between the laws.

- 2) *Multisourcing end-to-end operations to several providers.* Several independent contracts must be entered into for multiple providers which must then be coordinated.
- 3) *Sharing of common outsourcing services among multiple subsidiaries in a company.* Often, a single master services agreement is signed with a multinational company. But what follows are numerous transactions among disparate internal customers whose requirements are separate from and inconsistent with each other.
- 4) *Baselining outsourced operations.* Baselines constantly change based on many variables and must be revisited.

The Way Forward

The objective of an outsourcing contract should be to effectively manage both the delivery of outsourcing services and the relationship between the parties, by providing guidance on what the parties must do and, if necessary, a legal course of action to seek out alternatives. Given the evolution of common contract law and acts of legislation based on the "transactional contract" model, it would seem that the objective is unattainable. Should providers and

customers not worry about signing contracts? Should they accept their plight by continuing to struggle between the reassurance of having a signed contract in-hand and intelligently working together to generate value through their outsourcing?

Strategic Thinking

Developing an effective outsourcing contract starts at the beginning of the outsourcing life cycle, with strategic planning. All aspects of the contract must be taken into consideration, such as the scope of the contract and its duration, the architecture of the contract (for example, one umbrella contract with many individual adoptions), how bounded rationality and outsourcing models will impact the contract, how terms will be proposed and negotiated, the risks that will be encountered under the plan, and how those risks can be mitigated, through either traditional contract management steps like liability limits or through noncontractual "governance" steps such as readjusting service levels or redefining scope. The competency and available resources that reside among the parties to manage outsourcing must also be considered.

Good planning and good management are more important to an effective outsourcing contract than good negotiation,

at least as negotiation is particularly understood. Attempting to negotiate according to the classic contract model can defeat the essential purpose of an outsourcing transaction. A good outsourcing negotiator can be likened to a team manager who sees the bigger picture and comes prepared with a game plan that makes the best use of the contracted players.

Professional Knowledge and Skills

Following best practices for outsourcing contract formation and management, organizational charts and position descriptions that distinguish between negotiation teams and management teams begin to blur. But while the number of professionals involved in an outsourcing deal may become smaller, the skills required of them must become more multifaceted. For outsourcing professionals, knowing the dynamics between contract doctrines and the numerous constraints placed on contracts by outsourcing is indispensable.

The classic transactional contract, for example, along with creating enforceable legal claims, can place either party in a difficult position, leading to moral hazards: customers withholding work that is in scope to combat captivity and providers cutting corners to maintain profit. Instead, outsourcing parties must look past previously negotiated terms to how they can generate better value, by initiating renegotiation or re-evaluating the basic engagement itself. **ISM**

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