



TEAM

A Litigation Perspective on Outsourcing Relationships

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Typically, an outsourcing relationship is long in duration and results in interdependence between the companies involved, which is why it is important to create as much clarity as possible in contracts and communications concerning disputes. Ambiguity and vague standards are difficult to prove, and when disputes arise they can lead to costly litigation and acrimonious relations between companies that rely on each other for their business success. In this article, we examine aspects of the outsourcing relationship and dispute resolution from a litigation perspective.

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Although litigation is a last resort in outsourcing agreements, a litigation perspective will improve your results with outsourcing agreements. As you draft contract terms, consider how you would prove the elements of a claim if a dispute were to arise, and this should help you draft clearer contracts thereby minimizing the number of disputes and the cost of resolving them. Similarly, when disputes do arise, it is wise to create a proper "real-time" written record with the service provider that will facilitate informal resolution of disputes or position you to prevail in formal dispute resolution proceedings if a settlement cannot be achieved. In short, thinking like a litigator will help you avoid trouble or help you prevail if trouble cannot be avoided.

Two characteristics distinguish outsourcing relationships from many other commercial relationships: the high degree of interdependence between two otherwise separate companies, and the lengthy term of the contract. These characteristics have important implications for drafting outsourcing contracts and resolving disputes.

Parties to outsourcing contracts have strong business incentives to make the relationship work. The customer is turning over an important part of its business to be executed by an outsider, while the service provider is making substantial investments of time, people, and money to address the special needs of the customer. As a result, termination of the relationship likely will cause both parties serious economic disruption. Furthermore, it is important that disputes be resolved quickly, fairly, and in a manner that will not make it difficult for the parties to continue working together effectively.

Because of the long duration of outsourcing contracts, it is difficult to anticipate all the issues that may arise during the relationship, particularly as changes occur in each party's business. One approach is to develop general standards that can evolve as conditions change; however, generality results in uncertainty, uncertainty breeds disagreement, and disagreements threaten the stability of outsourcing relationships. Drafters of outsourcing agreements should not give up trying to address specific problems that can be anticipated just because they cannot anticipate all that may happen.

When disputes do arise, resolution should be a means to a larger end—preservation of an effective working relationship. Because outsourcing relationships develop over time, the parties have an opportunity to shape the record as it is developed by making detailed correspondence. If both parties seize this opportunity, then the record likely will be reasonably clear and amenable to a fair and efficient resolution. If only one side seizes this opportunity, then it stands a good chance of prevailing over the other side.

Litigation Prevention in Drafting the Contract

There is a tendency to use vague terms in the contract to address unknown future circumstances. Examples include: material breach; gross negligence; willful misconduct; direct, indirect, consequential damages; best efforts; generally accepted standards; and commercially reasonable efforts. These concepts are unclear in the case law and difficult to prove from an evidentiary standpoint.

As mentioned earlier, uncertainty breeds misunderstanding. It also engenders costly litigation because the parties will not be able to resolve their dispute through a summary judgment motion brought early in the case based on legal, as opposed to factual, grounds. Unless the matter is settled, there likely will be significant discovery and an evidentiary hearing. The matter may be difficult to settle because uncertainty makes each side evaluate the likely outcome of the case very differently.

What can be done to address the problem? One approach is to reduce the uncertainty by using a non-exhaustive list of specific examples. These can be useful if the subject matter of the dispute falls squarely within the scope of the examples, but examples are also useful in demonstrating the intent of the parties in resolving unanticipated problems.

For example, there is much confusion in the case law as to what is meant by direct versus indirect or consequential damages. Rather than leave the issue open to argument once a dispute has arisen, the contract might state: "Direct damages include but are not limited to the additional cost of securing an alternative service provider."

Contract provisions limiting liability or remedies may include exceptions for "gross negligence" or "willful misconduct," but these terms have no clear meaning in the law. Where is the dividing line between ordinary negligence and gross negligence? Use of the term "gross negligence" increases the likelihood of a contested issue of fact foreclosing the possibility of resolving the dispute on summary judgment. Also, does a deliberate breach of contract constitute willful misconduct? Different jurisdictions answer this question differently. To reduce uncertainty, consider using a better-defined term such as "intentional tortious act."

In short, it is useful to review the terms of an outsourcing contract from a litigation perspective and consider how difficult it would be to persuade a judge or jury of the legal and factual merit of your position if a dispute occurred. If there is uncertainty in either the law or the facts, consider what can be done in the contract to reduce that uncertainty.

Attention should also be given to the dispute resolution process specified in the contract. The process can have a serious impact upon the morale of the parties and their commitment to making the relationship work. You do not want to win the battle and lose the war. The big picture is the relationship, and it will sour if the process is unfair or unnecessarily adversarial, or if disputes fester for a long time before they are resolved.

Finally, it is important to anticipate the scenario when a third party sues the customer, but not the service provider, based upon conduct within the service provider's scope of services. Many agreements contain "indemnity" and "duty to defend" provisions with respect to third-party claims, but often these provisions do not adequately take into account how such litigation would proceed. The claims may involve activities that are within the customer's scope, those that are within the service provider's scope, or activities where there is overlap between these activities. The service provider's ability to pay a judgment may also be more limited than the customer's. As a result, the customer may not be comfortable relying upon the service provider to defend the suit.

Dispute Resolution Techniques

Disputes in outsourcing relationships often develop slowly over time, in which case there is ample opportunity to shape the record. A party's objective should be to obtain helpful evidence and admissions and avoid surprise by learning the other side's best arguments, and pinning them down to those arguments, long before formal dispute resolution begins.

For example, if a customer is concerned that a service provider may fail to meet a deadline for a transformational project, the customer might send a letter to the service provider including the following:

We believe that you have not made commercially reasonable progress on the project and will be unable to meet the current deadline. Failure to implement according to the deadline will result in our suffering substantial losses. We wish to mitigate these losses by retaining a new service provider now unless you are able to provide specific, credible written assurances that you will meet the deadline.

If the service provider does not respond adequately, or at all, the customer will have substantially less risk in terminating the contract and/or arranging for an alternative service provider for the project. If the service provider responds to the letter but fails to perform as it promises, the probability of success in subsequent litigation against the service provider is high.

In short, it is important to document concerns in letters sent to the other party to create a clear record for subsequent dispute resolution. Similarly, it is important that no significant letter from the other side should go unanswered. In litigation, silence may be construed as an admission.

In preparing written communications, one should think about a juror or arbitrator reading the correspondence. It is important to maintain a reasonable tone and provide more background, including chronology, than might be necessary for the specific recipient of the communication. This way, if the matter is not resolved amicably, a fact-finder will have a better understanding when he or she reads the document in a trial or arbitration. The power of a well-written document in a litigation or arbitration proceeding cannot be overstated, particularly if the other side does not respond or does not respond persuasively.

Controlling the flow of information also is very important when a dispute is developing. Consider designating a lead lawyer and business person and have all major communications with the other party flow through them. The team should be instructed to forward all e-mails from the other party to the team leaders and not to respond to e-mails without team leader approval. Also, it is critical to use a secure internal communication network and advise all participants that whatever they put in written form, electronically or hard copy, could be discoverable. Therefore, they should be given guidance as to what type of record to make and not to make.

Conclusion

Clarity is important in drafting outsourcing contracts and in addressing disputes that may arise during the relationship. Both parties have an interest in minimizing uncertainty in their relationship and avoiding disputes, or if disputes arise, in rationally resolving them as quickly and amicably as possible. Accordingly, if sufficient attention is paid to clarity at the time the contract is executed and when trouble first appears, the chances are good that disputes can be avoided or resolved without disrupting the stability of the long-term relationship.

[◀ Back to Inside Sourcing - June 2011](#)

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