



# **The Outsourcing Contracts Dilemma: Best Practices for Contract Formation Within the Outsourcing Lifecycle**

White Paper

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## INTRODUCTION

**Dissatisfaction with Outsourcing Contracts.** Written contracts are not universally accepted as an adequate or even advantageous means of governing outsourcing transactions. One prominent outsourcing advisory firm criticizes the effectiveness of outsourcing contracts this way:

“Looking to the contract to determine how to manage the chaos of [outsourcing] transition is fruitless; while outsourcing contracts serve many useful purposes, they fall short on informing the customer and service provider exactly how they will work together to manage all of the changes outsourcing requires. Contracts are written in legal language and focus on what the parties will do, but little on how they will operate together.”<sup>1</sup>

Empirical evidence of a perceived inadequacy of outsourcing contracts can be found in survey data on their frequent renegotiation. In a 2006 survey of 40 companies across diverse industries that had renegotiated IT and business process contracts, the top 4 reasons given for renegotiation were 1) a change in business volume, 2) a change in service scope, 3) issues with service pricing, and 4) expiry. The report concluded:

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<sup>1</sup> Vantage Partners Study. “Managing Outsourcing: Essential Practices for Buyers and Providers” (2006). The study consists of a jointly conducted survey with Cutter Consortium, EquaTerra and BT Vital Vision Program of almost 200 buyers and providers globally, mostly in the private sector but also in the public sector.

“[The] art of successful outsourcing is less dependent upon strong contractual language than it is on the effective alignment of expectations among the parties.”<sup>2</sup>

The proposition that contracts do not serve a useful role in a business-to-business (B2B) services industry like outsourcing is nothing short of earth shattering. Contracts are universally employed in business transactions and are considered by most sophisticated parties as a necessary prerequisite to doing business. Why would contracts have a negative image in a complex and high dollar industry like outsourcing? What exactly are the problems companies encounter with outsourcing contracts? Does the root of these problems lie in how outsourcing contracts are negotiated? How they are managed? Do characteristics of the outsourcing service model make contracting problematic?

**Overview of White Paper.** This White Paper looks at contracting in today’s outsourcing industry worldwide. The discussion will look at information technology outsourcing (ITO) and business process outsourcing (BPO) in particular, although the discussion is relevant to other segments of the outsourcing industry, e.g., knowledge process outsourcing (KPO).

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<sup>2</sup> TPI Research Report “Restructuring Outsourcing Agreements: An Indication Of Failure, Or A Tool To Increase Value?” (January, 2007).

## HOW OUTSOURCING CONTRACTS ARE FORMED

**Research of Outsourcing Contracts Formation.** James River Consulting conducted an exhaustive 100 plus hour research project that looked at how outsourcing contracts are presently put together worldwide. The research looked at online materials provided by outsourcing advisory consultancies and service providers, academic publications in the fields of management and systems, available copies of outsourcing contracts, and discussions with outsourcing industry professionals in organizations such as the International Association of Outsourcing Professionals (IAOP) and the International Association of Contract and Commercial Management (IACCM).<sup>3</sup>

**Outsourcing Lifecycle.** Approaches to outsourcing contract formation identified through the research were analyzed within the framework of an outsourcing lifecycle. Outsourcing lifecycles have been both the subject of academic study and included in the marketing materials of management consultancies. An adapted version of an outsourcing lifecycle developed by academics Sara Cullen, Peter Seddon and Leslie Willcocks in 2005 was used for the

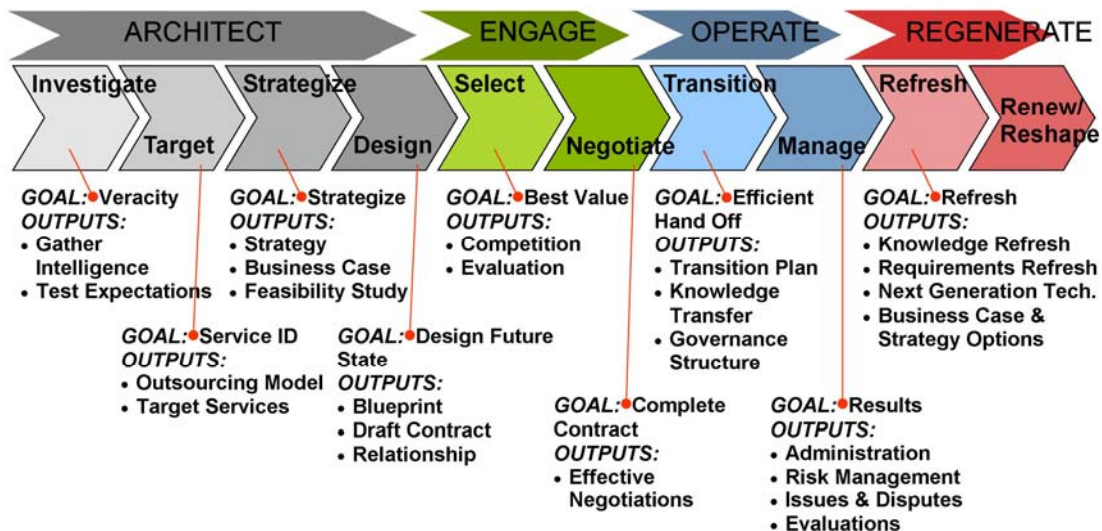
analysis in this White Paper.<sup>4</sup> Figure 1 presents the Cullen/Seddon/Willcocks lifecycle, modified into a flat, linear process flow, and includes an adaptation of the goals and outputs listed for each stage in the original lifecycle. Specifically, each approach identified through the research was analyzed in terms of how well that takes into account the lifecycle stages and supports the corresponding goals and outputs.

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<sup>3</sup> James River maintains an ongoing survey of outsourcing contracts approaches. James River invites interested parties to submit contact information and material describing use of described approaches, any additional approaches, or variations or combinations of approaches, to [info@jamesriverllc.com](mailto:info@jamesriverllc.com).

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<sup>4</sup> S. Cullen, P. Seddon and L. Willcocks, "Managing Outsourcing: The Lifecycle Imperative," Vol. 4, Issue 1, March, 2005 (University of Minnesota). Figure 1 in the article sets out the 4 phase, 9 stage lifecycle. Figure 2 in the article presents accompanying goals and 54 outputs. The Cullen/Seddon/Willcocks lifecycle was found to be the most comprehensive and insightful of the roughly dozen lifecycles researched for this white paper.



Adapted from S. Cullen, P. Seddon, and L. Willcocks, "Managing Outsourcing: The Lifecycle Imperative," MIS Executive Quarterly Vol. 4, No. 1, March, 2005

Figure 1 Outsourcing Lifecycle Model

**Taxonomy of Approaches.** The research produced a taxonomy of 10 different categories of outsourcing contract formation. The approaches differ from each other in several ways including how terms are proposed, at what point terms are negotiated, what terms are included in the contract, and whether the contracts attempt to account for ongoing management of the services.

**1) Strategic Sourcing.** Strategic Sourcing has long been followed by the Government and the Fortune 500. In the Design stage (Architect phase), prior to issuing an RFP, the customer drafts a near-final contract for all terms including service related terms like scope and SLAs, and legal terms and conditions. The draft contract is attached to the RFP to be issued

during the Select stage (Engage phase). According to express language in the RFP, responding providers are only allowed to take limited exceptions to the terms. During final negotiations in the Negotiate stage the selected provider may only request minor "linguistic" alterations to the prescribed contractual language.

As the name suggests, Strategic Sourcing secures the incorporation into the contract of the customer's strategic goals developed in the Architect phase. However, in doing so the approach effectively denies providers the ability to negotiate the outsourcing contract, undercutting the effective negotiation output in the Negotiate stage; specifically the lack of

negotiation forecloses value trading and mutual agreement to terms.

**2) Term Sheets.** Term Sheets are a well known method for establishing a preliminary agreement between parties. In essence they consist of a limited set of terms that are written in lay language. The advantage of Term Sheets is that they narrow down initial discussions, thereby paving the way for successful follow up negotiations. Term Sheets can consist of only a few commercial (service related) terms like price and scope or they can also include legal terms such as liability and ownership rights. Term Sheets are not meant as substitutes for contracts: a principle of this approach is that a complete and final contract must be negotiated and executed before the Operate phase begins.

Term Sheets are concerned almost exclusively with concluding negotiations in a timely fashion prior to commencing work.

**3) Must Have's.** The name of this approach comes from an established advisory services firm. With Must Have's, a few issues thought to be the most contentious between the parties (e.g., price and scope) are identified and settled at an initial meeting of executive management at the initiation of the Negotiate stage. All other terms are then negotiated by teams in follow up. However, unlike Term Sheets, finalization of the contract may take place at any point during the Transition stage or later in the life cycle.

**4) Framework Agreements.** Framework Agreements are popular among outsourcing parties in Europe. During the Negotiate stage, the parties negotiate a "framework" contract that sets forth A) final terms and B) defined processes for subsequently definitizing terms that are not ripe for negotiation due to lack of data, usually service related terms including prices and service levels. Later in the lifecycle, at some point during the Transition stage and/or Manage stage, pursuant to the Framework Agreement one or both parties conduct baseline assessments or conduct pilot projects to capture relevant data about the work, with the intention of using the data to negotiate and finalize the remaining terms in the contract as soon as possible. Another technique used in this approach is to put "interim" terms in the Framework Agreement in the Negotiate stage.

Framework Agreements seeks to avoid delays in the transition of outsourced work and to action the real time and first hand assessment of the outsourced work, or to generate data, which implicitly supports goals and outputs in the Transition and Manage stages, while guiding the parties into entering as much of a complete contract as is perceived feasible given available data,

Framework Agreements can leave important commercial terms remaining "on the table" without agreement.

**5) IAOP Book of Knowledge.** The International Association of Outsourcing Professionals (IAOP)

Book of Knowledge seeks to establish a standard description of outsourcing, including how outsourcing contracts are formed. According to the Book of Knowledge approach, terms are separated into modules: “master framework” terms; service descriptions; and pricing. A draft of the master framework terms are included by the customer in the RFP in the Select phase, and providers are requested by the RFP to accept the terms as is or take exception to the terms and propose their own. The provider’s changes to the draft contract—it’s negotiation position—are then counted as evaluation criteria in selecting the best provider. Upon execution of the master framework contract, individual service contracts including pricing are then negotiated by the parties and executed under the master framework.

The IAOP Book of Knowledge approach is distinguishable from the other approaches for two reasons. First, the approach divides up the contract controlling the outsourcing engagement into separate services contracts. Second, it is also distinguishable in that it emphasizes the importance of the Select stage goal of best value.

**6) Structured Negotiations.** Negotiation of contract terms is broken up into outsourcing-centric subject areas under the Structured Negotiation approach. According to one advisory services firm that promotes this approach, negotiations start with terms deemed necessary for transition of the

outsourced work to occur. For purposes of negotiation, these transition-imperative terms are further segmented into categories that don’t line up with the typical organization of a contract document but are rather specific to outsourcing: People, Structure, Process, Security and Continuity. The parties can execute either a binding contract covering these terms at the end of the Negotiate stage, or if they want to avoid delay, sign a non-binding Term Sheet to be later finalized during the Transition stage. Once all transition-imperative terms of the contract are finalized, the parties then proceed to negotiate other terms. However, a principle of the approach is that actual delivery of services (Manage stage) cannot begin until all the modules of a completed outsourcing contract have been executed.

Structured Negotiation minimizes delays in the transition of outsourcing work while maintaining support for completion of a contract at least by the end of the Transition stage.

**7) Governance.** At a philosophical level, Governance manages outsourcing work through a “good faith” relationship between the parties, rather than through the more “adversarial” enforcement of contractual obligations. Under the Governance approach, a formal mechanism for managing outsourced work, particularly managing changes and service levels, is described in detail in the contract. Terms for outsourcing management may be set

unilaterally by the customer in the Architect phase or mutually by the parties in the Engage phase.

With Governance, negotiation of a complete and definitive contract in the Negotiate phase as the primary means of managing outsourcing performance is de-emphasized based on a view of outsourcing as inherently unpredictable and changing. Rather, Governance supplants contract terms with management decision making as the primary way of addressing the goals and outputs of the Operate phase.

**8) Sole Source.** According to one major law firm that markets outsourcing advisory services, outsourcing providers and customers en masse have become dissatisfied with the time and cost of competitive outsourcing procurements, and so are omitting the competitive RFP process from their outsourcing initiatives all together. Instead customers initiate negotiations with one outsourcing provider. This practice is often referred to as Sole Source.

The sole purpose of Sole Source is to eliminate transactional costs other than those necessitated by negotiation.

**9) Accelerated Competitive Dialogue.** In this advisory services firm's highly different approach, joint customer-provider workshops are conducted between the customer and a group of interested providers to achieve the Architect phase goals of

identifying outsourcing opportunities, developing strategy and defining outsourcing requirements. Based on the experience of the workshops, the customer then selects one of the participating providers and negotiates a contract.

**10) Renegotiations.** As discussed in the Introduction, many outsourcing contracts are renegotiated at some later point in the lifecycle. Some well known advisory services firms in fact recommend Renegotiation as a conscious approach to outsourcing contracts. In other words, parties are advised to negotiate complete and final contracts prior to the commencement of the outsourcing engagement, with the understanding that they will in all likelihood renegotiate some or all of the contract at a point later in the lifecycle, as needs dictate.

**Evaluating the Approaches.** In hindsight, the number of ways outsourcing providers and customers contract with each other according to the taxonomy is not surprising given the number and variety of goals to be achieved in the stages of the lifecycle. All of the 10 approaches in the contract formation taxonomy have one or several overarching purposes that validate the approach as a sound business practices when used to fulfill that purpose. Guidance on how to choose between the approaches comes from understanding the purposes that are served by the approaches as well as the needs of the parties to an outsourcing transaction. Figure 2 is a table showing

the choices between taxonomy approaches.

Needs of the Outsourcing Parties	Outsourcing Approach That Meets the Needs	Competencies and Skills Most Important to Approach
<i>"We want to outsource as quickly and cheaply as possible, including doing the deal?"</i>	<b>Sole Source</b>	Legal Dept., Targeted Ops Mgmt. & Personnel
<i>"We want to get a bullet proof contract in place to protect us in case things go wrong?"</i>	<b>Renegotiation</b>	Legal Dept., Outsourcing Project Team
<i>"The outsourcing must align with our strategic goals, so strategy must be built into the contract?"</i>	<b>Strategic Sourcing, Accelerated Negotiation Dialogue</b>	Outsourcing Project Team, Procurement Dept. (with input from Executive Mgmt.)
<i>"We'll never really know the true picture of the targeted operations, or how it will look in the future, so any contract has to be completely flexible?"</i>	<b>Governance</b>	Targeted Ops Mgmt., Contracts Mgmt. Dept.
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<i>"The outsourcing project is too big to digest all at once, we need to outsource in smaller bites."</i>	<b>Framework Agreement, IAOP</b>	Outsourcing Project Team, Contracts Mgmt. Dept.
<i>"We need to start the outsourcing project right now if we are going to benefit from it, with or without a contract?"</i>	<b>Terms Sheets, Must Have's, Structured Negotiations</b>	Executive Mgmt., Legal Dept. (for contract, Outsourcing Project Team and Targeted Ops Mgmt. for Transition)

Figure 2 Outsourcing Contracts Formation Approach Choice Table

The \$64 question for all of the approaches is: Does a contract come into existence during the lifecycle that effectively governs the outsourcing transaction, including both the services and the overall relationship between the parties? Each approach has a different answer. Some of the approaches in the

taxonomy produce a complete contract, notwithstanding their shortcomings in achieving other goals. Other approaches produce contracts that attempt to govern future issues and disputes but not by force of contract. Other approaches put off negotiation of a contract altogether in favor of

commencing the outsourcing engagement in a timely fashion.

## CONSTRAINTS FACED BY OUTSOURCING CONTRACTS

**Contract Ineffectiveness.** Like any other B2B services contract, for outsourcing contracts to be effective, they must possess several qualities. First, they must be comprehensive. All of the terms that are needed to govern the outsourcing must be included. Second, outsourcing contracts must be definitive. They must clearly and accurately define the outsourcing engagement as seen by the parties. Third, outsourcing contracts must be authoritative. The terms must be enforceable vis-a-vis the parties and in a tribunal.

But constraints exist that prevent outsourcing contracts from serving as effective service and relationship management mechanisms across the lifecycle. These constraints can be grouped into three categories: 1) Rational Constraints; 2) Legal Constraints; and 3) Business Constraints.

### Rational Constraints.

**Bounded Rationality.** Figure 3 depicts what makes contracts effective and what undermines their effectiveness during the course of the outsourcing lifecycle. Inputs that create a loss of contract effectiveness, shown in the upper right corner of Figure 3, are the consequence of the “bounded rationality” of the parties to

an outsourcing transaction.<sup>5</sup> Poor customer assessments and poor knowledge transfer of outsourced operations, lack of value trading caused by customer sourcing practices, commencement of outsourcing prior to making significant progress in negotiations, unpredictable changes in requirements and assumptions, and bad faith dealing due to unfulfilled expectations are examples of bounded rationality in outsourcing.<sup>6</sup>

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<sup>5</sup> The origin of the term “bounded rationality” can be found in H. Simon, *Models of Bounded Rationality* Volume 1 “Economic Analysis and Public Policy” (1982 MIT Press).

<sup>6</sup> “Attempts to include all possible future scenarios into an IT outsourcing contract requires intense efforts from both the outsourcing organization and the IT suppliers and may well be an impossible task...” E. Beulen & P. Ribbers, “IT Outsourcing Contracts: Practical Implications of the Incomplete Contract Theory,” Proceedings of the 36th Hawaii International Conference on System Sciences (HICSS’03), January 6-9, 2003 (IEEE).

Incompleteness in outsourcing contracts is attributed to factors such as asset specificity, uncertainty and measurement; frequency of the transaction; and time pressures that often exist to come to an agreement and the costs associated with the preparation of the outsourcing contract.

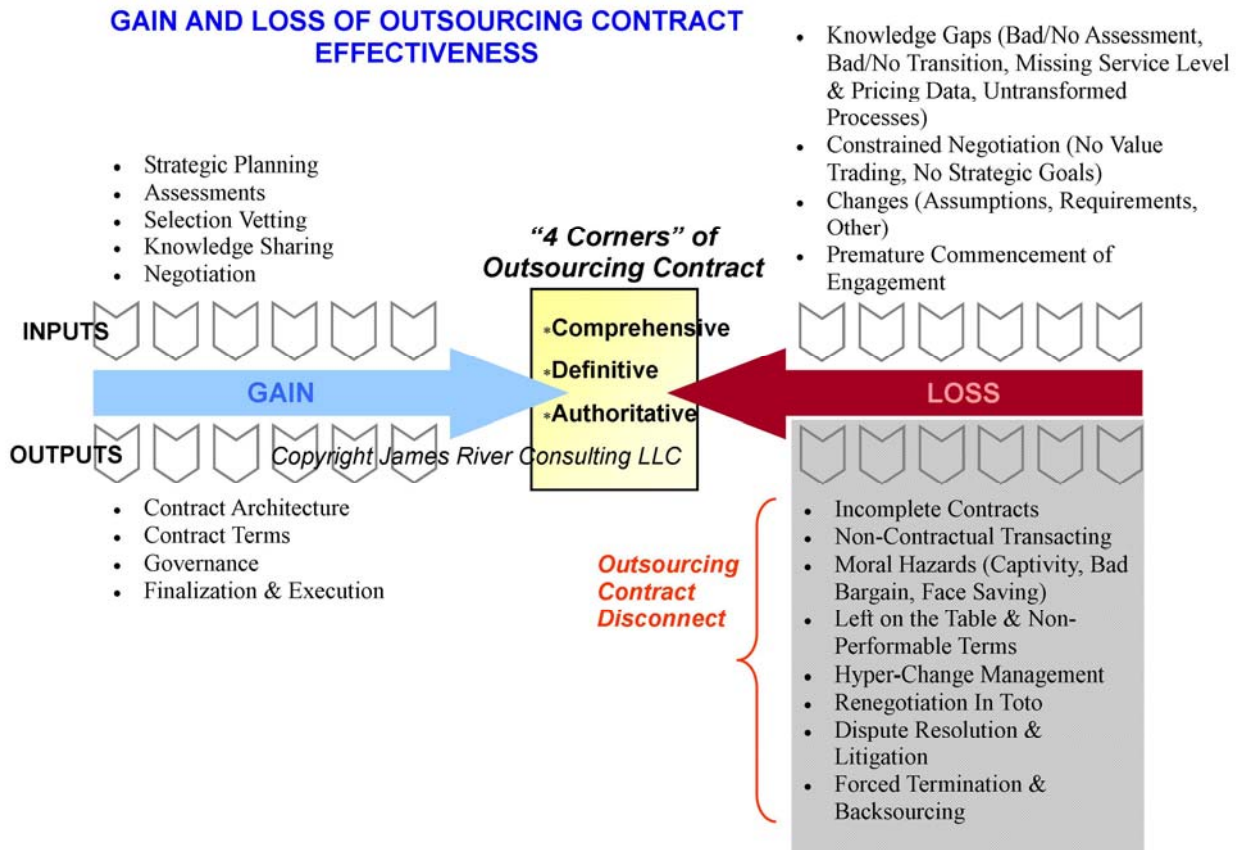


Figure 3 Gain and Loss of Effectiveness in Outsourcing Contracting

The symptoms of bounded rationality are highlighted in gray in the lower right corner of Figure 3. They are the problems that confront corporate lawyers, contracts managers, accounts managers, and outsourcing professionals charged with outsourcing responsibilities.

**Legal Constraints.**

**Relational Contracts.** As shown in the taxonomy, outsourcing contracts are often treated more like working documents by parties in an outsourcing transaction. The contracts produced by some of the approaches in the taxonomy offer some examples:

the contract only partially describes the services to be offered under the transaction or only states particular contractual terms agreed upon to date, with the remaining services or terms to be included later in the lifecycle; the contract merely lays out rules by which buyer and seller will transact business during the life of the outsourcing engagement; the terms in the executed contract serve as interim terms until knowledge sharing and lessons learned can be leveraged to negotiate more definitive terms.

These “in-progress” types of contracts strain the boundaries of contract law,

at least in the United States.<sup>7</sup> The Restatement (Second) of Contracts, the most widely used treatise in the US to clarify generally accepted contract doctrines, defines a contract in several ways. Contracts must contain a “bargain” in which the parties will exchange valuable things between each other, whether at present or in the future.<sup>8</sup> Agreements that only include framework terms about how outsourcing will be administered, or governance terms describing how provider and customer management will interface during an outsourcing engagement are not bargains. Contracts must show that there is “mutual assent” by both parties to the agreement, that they will carry out their end of the bargain without further need for any additional assent from either party.<sup>9</sup> Beginning the transition of outsourced operations while negotiations are in progress does not legally establish that parties have agreed to outsource. Contracts must contain all essential terms for of an agreement, otherwise legal recognition of the existence of an agreement depends on courts supplying the

missing terms.<sup>10</sup> Agreeing to terms only pertaining to the transition phase of outsourcing or only agreeing to terms thought to be contentious is not an agreement to outsource.

Going back to the three qualities that make contracts effective, compliance with contract law by definition makes outsourcing contracts authoritative. However, at the same time satisfying legal doctrine undermines comprehensiveness and definitiveness in outsourcing contracts because outsourcing parties are not free to draft language that literally describe their working relationship. The disconnect between contract law and the business of outsourcing is that **outsourcing parties are concerned with making the outsourcing engagement successful, while contract law is concerned with forcing parties to act in a particular way.** Put another way, **while the law wants to preserve decision making to produce prearranged outcomes, outsourcing wants to foster decision making that will create value goals.**

Figure 4 depicts how contract law operates to constrain the drafting and management of continuous improvement clauses in outsourcing contracts.

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<sup>7</sup> The conflict raised by outsourcing contracts and contract law was first identified in the 1969’s by Professor Ian MacNeil in his work on “relational contract theory.” Relational contract theory describes how poorly classical contract theory, which is based on a discrete transaction model, serves modern contracts which depend not on the bargain but the relationship between the parties. See I. MacNeil, The Many Futures of Contracts, 47 Southern California Law Review 691 (1974).

<sup>8</sup> Restatement (Second) of Contracts Sec. 17 (1981 ALI)

<sup>9</sup> Restatement (Second) of Contracts Sec. 26 (1981 ALI)

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<sup>10</sup> Restatement (Second) of Contracts Sec. 33 (1981 ALI)

## CONSTRAINTS OF CONTRACT LAW ON OUTSOURCING CLAUSES

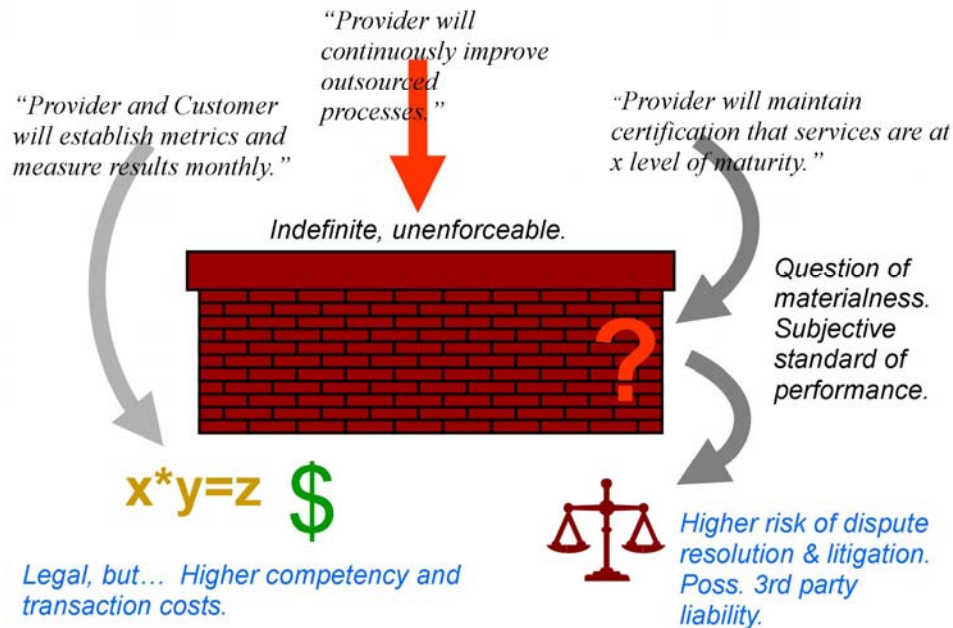


Figure 4 Operation of Contract Law Requirements on Continuous Improvement Clauses

**Waiver Through Non-Contractual Transacting.** It would seem a reasonable and practical thing to say “We’ll agree to whatever terms we can agree to now, put them into the contract, and then work our way through the remaining issues as we go along.” A number of the approaches in the taxonomy in effect follow such a hybrid outsourcing management model. But once a contract purporting to govern the transaction is entered into, managing outsourcing outside of the contract can create enforcement problems.

### Business Constraints.

**Baselining.** Outsourcing mechanisms such as service level penalties and usage based pricing can be developed and implemented via contract terms to increase outsourcing’s value to the customer. These mechanisms require baseline data about past performance which may or may not exist. In the same way, business process models of the customer’s operations may be non-existent but nevertheless a prerequisite to definitizing services in the contract. Customers and providers must negotiate which bears the responsibility of compiling baseline data and whether the baselining will

become part of the outsourcing contract's scope or whether it will be done "at risk" prior to contract execution.

**Globalization.** Cost savings and lack of in house expertise are the two biggest reasons for outsourcing. In response to these drivers, outsourcing has become a global enterprise. Services provided for a single outsourcing engagement may be comprised of operations in several continents. Accompanying this globalization trend are different and sometimes conflicting legal and regulatory frameworks for doing business in multiple jurisdictions. Laws and regulations in multiple jurisdictions in which delivery of outsourced work occurs can determine to a great degree how outsourcing contracts are formed. Ways of architecting contracts so that they will holistically address the services while also managing conflicts between laws must be employed. The framework agreements, structured negotiations and individual services agreements described in the taxonomy are some of the approaches taken in multi-jurisdictional situations. Outsourcing contracts must embody planned architectures to achieve both definitiveness and comprehensiveness — all legal issues are addressed in all jurisdictions while addressing the service as a whole.

**Multi-Sourcing.** Outsourcing engagements are not always successful. To better hedge against the risk of failure, customers have

moved away from the long time practice of outsourcing whole operations to a single vendor under a long term outsourcing contract, and towards the sourcing of portions of operations to several vendors under shorter term contracts, called multi-sourcing. With multi-sourcing comes issues of interoperability between outsourcing providers and between the providers and the customer's operations. Besides increasing the frequency of contract negotiations, a multi-sourcing environment calls for contract terms that address the coordination of responsibilities among the parties.

**Shared Services.** Outsourcing providers may have more than one internal customer in a company. Under a shared services model, overlapping operations of customer organizations are consolidated into one outsourced service provider. Shared services can make for a schizophrenic-type relationship between a provider and the several customers who in fact are the same entity. Exactly how the provider-multiple customer relationship will work in a shared services scenario must be crafted into contract language. In particular a line must be drawn between customer points of contact and legal representatives with authority to contractually bind the contracting entity.

## CONCLUSION

**Outsourcing Contracts Best Practices.** As previously mentioned, the purpose of the research done for this White Paper and the building of an outsourcing contract formation taxonomy is not to champion any one approach to outsourcing contracts over another, but to takeaway best practices for entering into and managing outsourcing contracts more effectively.

Best practices for outsourcing contracts cannot be reduced to a set of hard and fast rules. A great deal of professional judgment must be exercised. The competency to do this may or may not exist within either customer or provider companies. A lack of this competency may have severe financial consequences.

Figure 5 presents outsourcing contracts best practices as dynamics surrounding and influencing the concept of contract effectiveness.

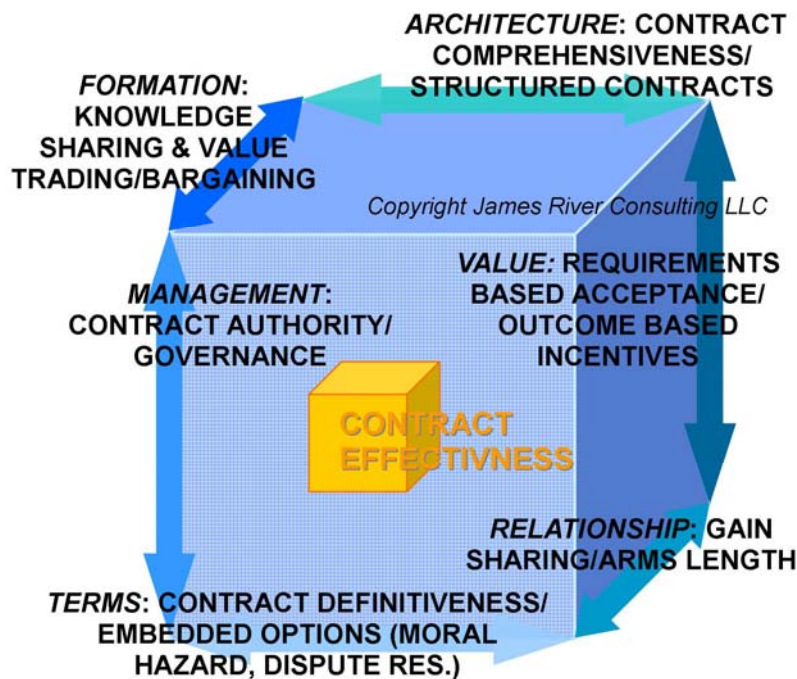


Figure 5 Outsourcing Contracts Best Practices Dynamics Cube



The author, Eric Esperne, is President of James River Consulting LLC. Eric has worked in the information technology and telecommunications industries for over 15 years as an in house lawyer, general counsel, director of contracts, senior strategic software procurement team member, Internet product development team member, and proposal team member. His employers have included large multi-nationals like MCI Worldcom and Cable & Wireless, and small systems integrators with both Government and private sector clients. Eric has also worked as a consultant advising Government agencies on their IT procurement. Eric is a member of the Mass Technology Leadership Council, the National Contract Management Association, the International Association for Contract and Commercial Management, and the International Association of Outsourcing Professionals. Eric received his BA from Northwestern University, his JD from American University, and has completed coursework in the Georgetown University LLM program and towards an MA in Technical and Science Communication at Drexel University.

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