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LESSONS LEARNED FROM OUTSOURCING DISPUTES

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The new norm

The current challenging economic conditions are driving additional outsourcing activities. However, the need for companies to achieve greater efficiencies and reduce budgets means customers are being forced to do more with less. In addition, the pace of technological change is accelerating and companies need to be able to swiftly react to unanticipated changes in the market-place or otherwise fall behind the competition.

With outsourcing contracts historically having terms ranging from five to ten years, the industry has reached a point where there are examples of high profile failures - and the hidden risks and causes of these failures can be identified more easily. Recent examples of cases that have ended up in court include the dispute between Ericsson and H3G, arising out of the termination by H3G of an IT outsourcing contract and the well-publicised case between BSkyB and EDS/HP, where EDS/HP paid BSkyB a reported £318 million in damages.

For every example of a failed outsourcing deal that is taken to court or reported in the media, our experience shows that there will be several more troubled deals in which the issues are resolved quietly between the parties behind closed doors.

The purpose of this article is to consider what lessons can be learned from some of those troubled sourcing deals.

Improving the chances of success from the outset

When many of the long terms sourcing transactions, now reaching maturity, were entered into, the economic backdrop was very different: no-one had foreseen the global down-turn or the pace of technological change. Although most contracts provided for a limited degree of change without the parties having to re-negotiate the contract (e.g. by use of the ARCs and RRCs model), they were not sufficiently flexible - in terms of their operating or charging models - to cope with the degree of change required.

It is essential that customers and suppliers need to recognise that through the lifecycle of any contract, unanticipated macro economic events or significant technological changes may arise which could materially impact the demand for services (both in terms of nature and volume).

One obvious way to mitigate this risk is to have shorter contract terms. Over the last few years, terms of between three and five years have become the norm. As a consequence, if and when unforeseen events do arise, the parties are more likely to be able to find a solution to address them. However, that is by no means the only potential mitigation.

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When entering into an outsourcing contract, a key issue for the customer will be whether the value of the deal is greater than the value of the alternatives that the outsourcing arrangement will preclude. It is common to undertake financial modelling when making these assessments, but companies will not properly understand the real value unless risk is factored in. If not, it is easy for the up-front financial value to be eroded quickly and for disputes to arise.

In recognition that environment to be supported will almost inevitably change and, therefore, so will demand for the services (both in terms of nature and volume), the contract should be designed to give much greater flexibility than was historically the case. The charging model underpinning the deal should recognise this fact also. For example, securing a lower unit cost by giving a minimum revenue commitment may make economic sense at the outset, but if the demand for services subsequently falls below the minimum revenue commitment, it becomes unsustainable.

A financial model which requires the payment of a partial termination fee if the consumption of services falls below a prescribed level could also become problematic at a time of unpredictable demand.

Solutions which include "financial engineering" (giving lower charges in the early years, in exchange for less competitive charges in the later years) are also best avoided as they can limit flexibility.

Historically, the change control procedures contained in contracts simply provided that if one party wanted to materially change the nature or volume of the services, the agreement of the other party was required, often leading to disputes. Having predictability as to the cost of change should be a key objective. An agreed cost standards should be incorporated in the contract, making clear which changes will be at no cost (e.g. re-deploying a particular resource to another task which requires the same amount of effort) and which changes will be chargeable (e.g. an increase in scope) and setting out the basis upon which changes to the charges will be determined (and an expedited dispute resolution process if agreement cannot be reached).

Life cycle management (including resolving outsourcing disputes)

Getting the contract right at the outset is of critical importance. However, managing the arrangements and the risks carefully and effectively throughout the life-cycle of the contract is of equal importance.

Outsourcing disputes can be extremely difficult to resolve. Suppliers provide critical services, become embedded in a customer's business, and are expected to deliver transformational change and savings to the customer. As a result, outsourcing disputes tend to be high value and highly significant for the customer and supplier.

The key to avoiding this situation is a clear understanding of the reasons why outsourcing relationships run into difficulties, and a realistic assessment by businesses of the benefits and risks of entering into a large scale, long term outsourcing arrangements. Our experience of outsourcing disputes across a wide range of sectors and industries suggests that there are some common root causes:

- There is a tension between the desire of the customer to generate cost savings, and do so quickly, and the desire of the supplier to "win the deal" and protect profitability over the life of the deal. Pushing too hard at the outset on price may be attractive but counterproductive;
- Failure to define the scope of services. Vagueness in this area, or an agreement to agree the details later, is often a recipe for later disputes;

- Failure to allow for market developments in areas (such as IT outsourcing) where technology can develop rapidly over the course of an agreement spanning several years. This can leave a customer with no option but to pay for additional or different services in order to maintain efficiencies.
- The complex nature of many outsourcing deals means that even in the best drafted agreements it is impossible to anticipate every situation that may occur in a contract that could last for many years.

A key consideration in resolving any disputes which do arise is whether to litigate. For every outsourcing dispute that is litigated, numerous others are resolved by a private renegotiation. There are good reasons for this "behind the scenes" approach, other than a healthy fear of litigation.

- Reputation - other than in extreme circumstances, suppliers do not want to be seen to be in dispute with their customers;
- There are other business drivers to continue the arrangement – this is often a long term contract, with most of the economic benefit derived from the later years;
- There is a real risk of business disruption if it were necessary to end the relationship;
- Where staff have transferred across to the supplier, it may be difficult to take the outsourced service in-house or set up new arrangements; and

  The complexity of many outsourcing relationships, and the inter-dependencies required from both parties to make it work, means that establishing where fault lies is costly and challenging in itself.

A good contract will provide many alternatives to legal action, gradually escalating from informal dispute resolution procedures, through formal exit provisions and all the way to litigation or arbitration.

At the outset of any dispute, it's important to identify the legal remedy that is available and to take steps to preserve this and ensure it is not prejudiced by any of the other steps taken, should it eventually become necessary to take legal action. The usual legal remedies to be considered are:

- Mandatory injunctions;
- Order for specific performance;
- Termination of the contract; and
- Claim for damages.

Potential claim for economic duress

Supply and service level threats are a common negotiating tactic, which can leave the customer with little choice but to give in to the supplier's immediate demands.

A customer might also contemplate withholding payment under the contract in the event of a dispute, however, this would not be sensible unless the contract expressly allowed for this as part of the dispute resolution mechanism.

If a supplier were to use such threats to extract more money from a customer, the customer could potentially have a claim for economic duress. This claim might be available under English law if:

- as a result of an illegitimate position taken by the supplier;
- the customer pays money to the supplier or incurs loss or expense; and
- for commercial and economic reasons, the customer had no other option.

Factors that the court will consider are whether the supplier's conduct was an actual or threatened breach of contract, whether the supplier acted in bad faith, whether the customer had any realistic practical alternative and the customer protested at the time and confirmed or sought to rely on the contract.

Managing outsourcing disputes

In the event a dispute were to arise, certain steps should be considered at the outset to preserve the usual remedies:

- Expressly reserving the right to terminate, so that any steps taken in the meantime cannot be construed as a waiver or affirmation;
- Preserving documents/data needed to prove the claim;
- Setting up a paper trail showing the evolution of the dispute, whilst at the same time, avoiding the creation of sensitive documents that may need to be disclosed;
- Ensuring access to witnesses, a concern where key personnel leave during the course of the dispute or where witnesses are consultants who are under no obligation to co-operate;
- Recording costs incurred in connection with the dispute, including management time; and
- Taking sensible steps to mitigate losses.

Outsourcing disputes can be costly to resolve and the costs are front loaded to a large extent. Some of the reasons for this are:

- The disputes tend to be complex, with no quick and easy solution;
- Dispute resolution clauses tend to be multi-layered;
- A detailed investigation is needed to identify the cause of the dispute and who is at fault;
- Disputes around interpretation of the contract are inherently uncertain;
- Legal advice is needed to assess the legal merits of the dispute, identify options to resolve the dispute and to formulate a strategy;
- Steps need to be taken to minimise the risk that remedies will be lost or prejudiced and to ensure recovery is maximised;
- Outsourcing projects generate a lot of documentation, much of which will need to be reviewed by lawyers; and
- Technical expert assistance is often needed to assist in the investigation and pursuit of any claim.

A key means of controlling costs is to ensure there is flexibility to use different processes to resolve different issues in dispute. Each process can be tailored to keep the costs incurred to a reasonable level. For example:

- Time limits can be imposed on the parties in terms of making and responding to claims and resolving the dispute informally;
- Limits can be imposed on the length of written submissions; and
- If a form of expert determination is used, a decision could be given on a document only basis or following a very short oral hearing.

Conclusion

In the best relationships, outsourcing proceeds well, with each party feeling comfortable that they are being treated fairly. In other cases, disputes arise that are complex, costly and difficult to resolve. These disputes can put the outsourcing relationship at risk, threaten the customer's business and take up valuable management time.

Both parties have an interest in minimising uncertainty in their relationship and avoiding disputes, or if disputes arise, in rationally resolving them as quickly and as amicably as possible.

If sufficient attention is paid to clarity at the time the contract is entered into, if the risks and potential causes of failure are managed carefully throughout the contract and if potential disputes are addressed when trouble first appears, the chances are that disputes can be avoided altogether or resolved without too much difficulty.

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