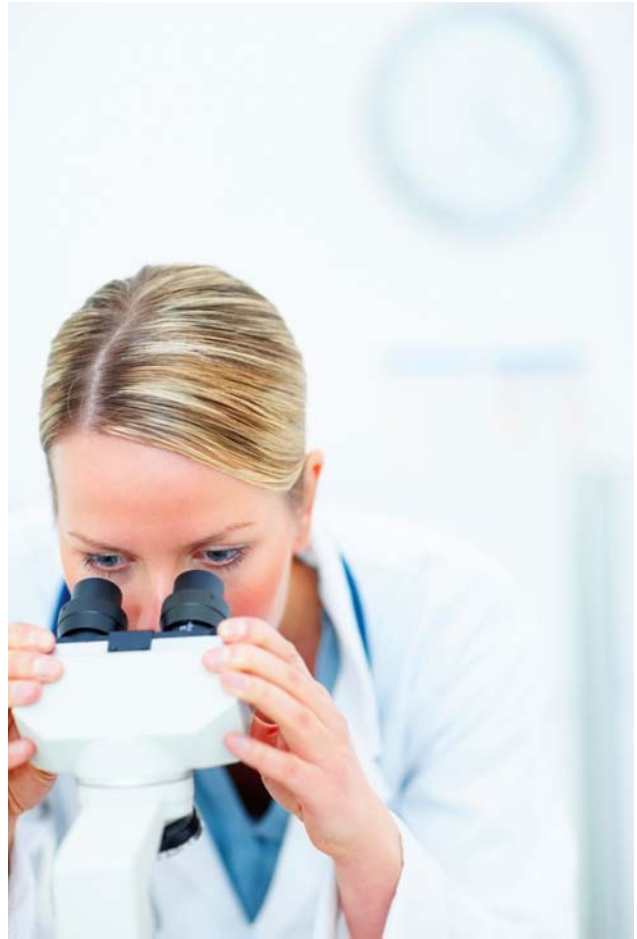


An Incurable But Manageable Condition: Diagnosis and Prescription for More Effective Outsourcing Contracts

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Introduction. Negotiating outsourcing contracts can be exasperating. It's not just a matter of negotiating good contracts. Often it's a matter of getting any sort of contract in place before the work begins. No one wants to wait for all of the t's to be crossed and i's to be dotted, and delay may be fatal when the outsourcing will put strategic plans into action. But moving ahead with transition of infrastructure or release of code, without a contract, usually does not play well with the corporate legal department. Any in house lawyer worth his or her salt knows that the prime directive in engaging service providers is "No work starts until the contract is signed." Executive management will not be advised to sign until all terms have been covered off. This stark attitude towards negotiating outsourcing deals is instinctive for lawyers in Anglo-American jurisdictions, because it is how they are trained.

"This Pig for Those Coins."At the very root of Anglo-American contract law lies the simple concept of a "bargain." What is a bargain? Two men walk into town, one from the East, the other from the West with a pig in tow, and they meet at a barrel in the town common. The first man says "I have this pig to sell" and the second man lays some coins on the barrel head and says "I'll buy it, bring it here an hour before sunset," and both men shake hands. That is a bargain. It

doesn't matter what the contract is for--pigs or global Internet services--if there isn't a bargain with definite terms then there isn't a contract.

In the world of outsourcing, transactions aren't so simple. That is because the bounded rationality of the parties—the ability to make fully informed and voluntary decision—doesn't allow them to enter into a bargain. If a customer agrees to outsource its IT operations but hasn't commissioned any kind of assessment, even though the operations are transitioned to the provider, a legal contract for the services can't exist until the assessment is made and the parties agree on commercial terms like pricing. That is because the parties only agreed that they will transition the services and do an assessment, and this holds true despite what is written in the contract. The parties have yet to agree on essential terms that describe what is being exchanged. Or it could be that an assessment was done by the customer and a price agreed on before the transition, but the assessment was so poorly done as to have lead the parties to mistakenly agree on terms. Here too the parties do not have a legal contract for services (unless they renegotiate or an arbitrator makes equitable adjustments).

Industry Responses. Outsourcing advisors often talk about the need for flexibility in outsourcing contracts and the use of governance entities 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 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, e.g., this pig for those coins. Hybrid contract-governance arrangements can work to cross purposes because dealings between the parties outside of the contract can eventually waive its terms, as well as undermine its authority.

Bounded rationality is also why so many different approaches to negotiating outsourcing contracts have come into practice, such as framework agreements, structured negotiations, or entering into contracts with the intent of renegotiating the terms. These various approaches 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. They are also attempts to address the high transaction costs and long delays of

negotiation commonly experienced in outsourcing deals. Figure 1 captures the constraints that exist on entering into and managing effective outsourcing contracts.



Figure 1

Relational Contract Theory. The idea that contract laws conflict with modern business transactions such as outsourcing is not new. In the 1970’s and in later years, an American law professor named Ian MacNeil wrote several law journal articles and lectures on the subject, which he coined “relational contract theory.” In short, MacNeil reached the conclusion that contract law was not only “useless” but

“misleading” to parties entering long term relationships that require a great deal of cooperation and where gains and losses are not a zero-sum game. While outsourcing wasn’t a recognized business transaction back then, MacNeil clearly understood that in our modern economy it doesn’t make sense to expect companies to plan all work to be done prior to signing a contract, the classic model that our contract law is based on. He recognized that at best planning “structures and processes” could be agreed on, understanding that the structures and processes were both internal and external to contracts and were nothing more than leads to transacting business. At the same time, MacNeil recognized that “transactional” contracts, in which all work is planned prior to the contract (e.g., “this pig for those coins”) had done a pretty good job of propelling human commerce for the past several centuries, and that contract law wasn’t going to change anytime soon.

MacNeil’s work and the scholarship that has followed on relational contract theory is too deep to do justice in this article. The important takeaway is that the problems encountered in contracting for outsourcing services are real and are unavoidable.

Impact of Outsourcing Models. 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 for a customer site and the laws in force where the provider's facility sits.
- 2) ***Multisourcing end-to-end operations to several providers.*** Several independent contracts must be entered into equaling the number of providers, yet the service provision isn't complete unless all providers work in coordination.
- 3) ***Sharing of common outsourcing services among multiple subsidiaries in a company.*** Even though only one contract document is signed, there will exist numerous transactions among disparate internal customers that will constitute individual agreements.

- 4) **Baselining outsourced operations.** Baselines constantly change based on many variables. They must be revisited if they are to be counted as part of the contract.

An Incurable But Manageable Condition. 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 circumstances, 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.

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 (e.g., one umbrella contract with many individual adoptions), how bounded rationality and outsourcing models will impact the contract, how terms

will be proposed and negotiated, and the amount of risk created by dealings not under contract that can be tolerated. The competency and available resources that resides among the parties to manage outsourcing, either through traditional contract management or through non-contractual “governance,” must also be considered.

Negotiations. Good planning and good management are more important to an effective outsourcing contract than good negotiation, at least as negotiation is popularly understood. The negotiator who fancies himself as a gun fighter standing in the middle of the street at high noon has no business negotiating outsourcing contracts. A good outsourcing contracts negotiator can be likened more to a team manager who sees the bigger picture and comes prepared with a game plan that makes the best use of the players. Following best practices, organizational charts and position descriptions that distinguish between negotiation teams and management teams begin to blur. But while the number of players in an outsourcing deal may become smaller, required skills must be multi-faceted. What must be understood is that attempting to negotiate according to the classic contract model can defeat the essential purpose of an outsourcing transaction.

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

Figure 2 graphically portrays these dynamics.



Figure 2

For example, the classic transactional contract, 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; 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 reevaluating the basic engagement itself.



ABOUT THE AUTHOR

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