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Outsourcing Governance: The Value Of A Written Record

Law360, New York (June 11, 2012, 12:51 PM ET) -- Outsourcing customers too often learn the hard way the value of a helpful written record. In this article, we present three scenarios demonstrating how bad communications records lead to bad outcomes for clients and how those customers could have achieved better results.

In each scenario, the customer has outsourced a back office function — such as information technology, finance or human resources — to a supplier under a long-term, fixed-price outsourcing contract. The supplier's services rely on cooperation from the customer. The contract naturally does not define all requirements because of the complexity of the function and the inevitability of change.

Scenario No. 1

In the outsourcing contract, the supplier agrees to take all reasonable and customary steps to protect computers from malicious code. The supplier installs antivirus software on the customer's computers, regularly updates that software and maintains firewalls and intrusion prevention systems to protect against data breaches. During the contract term, it becomes more common and technologically feasible to install a Web proxy system to control which websites employees may visit on company computers, thus reducing the risk that employee activity on the Internet will result in infecting the company's systems with malicious code.

Several of the customer's departments discuss the benefits of a Web proxy system. An employee in information services sends an email to supplier's desktop support manager asking what would be involved and how much it would cost to install a Web proxy system. One of the customer's human resources employees sends an email to the supplier's account manager asking if similar companies have installed Web proxy systems, how restrictively those systems have been programmed and how employees have reacted to these new systems. The customer's security department sends several emails to third-party consultants asking for advice as to what new anti-virus systems have been implemented and the costs and effectiveness of the various alternative systems.

Ultimately, the three divisions recommend a Web proxy system. The customer's CEO and chief financial officer agree and ask the chief information officer to request that the supplier implement such a system. The CIO contacts the supplier's account manager and makes the request. The CIO, based on a review of the contract, notes that the Web proxy system has become a reasonable and customary measure for data security and involves no additional charge.

The supplier's manager says she will discuss the proposal with her colleagues and get back to the customer's CIO. The supplier's legal department checks for emails regarding this subject and finds the two email messages sent to supplier described above. As a result, the supplier decides to take the position that the Web proxy system is a "new service" involving large additional charges.

The customer's CIO objects to treating the Web proxy system as a new service, arguing that it is an "in-scope" service because it is necessary for secure use of the desktop and mobile computers in an evolving technological environment. The supplier disagrees, arguing that the Web proxy system is a new service and that it is a significant change to the existing services that imposes materially different obligations on the supplier, requires materially different levels of effort, resources and expense from supplier and is not adequately addressed in the current resource baseline and charging methodology.

When the CIO continues to object, the supplier's account manager sends the CIO copies of the emails that the customer's employees sent to supplier. The supplier's account manager suggests that these emails showed that the customer's own employees recognized that a Web proxy system was not generally accepted in the industry and that the customer ultimately would be responsible for the cost of implementation.

The CIO is surprised and upset by these emails and has an unpleasant meeting with the CFO about the situation. The proposed increased charges are in the millions of dollars. The CFO consults the law department. The law department collects additional emails, including the security division's emails to outside advisers seeking information concerning new systems and their costs and effectiveness. They also find hundreds of internal emails in which employees in each of the divisions are discussing a Web proxy system as something new, expensive and not yet widely used.

The CIO identifies research from recognized industry experts stating that Web proxy systems are reasonable, that they have been implemented by leading companies and that they are, in fact, necessary to repel new forms of malicious code. But the law department advises that the email messages that characterized the systems as a "new option" and presumed that the customer would pay the cost of implementation would be given strong weight by a court as admissions against interest.

Customer initiates the informal dispute resolution process. Ultimately, the customer agrees to pay most of the charges for the new system. The supplier agrees to absorb the cost of keeping the Web proxy up to date.

How could customer have achieved a better outcome?

First, the customer needed better communication with its employees. The customer should have sensitized its employees concerning the scope of the contract and instructed them not to characterize services as out-of-scope or to seek any cost estimates from a supplier for services without clearance from a designated manager such as the CIO.

Second, the customer could have had in place policies and training to ensure that all communications with the supplier concerning any changes in services were coordinated through the governance team.

Third, the customer could have communicated with supplier only after forming an internal view on whether the Web proxy was a new service under the terms of the contract. Ideally, the internal communications on contract analysis could have involved lawyers and been protected by the attorney-client privilege.

Scenario No. 2

The supplier misses several interim transition milestones. Missing the final transition milestone would risk imposing costs and business disruption on the customer. Impatient with supplier's lack of progress, the customer's governance team assigns more of its employees to the joint customer/supplier task forces working on the transition and those customer employees perform numerous tasks that supplier agreed to perform. The joint team achieves the final transition milestone.

The customer then seeks compensation for the additional resources that customer assigned to the transition. The customer cites contract clauses indicating that the cost of performing supplier obligations is a direct damage. The supplier refuses to pay, arguing that the customer was merely cooperating as required under the contract. The vitriol increases as the customer accuses the supplier more directly of inadequate performance. The supplier responds that the final milestone was achieved on time despite the customer's uninformed micromanagement and the difficulty of working with the people that the customer foisted upon the team without purpose or good reason.

When the customer's lawyers review the written record, they find little to support the governance team's recollections about the problems or the supplier's effort. The customer's primary evidence would be testimony of the people who did the work. Some of them may lack credibility because they are employed by the customer. Others may be biased against the customer because they were laid off following the transition and/or are now employed by the supplier.

No one knows what the testimony of relevant witnesses would be by the trial date. By contrast, the supplier has detailed records from its position as project manager that do not acknowledge the help that the customer provided and, instead, characterize what the customer sees as supplier's failure to perform as changes in scope or requirements made by the customer. As a result, the customer settles for only token compensation from the supplier.

How could customer have achieved a better outcome?

At the first sign of trouble, the customer could have sent an email message to the supplier asserting that the supplier was failing to perform its obligations and demanding new intermediate milestones as well as reasonable assurances of timely performance of the final milestone. The email also could have warned that customer would add resources at the supplier's expense if the assurances of performance were not received or if the new intermediate milestones were not achieved — the email also could have provided an estimate of those expenses. If the intermediate milestones were not achieved, the customer could have sent another email listing the new resources it was adding to mitigate damages and the cost that the customer believed the supplier should pay.

Any response by the supplier to the customer's messages would be valuable. Failure to respond could be viewed as confirmation of the customer's position. Reasonable assurances could have avoided the expenditure of customer resources. A claim that the customer was at fault for the delay would have allowed the customer to address the supplier's claim in an email message. If the supplier's position had merit, the customer could have solved the problems. If the supplier's position was groundless, the customer's email could have demanded specific proof. If the supplier failed to back up its claim, the customer could use that failure to support the customer's position.

That process would have allowed the customer to prove its case with email exchanges instead of trying to sort out witness testimony and evidence of work performed. Also, if the customer documented its concerns and warned supplier of the consequences of failing to take corrective action, the supplier representative who received these communications probably would have circulated them to the supplier governance team, increasing the chances that the supplier would have solved the problems. Finally, the customer would have appeared more reasonable in a subsequent litigation or arbitration if it could easily prove by written communications that it had warned the supplier and gave it another opportunity to perform before adding new resources.

Scenario No. 3

During the first two years of a contract, the customer's governance team and the supplier's engagement team enjoy a warm and mutually supportive relationship. All concerns are addressed in collaborative work sessions. The customer's engagement team never feels the need to "pull out the contract" on supplier or to "lawyer up." The actual practice drifts substantially from the contract.

The customer appoints a new CFO, who hires advisers to perform a market assessment. These advisers declare performance to be poor and prices to be high relative to industry standards. The CFO replaces the governance team and gives supplier notice of a material breach and an intent to terminate the contract for cause. The supplier disputes customer's position and states generally that it is in compliance with the terms of the contract as modified by the governance discussions and that the performance complaints are actions in bad faith to avoid termination for convenience charges.

The customer proceeds to terminate for cause, and supplier sues for wrongful termination, seeking a substantial termination fee. Discovery in the litigation costs customer more than $1 million, and the result is uncertain on the eve of trial because documentation of what happened is sketchy and the outcome may turn on the jury's assessment of the credibility of witnesses. As a result, the matter is settled before trial with the customer paying a substantial settlement amount to the supplier.

How could the customer have achieved a better outcome?

The customer could have built the initial collaboration around sound project management principles such as verifying performance against agreed requirements, modifying the written requirements to reflect new agreements and sending firm correspondence when performance did not conform to written requirements.

Even without a strong early start, the customer could have obtained a better outcome when the new CFO arrived. The customer could have conducted a legal audit to assess compliance compared to the contract instead of to industry standards and a legal review to determine what evidence existed to support the customer's position.

If that audit revealed a tangled, largely undocumented arrangement, then the customer could have (1) entered into negotiations to reset the relationship, (2) documented the revised agreements and (3) begun sending notices demanding that breaches be cured. The legal audit could have revealed, before the customer terminated the contract, that the customer did not have all of the evidence that it needed to win a case without relying on the credibility of witness testimony.

Conclusion

When customers create a clear written record on a real-time basis to support their positions on issues that later may be disputed, they increase the chances that they will be able to resolve the issues favorably during informal dispute resolution proceedings. The issues will be well focused, and the supplier will recognize that it has a weak case if the matter proceeds to formal dispute resolution.

Furthermore, it will be less expensive to assemble the relevant evidence, and the evidence will be more persuasive to the extent that the customer has summarized the relevant facts in real time written communications. Also, these steps reduce uncertainty and narrow the range of beliefs about underlying facts, thus making it more likely that disputes can be resolved in collaborative negotiations.

Sometimes customers are reluctant to make a written record as a dispute arises because they feel that becoming “legalistic” will damage the relationship. However, polite and objective communication by each side will actually help keep the relationship on track by leading to fair outcomes without the parties incurring substantial litigation expense. Executing a clear contract and following up with clear post-contract communications when troubles arise are the best ways to preserve the relationship and achieve its objectives.

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