

## BEST PRACTICE

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# The Spirit of Outsourcing

## **Contract to keep you safe; governance to make you smile**

Governance is the hottest of all the hot topics in outsourcing. It is often said that a relationship has failed if you have to wave the contract in your partner's face. Even worse if you have to have your lawyers wave the contract in their face for you. But, whereas the contract is a protective, risk-mitigation measure, there is a crucial flipside. Sound relationship management requires a robust, structured formula that provides the focus, pragmatism and direction to drive value: good governance is that sweet spot where the interactions between the customer and the supplier build into positive and mutually beneficial relationships which can readily survive the challenges which inevitably arise in long-term commercial contracts.

## **Value Leakage: Killing Value Softly**

Research by Information Services Group (ISG) indicates that between 5 and 30 percent of the expected value of outsourcing transactions is lost through ineffective governance. In a typical outsourcing agreement, this equates to lost value of approximately US\$600,000 per year for every US\$10 million in annual contract value under management. In support of this, research by the International Association of Outsourcing Professionals (IAOP) found

that "... 63 percent of companies surveyed believe they lose an average of 25 percent of contract value due to poor governance."

## **Heading for a Breakdown: The Vital Signs**

A key indicator that a partnership is on shaky ground is feelings of contempt. Developing an air of disdain for your outsourcing partner per se is a powerful predictor of a relationship breakdown. According to Dr. Bharat Vagadia, of a strategic governance platform, Governance Director: "Scale and complexity of the interaction means there is little real oversight and even less insight into what is happening on the ground. Misunderstanding and communication breakdowns, through use of inappropriate communication channels or ineffective communicators will lead to a loss of respect – the forerunner of developing contempt for each other. The best way to avoid this is to integrate strategy, action and mindsets to the enduring vision that is provided by those that govern."

## **The Look of Gov**

So what does good governance look like? Who better to ask than outsourcing specialist lawyers?

Peter Dickinson of Mayer Brown said: "When you've got good governance, it enables issues to be dealt with and for

the parties to continue with the contract and, indeed, to have stronger relationships as a consequence of that. Some of these issues would, in other contracts, cause very significant problems and could cause an irreparable breakdown in the relationship. Good governance is well structured: it not only looks good on paper, but when it's operated on a day-to-day basis, it works smoothly and effectively."

Kit Burden of DLA Piper suggests that "good governance is really based upon two key principles: trust and openness. Good governance is where nothing is swept under the carpet, issues are aired and made visible as early and as transparently as possible so that neither side has any surprises. In order to do this effectively – no matter what you've got in a contract – requires trust and openness."

### **Trust Me, I'm an Outsourcer**

Colin Craig, an analyst with Information Services Group (ISG), is adamant that trust takes time: "it's about working with the parties and living up to the promises that are made. It's all about saying 'okay we'll deliver ABC, XYZ by such and such a date. Over time, trust will start to build up. The challenge is that in a lot of sales cycles sometimes the sales people can be somewhat enthusiastic about what can be delivered and when that doesn't come into reality that's a key killer for trust."

Trust tends to build between individuals, which makes it a massive challenge when people move jobs. Bharat Vagadia said: "When new relationship managers come in, they need to rebuild trust from scratch. That's where things can get delicate. New people coming in want to make an impression, do the right things. But because the trust isn't there, there is a tendency to say, let's refer to the contract, and as soon as you say that, you start down a very negative kind of slope."

### **Trust Us, We're Outsourcers**

When asked what it takes to transcend individual relationships to build inter-organisational trust Colin Craig said: "If the culture of an organisation has a focus on a strong customer service which is delivering what it says it is going to deliver when it is going to deliver it, along with being open with clients and actually sharing with customers when they've got problems and they're not going to be able to deliver things. Clients don't tend to be ogres or unrealistic people, if you're open with them and say 'look you've asked us to do this, with the best will in the world it's not going to happen and here's the reasons why, and here's what the mitigation is', they will get over it pretty quickly, they're quite pragmatic people. So I think it's in the culture of organisations and how they approach clients particularly when things aren't going so well."

### **We Need To Talk. It Says So, Here, Here, and Here.**

Quizzed on how to contractualise communication, Kit Burden said: "Good contract structure can encourage openness and transparency. But adopt a less is more approach: Don't demand so much information, or so many reports or so many meetings that they become an industry in and of themselves – you'll end up drowning with information. Too many customers ask for absolutely everything to be reported upon, the meetings at the

nth degree, even when they wouldn't have ever done that with their own internal people providing the services. They end up micro managing, because the more information they get, the more tendency there is for the customer to meddle in the way in which the supplier is providing the service, which is generally a major cause of problems arising when outsourcing transactions."

Peter from Mayer Brown added: "I think it's important both from a customer and a supplier's perspective for there to be a clear record of matters that are raised, how they propose to resolve them and what has been done. It's important from a customer perspective to be able to demonstrate that this has been a recurring problem for a long time. It could, in extreme circumstances, be relevant if they decide that they want to rely on the termination rights, where there have been persistent failures to deliver and, further persistent failures to remedy issues. Speaking exclusively from the supplier side, you also want to be able to demonstrate that you are resolving issues when they're highlighted to you. So I think it's in both parties' interests to always make sure that, through the governance procedure, issues are reported, noted, action plans agreed upon, outcomes recorded."

Kit went on to advocate contractualising a "very streamlined approach to getting communications to people further up the tree in terms of executives. There should be a process of early escalation within the project teams to see if the matters can get resolved, rather than leaving them to fester, on a day-to-day basis and just get worse and worse and worse. Getting people that bit more senior involved helps, as people more emotionally detached from the project can view issues more objectively. As soon as issues can be packaged up and brought up to somebody relatively senior on both sides, you can resolve them, and set out the basis of moving on. "

### **Really? You Should Have Said!**

An all-too-common debate is 'are both parties doing what they should?' Well-advised customers have a provision in the contract which obliges the supplier to take swift action if they believe client-side responsibilities are being neglected. Kit Burden said: "This works on the basis that if they don't tell them for whatever reason, then the supplier loses the right to rely upon that customer failure if they then fail to perform their own obligations any time in the future, and that's obviously quite tricky. Yet if they haven't followed the contract process they might still be held liable under the contract, even if it was the customer's performance that caused the milestone to be missed."

### **Pain and Pain Relief**

Relationships struggle when parties' positions are imbalanced right from the get go. Business models can be fragile through over optimism or terms of costs or delivery times. Customers sometimes are not completely open about their capabilities to support the project. These situations will always cause problems. Sometimes, problems cannot be eradicated privately. It is estimated that half of all end up needing some sort of external 'counselling,' with all well drafted contracts these days containing some sort of provision for private, confidential mediation and arbitration.

Peter said: "In our view, mediation is useful, first because the outcome of the mediation is non-binding, it's confidential, and it also enables you – in front of a third-party expert – to test how strong your arguments are. If the mediator listens to you and says, "You must be joking," then you probably think, "Okay, maybe this isn't the right argument." On the other hand, if the mediator listens and says, "Yeah, no, that all makes sense," and then spends the next three hours or next three days in the room with the other side, then you know what he is doing is he is trying to persuade them that they need to move their position. It's always quite interesting. If mediation doesn't lead to a happy resolution, then the next steps are either going to be arbitration or, assuming the contract provides for arbitration, it could be going to court."

### The 100 Million Dollar Sentence

Very few outsourcing deals end up in court – but when they do, the stakes are always high.

Peter said: "It probably isn't in either party's best interest to be seen as to be suing each other; neither party will necessarily come out of it well. That links onto the following fact: litigation is inherently uncertain. Even if you've got the best, strongest case, you may go before a judge who reaches an irrational decision, and then you have a choice: you either accept it, or you appeal, and the costs just start to escalate. In fact, an example, one of the cases that we were involved in that went to court was all around what did a single sentence in the contract mean, and the value attaching to that single sentence was over £100 million."

A hundred million resting on the interpretation of a benchmarking provision – but, even if you were to win the high stakes game of courtroom roulette, you're not guaranteed to get all of the rake. You might not get awarded the full £100 million, and by the time the lawyers have been paid – litigation is expensive in the extreme – you might be as low as £700 million, even if you win.

The moral of the story: do whatever it takes to stay out of the courtroom. "It's all very well having a contract with lots of rights", said Peter "but you don't want to go to the lawyers every time it's not going well."

### Summing Up

Smart outsourcers get the governance right from the get-go. Build a schedule that will be fit for purpose in the good times and the bad. People, products and services will all change over the life of a deal. Neglecting to prepare for this fact will leave you at the mercy of your lawyers. And while these men will fight zealously to defend you, it makes sound business sense to do everything in your power to avoid having to trouble them too often.

According to Peter of Mayer Brown, "you can have all kinds of contractual safeguards in terms of notification of issues arising etc. Here, the lawyers can breathe a sigh of relief and say they've done things properly. But if either party doesn't embrace the contract provisions in the right spirit then it is largely doomed to failure."

The terms of the contract may be on the paperwork, but the spirit of those terms: that's the governance.

## NATIONAL OUTSOURCING ASSOCIATION GOVERNANCE MUST-DO CHECKLIST

NOA Board Member Dr. Bharat Vagadia advises, that to achieve the desired state of good governance, organisations must:

- Align the interests of the parties and relevant stakeholders through a jointly agreed vision for the deal
- Breed a culture of good governance with empowered participants, appropriate behaviours and attitudes with unfettered visibility across the hierarchy
- Construct a clear decision-making framework, process and system instilled with clear ownership and control
- Strike a balance between many-to-many communications between the parties with the ability to maintain some level of control
- Ensure clear individual and organisational accountability
- Focus on the strategic business objectives without getting lost in the woods
- Governance and relationship management must be seen to be complementary
- The governance framework must seek synergies and complementary competences to deliver innovation, in whatever form agreed
- Design of governance framework needs to be appropriate for the deal size/complexity and maturity of the relationship
- Change must be considered a normal part of the business and not something that is slow, cumbersome and contract driven
- Look for a balance between the conformance aspects of the deal and the performance and value elements of the deal
- Strive for real time visibility of the health of the relationship i.e. the level of attainment of business value and achievement of the intent of the deal
- Demonstrably embed policies and standards into the operations
- Issues should be dealt with where they occur, as quickly as possible, with a consistent dispute resolution process, which seeks to find appropriate solutions quickly without blame attribution
- Install a joint governance system which helps manage and govern the deal