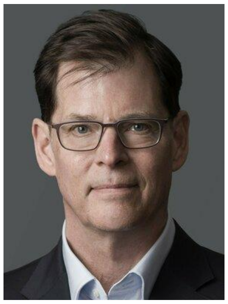
Portfolio Media. Inc. | 230 Park Avenue, 7th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

7 Ways To Address Unknowns In Outsourcing Contracts

By **Brad Peterson and Laura Buchanan** (December 13, 2023, 1:44 PM EST)



Brad Peterson

Laura Buchanan

There is good reason to be uncertain about what 2024 will bring for companies outsourcing critical business functions.

A year ago, for example, few were predicting the surge in new generative artificial intelligence products or the widespread technology industry layoffs we saw in 2023. Generally, business uncertainty appears far greater now than during the 1990s, when outsourcing business models were developed.[1] Thus, there is also good reason to focus on how to address that uncertainty.

This article describes contracting approaches now being used to address uncertainty in large, long-term outsourcing transactions. Uncertainty is a major factor in those big deals because success relies on numerous factors, decisions become increasingly difficult to reverse as the deal progresses, and a failure can damage the prospects and reputation of the entire company. However, many of the lessons learned can be applied across a wide range of outsourcing contracts.

1. Distinguish Uncertainty From Risk

For this article, we are using economist Frank Knight's widely used definition of "uncertainty."

Knight stated that "a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all."[2] With a risk, a contracting party knows the range of outcomes and the chance of each outcome. With an uncertainty, the outcomes and chances are unknown to the contracting party.

A party can also address risks in ways that do not work for uncertainties. For example, parties commonly address risks through compensating controls, technical and operational mitigations, insurance, warranties, indemnities, limitations of liability, and so forth. Knowing probabilities of possible outcomes allows a party to calculate the value of addressing risks in those ways and thus to create a business case for doing so.

The same cannot often be said for uncertainties. One way to address an uncertainty is to invest in identifying events and outcomes and measuring probabilities until the uncertainty becomes a risk, which can then be addressed as a risk.

That said, the number and range of the uncertainties — being unknown unknowns — are formidable and unquantifiable. We will thus spend the remainder of this article describing ways to address uncertainties as uncertainties.

2. Invest in Clarity

First and foremost among the uncertainties is whether the intent of the parties will be clear to the people who use it to run operations and resolve disputes over many years. Without clarity as to the promises being made, the parties cannot reasonably evaluate whether those promises are credible before signing and have been kept after signing. Clarity is thus an essential component in building and maintaining long-term business relationships.[3]

Clarity requires investment for many reasons. Achieving clarity through negotiations requires decisions and agreement on topics that are often difficult to discuss. Drafting clear contract language requires time and skill. Obtaining facts may require a detailed review of the in-scope functions, which may be both costly and disruptive.

Companies drive clarity in big deals using processes that can be applied to any agreement.

They start with a steering committee of executives committed to building a firm foundation for a successful long-term relationship. They prioritize a shared understanding of the deal, including the required due diligence, discussions and drafting. They create a culture of collaboration across companies, working to document a deal aligned to what a single enterprise would do to maximize value and avoid costly pitfalls.

Crafting language that clearly reflects the shared understanding of the deal is essential. That language should include commitments, options and incentives.[4]

3. Use Commitments, Options and Incentives

Commitments are the standard way to address risk in outsourcing contracts. The company seeks commitments from the supplier to provide specified products and services at or above necessary levels of quality and performance using specified technologies, locations and resources.

In managed services outsourcing, the supplier's commitment often extends to taking responsibility for performing an existing company function the way it is being performed at signing. In exchange, the company makes commitments to pay stated amounts when due and provide access to relevant resources. To some degree, commitments can include evolution and continuous improvement for readily foreseeable change.

To address uncertainties, companies seek options to change the commitments at reasonably firm prices. For example, the contract might allow the company to obtain out-of-scope services at reasonable time-and-materials rates, to reduce scope, or to change the technical or operational requirements as technologies and markets evolve.

Options increase agility by allowing the company to change outsourcing arrangements to match changing needs. In addition, options create savings because they may limit what the supplier can charge for a change — even a critical change where the company has little leverage — and reduce the chance of oversized commitments. However, to craft useful options, the company must anticipate what products and services the company will need to produce future desired outcomes.

When companies value certain outcomes but cannot specify what commitments might drive those outcomes, they create incentives for the supplier to act in the customer's best interest. Service levels and contractual damages are common examples, but in big deals, companies use a broad array of business metrics.

Their goal is to financially motivate suppliers to find creative solutions to improve those metrics. However, agreeing on effective incentives can be difficult because suppliers may have limited control over the outcomes.

4. Govern by Relationships

Even highly detailed commitments, options and incentives cannot address all of the uncertainty in outsourcing. Instead, companies fill the gap between the formal written contract and what actually happens during the term, creating an informal relational contract that operates alongside the formal written contract. Companies use the formal contract to support the relational contract through approaches such as the following.

Transparency

A party might be required to provide reports, provide access to monitoring systems, or allow audit of its books or operations by the other party. What the party learns can be used informally or formally to monitor and manage the relationship. Similarly, the parties might regularly exchange general information about their goals, challenges, capabilities and constraints. Exchanging that information can allow the parties to work more effectively to solve unanticipated problems and seize unanticipated opportunities.

Teams

Some contracts designate small teams, perhaps one specialist from each party, to jointly solve classes of problems. More sophisticated contracts might specify required skills for the team members and possibly provide for advance approval rights over designated key personnel.

Committees

Other contracts create one or more committees, often with three to six members from each party, to discuss and resolve issues. There may be committees on topics, such as service delivery or cybersecurity, and committees at different levels, such as operational, managerial and executive.

The contract may provide times and agendas for meetings, and might also permit a party to require a meeting upon the occurrence of certain events. If the decisions of a committee are in some way legally binding, there may be notice, quorum and voting provisions akin to corporate bylaws.

Decision Rights

Each party might be given the right to make certain decisions. For example, a party subject to regulations might have the right to interpret those regulations for the purposes of the contract.

5. Use Managerial Contracting Approaches

In some big deals, the company uses contractual provisions that allow it to manage suppliers in ways similar to how it manages its internal operations. These provisions are referred to as managerial provisions.[5]

Managerial provisions are of particular value if success depends on the employees of the company and the supplier working together as they would if they were part of a single enterprise with a single set of goals. Often, the company requires suppliers to follow company standards that were written for and also apply to internal operations.

For example, integrated product manufacturers require the use of very similar techniques in their component outsourcing arrangements as in their own operations. They specify details of supplier plant floor operations and have their engineers on-site to observe and help solve problems in supplier plants. A key benefit for the manufacturers is in their ability to verify process quality at every step, avoiding the difficulties of determining the quality of finished products.

The tighter adherence to company management practices created by managerial provisions may address some uncertainties. There is considerable research indicating that those management practices work well within companies.

For example, the World Management Survey compiles remarkably comprehensive information about managerial practices and firm performance.[6] A 2017 study using the WMS data found that "differences in management practices account for about 30% of total ... productivity differences."[7]

Using managerial provisions to flow down company management practices intensifies the need for the clarity, commitments, options, incentives and relational contracts described above, with a focus on how work is to be done. The company would need to invest in continuing to deeply understand functions that it has outsourced, which can be contrary to the objectives of many companies in outsourcing non-core functions.

Thus, companies in big deals tend to use managerial provisions only where the supplier's adherence to the company's standards is important to the company's larger business, and the company is confident that its standards are superior to those that the supplier would otherwise implement.

6. Modularize

Companies also seek to address uncertainty through modular deal structures, essentially structuring a big deal as a set of smaller deals. Extensive data supports the proposition that modular is faster, cheaper and less risky in a variety of scenarios.[8] Modularity explains the successful economics of, for example, cloud computing, which is based on immense numbers of individually low-powered devices.

The modular approach has many variations.

Some companies divide a large scope into modules and contract for them separately, allowing them to be reduced or added as needed and containing the effects of particular uncertainties within a module.

Others take a modular approach across time, for example, by structuring a transition in many waves and using an agile process for learning from each transition wave to make the next transition wave more successful.

Still others divide modules by deal structure. For example, a function might be divided into modules priced on inputs, modules priced on outputs, and modules priced on outcomes. This allows the company to leverage the best approach for each scope.

Using a modular approach also helps to make the approaches described earlier in this article more feasible.

A group of specialists on a module can optimize clarity, commitments, options, incentives, relationships and managerial provisions for that module. They can govern that module knowledgeably through teams, committees and decision rights. Companies can apply managerial provisions to modules where the benefits justify the investment — and omit managerial provisions from other modules.

In parallel, an overall deal structure with cross-module governance and cross-module services can help to optimize value across modules and shared functions.

7. Use Excuse Clauses

Force majeure is a long-standing approach to uncertainty. As laid out in a 1905 Louisiana Court of Appeals decision in Lehman Stern & Co. v. Morgan's, force majeure has been loosely translated to mean an "'act of God,' or, such an interposition of human agency, as is from its nature and power absolutely uncontrollable,"[9] and has long been used as a liability exception for certain types of unpredictable events. Related common law concepts include defenses of impracticability and frustration of purpose.

Force majeure clauses are commonly used in contracts for both risks, such as severe weather, and uncertainties. They can act as a catchall approach to uncertainty. Often, they include provisions such as the following:

- Relief from liability for performance to the extent prevented by a force majeure event;
- A designation of the force majeure events for which an excuse of performance is available, generally including a list of enumerated events that have a material adverse impact on the ability to perform;
- Specific obligations to reduce the effect of a force majeure event, such as obligations to take reasonable measures in advance to reduce the impact for force majeure events, such as a fire prevention system; rights to a primary or at least reasonable allocation of remaining supply; or rights to use designated overflow capacity, such as a hot seat at an alternate facility;
- General obligations to mitigate risk and share information to the extent practicable; and
- The right for the company to terminate if the force majeure event persists for a certain amount of time.

Notably, an excuse clause addresses uncertainty primarily for supplier. The company must find another way to address the uncertainty, such as an alternative supplier or having similar force majeure clauses with the company's own customers.

Conclusion

In big outsourcing deals, companies use various approaches to securing and delivering value amid rising levels of uncertainty. These approaches generally involve better coordination across enterprise boundaries and building flexibility into contracts to be more prepared for a larger range of conditions.

When they fit the deal, these approaches can enhance the benefits of having critical functions performed by outside suppliers in increasingly uncertain times. These big deals have paved the way for ever-wider use of these approaches to maximize value and avoid costly pitfalls.

Brad Peterson is a partner and Laura Buchanan is an associate at Mayer Brown LLP.

[1] See more generally the World Uncertainty Index at https://worlduncertaintyindex.com/.

[2] Risk, Uncertainty, and Profit, Frank H. Knight, Ph.D., Houghton Mifflin Co., The Riverside Press, 1921, paragraph 26 of Part I, Chapter 1. https://www.econlib.org/library/Knight/knRUP1.html#Pt.I,Ch.I.

[3] See Robert Gibbons, Rebecca Henderson, Relational Contracts and Organizational Capabilities, Organization Science 23(5), 1350-1364 (2011).

[4] See Brad Peterson, Estimating the Value of Contract Terms in Sourcing Agreements, Contract Management, Apr. 2012, available at https://www.mayerbrown.com/-/media/files/news/2012/04/estimating-the-value-of-contract-terms-in-sourcing/files/contractmanagement4-12/fileattachment/contractmanagement4-12.pdf.

[5] Lisa Bernstein and Brad Peterson, Managerial Contracting: A Preliminary Study,14 Journal of Legal Analysis 1, 176–243 (2022),https://doi.org/10.1093/jla/laac007.

[6] See Centre for Econ. Performance, World Management Survey, https://worldmanagementsurvey.org/. See also, Chad Syverson, What Determines Productivity?, 49 J. Econ. Literature 326, 329, 336-338 (2001) (discussing the design of the WMS and the "steps [taken] to enhance the accuracy and consistency of the survey.").

[7] Nicholas Bloom, Raffaella Sadun & John Van Reenen, Management as a Technology? (Nat'l Bureau of Econ. Rsch., Working Paper No. 22327, 2017).

[8] Bent Flyvbjerg, How Big Things Get Done: The Surprising Factors that Determine the Fate of Every Project (Random House, 2023), at 173.

[9] Lehman, Stern & Co. v. Morgan's L. & T.R.R. & S. S. Co., 2 Teiss. 236, 1905 La. App. LEXIS at *13 (La. Ct. App. 1905).