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Tech Talks

Negotiating for Value in Outsourcing Contracts

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Announcer
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Julian Dibbell
Hello and welcome to Tech Talks. Our topic today is "Negotiating for Value in Outsourcing Contracts." I'm your host, Julian Dibbell. I am a senior associate in Mayer Brown's Technology & IP Transactions practice. I'm joined today by my colleagues Mark Prinsley and Brad Peterson. Mark is a partner in the Technology & IP transactions practice based in London. Brad is also a partner in our Technology & IP Transactions practice out of Chicago. We are very fortunate to also be joined today by one of our longtime outside collaborators, Jon Lightman, from ISG. ISG is, of course, one of the world's leading transformation advisory firms, and so Jon, you're the perfect place to start here. Before we get into the nuts and bolts of contracting for outsourced services, can you maybe help us understand the broader business perspective? How is it that businesses out there in the market right now are using outsourcing to maximize value, both in terms of cost reduction and otherwise?

Jon Lightman
Thanks so much, Julian, appreciate it.

I thought it would be helpful with this group to frame the discussion, which obviously is going to delve into some legal issues, but I wanted to kind of maybe pull focus out a little bit to start with to say firstly, we're honing in on managed services and managed services are not the only way that companies leverage external providers, and as these new business models evolve, they coexist with older and newer ones. Prior to managed services, we had staff augmentation and subsequently we've seen a rise of as-a-service. All of these have very different attributes and they all kind of coexist, as I said in the market. Having said that, the market for managed services themselves continues to grow and I don't think this business model is going to go away any time soon, so I thought that would be helpful to kind of set the scene. And then secondly, to mention the fact that outsourcing is a delivery model. It's how work gets done and it's part of the ongoing make-versus-buy discussion that is going on constantly within the enterprises that that we all work for. While today we're focusing on drafting contracts to ensure that the value is realized and cost savings are achieved, it's worth noting that some of the drivers that we're seeing today pushing organizations towards outsourcing actually have nothing to do with cost savings. For example, access to scarce talent pools like cybersecurity and areas of joint innovation, co-innovation and co-investment aimed at creating new revenue streams. So while cost savings are an important aspect of many current outsourcing initiatives, they're not the only one. The other thing I would say is that most, but not all of the levers that drive cost savings are not the exclusive domain of outsourcing. If you think about something like labor arbitrage, that can be achieved through building a captive. If you think of automation, tools can be licensed directly and you can develop bots yourself without a third party. But outsourcing does act as a catalyst for some of these changes. In a sense, it's kind of pulling the band-aid off.

In addition, there are tools in the outsourcing toolkit which aren't actually available to enterprises. A classic one is scale. While purely thinking about the economies of scale and economic impact, actually oddly has not been a huge part of the ROI of outsourcing historically. As I mentioned before, around access to talent pools, the access to large global workforce does mean that outsourcing providers can often be more resilient and even more agile than their enterprise clients. One example is look at how quickly service providers were able to shift to fully remote work-from-home models during COVID. In many cases they did much faster and more effectively than their customers, and probably the most significant lever in the provider's toolkit that is not available to the enterprise client is the ability to financially engineer deals. So bring out a year savings forward through essentially amortizing the upfront investment over the term of the deal. Almost all deals today require material transformation to get to significantly reduced run rates and clients don't want to pay for this upfront, not surprisingly. Given the high inflationary environment and associated cost of money, I'm not sure if this model will continue to be successful, but it is certainly prevalent in the market right now. But it's important as you're drafting the contracts to understand that really this client is taking a loan from the service provider in order to fund that upfront investment and that needs to be carefully highlighted and isolated in the contract. It has impacts in areas like termination for convenience fees and finally, real cost savings come at a total-cost-of-ownership level. Reducing the cost of it in scope function, what you're actually outsourcing is only one element of the total picture. For example, in organizations, internal costs, reduction of shadow capacity and net new investments they need to make in developing appropriate vendor management, change management functions all need to be factored into the equation. And a well-drafted contract can ensure that some, but not all of these are considered as part of their overall deal. On that note, I hope I've answered a little bit of your question, Julian, about the framing so I'll hand it back to you to delve into the more discrete legal issues.

Julian Dibbell
That's exactly what we were looking for. Great summary of the sort of operational and economic

considerations that a business is going to be going into an outsourcing deal with the purpose of reducing costs. So, then the question is for Brad and Mark, how do we as lawyers contribute to that goal in the contracting process, what can we do, Brad?

Brad Peterson

To maximize value, the first thing you need to do is to make sure as a lawyer that what you ask for in the contract, every piece of it somehow manages to reduce total cost of ownership, as Jon said, or actually contribute to value in some other way. So let's look at that a bit. In the first thing is that every requirement that we put into the contract adds cost for the supplier. It may not be cost that changes the suppliers operating model or changes its operating costs, but it is a requirement that adds cost to some degree. If we can look at each of those obligations and think about stripping away things that are excess or not providing as much value as you end up paying for them, you can of course increase value.

Similarly, instead of sort of saying we want supplier to do everything that we're doing today, think in terms of what you actually want done tomorrow. Another way to look at this is to reduce supplier risk premiums. As lawyers, we often think, well, our job is to reduce the risk on the company side, but a company may be able to reduce its cost by reducing risks for suppliers. An easy example, not as legal, is the risk of inflation.

Suppliers may be willing to offer a better deal if the customer is willing to bear more of the risk of inflation or currency exchange rates or other potential problems. We can also reduce risk by allowing more due diligence, providing more reliable information and bearing more of the risk of changes. Think also about where the best place to allocate risks might be. If a risk is being placed upon the supplier, the first question is the supplier is best able to handle that risk? If the supplier is not best able to handle that risk, is it a risk where putting that risk on the supplier and asking the supplier to incur more cost to address it will actually generate enough incentive value to be worth doing. Then, a final thought is consider whether you actually need to buy some of the elements of the contract, or whether it would be just as easy to make those an option, or maybe something that you can rely on better alignment through a governance to achieve.

Julian Dibbell

Those are great points, what I was hearing there was a lot about like how to move risk allocations back and forth, sort of between the customer and the provider. But one of the themes I was picking up in Jon's opening remarks is, there's also an opportunity to increase value by taking a more collaborative approach with the provider. We can think of joint product development or IP and data monetization. Mark, are you seeing that out there and how does that work and how do we as lawyers contribute to that?

Mark Prinsley

Yes, I think we are seeing a real step change in the appreciation of the value of the data that a customer has and that can be generated in the course of a transaction and that data is only of value in a sense that if it's monetized, if, in the simplest form the supplier is as allowed to use that data for some purpose other than the provision of the services and years ago outsourcing agreements said stuff about the supplier being free to use anonymized, aggregated data which are collected during the course of the performance of the services without any real thought. It seemed like a small give for the customer, but actually in an era of machine learning and AI tools, any data is of value and actually separate customers also have a great deal of data which can be processed during the provision of services and that may be of considerable value to the supplier and the supplier may be able to exploit that in a way which is of minimal detriment to the customer, and that is a value generator which should not be ignored. Of course, as a lawyer, we would have to tell our clients that the things you need to look at in relation to this data are your data protection or PII obligations in relation to any data. Clearly you would want the data to be anonymized. You would also probably want it to be aggregated in a way which not only could it not be tied to an individual but it couldn't probably be tied to your individual organization. Provided you can get through the PII data protection and confidential information type issues, you may, as a customer, find that the data you have and attributed no value to is something which can be used to drive value in your deal with your supplier.

A second trend which we have seen over a number of years is the idea that the supplier and the customer might collaborate to offer a service to the market. In a sense you pull together the suppliers' efficiency abilities and the customers' subject matter expertise and you create something which is of value and interest to an industry. Together you create a tool which you can sell to the market and as a result of the revenue generated through the tool in the perfect world, the cost of the outsourcing, which is fundamentally what the customer has done in this model, subsidizes the cost of the outsourcing. There are definitely antitrust issues around this, which have to be managed because you are probably talking about people in the same industry collaborating in a way, if this idea of an industry tool takes off, but it's certainly in some cases worth investigating and may produce dividends in terms of the overall cost of the outsourcing, in fact being reduced by the revenue you can generate by doing business together with the supplier. We are definitely seeing people exploring that possibility.

Julian Dibbell
Right. Collaboration has the potential to unlock value in the business. So, the key point Jon makes is that outsourcing is a delivery model not an operating model. You are not necessarily changing how operations work by outsourcing but you can leverage the engagement with the provider to transform your own operating model. Brad, I am really interested in that and how can we as lawyers shaping the contract facilitate the new operating model and facilitate the transformation that can come out of an outsourcing deal?

Brad Peterson
Good question, Julian. In part, the traditional managed services outsourcing approach impedes the ability of suppliers to use their scale and the technology that they have to change the operating model. One thing that we need to do is rethink the contract in a way that allows the

suppliers to bring the best of what they do. Imagine that you have, we will call this deal, digital transformation through outsourcing. The supplier takes responsibility for a function as a managed service. You have charges based on the work that's completed, the outputs, not the way that any particular delivery model was being executed. You add new metrics for outputs instead of inputs. The supplier, thus it has an incentive to reduce the cost and increase the value of the operation, and you put it in a position where after, say the five-year managed service term the customer can take back the operation with the reduced costs. Then, you give the supplier substantial latitude to change the actual operating model. That is the most complex piece because the operating model in most managed services deals that we have worked on is based on customer technology. So suppliers will need the ability to automate what's going on within customer systems to add AI, to add bots, to add outside staff services to replace less efficient parts of the customer system.

Now customers are of course concerned about that. But as I said in the original piece, to allow suppliers to maximize value and avoid costly pitfalls, you've got to provide a certain amount of latitude. So you would still say that each change to customer systems would require the approval of customers change control board, but you would say that would only be withheld for very good reasons, such as a violation of technology standards or genuine adverse effects. You would probably set up some sort of a committee that would meet regularly to review the progress of the operating model changes with commitments by both sides to collaborate and make this more effective.

The supplier is going to need the customers' help to perform, not just in the co-development way, but the customer may be required to provide technical support, access to systems, access to data, a general cooperation from throughout the organization. The customer may also be required to subscribe to elements of the suppliers operating model. Many suppliers, for example, bring their own AI and RPA platforms. Other suppliers leverage outside SaaS services to perform key parts of their service delivery infrastructure.

Then you have agreements by the supplier to cooperate with ongoing change by the customer so that the organizations remain in sync. There are challenges, of course, but if you think about this and if you carefully work through the change in the operating model and collaborate to make that happen, you should be able to maximize value while avoiding pitfalls by leveraging the suppliers scale best practices, access to talent and all the rest.

Julian Dibbell
That's fascinating, Brad. I think it's getting us closer towards to a key theme here in this discussion, which is that, this is not just about reducing costs per se, it's about really finding greater value in your operations through the outsourcing. Beyond just the pricing issues, Mark, what are some other elements that we can look for and focus on to maximize value?

Mark Prinsley
Interestingly, Jon touched on three themes at the beginning of the talk which I think are all

relevant and they are really labor, tech licensing, data security and cyber and dealing with them each in turn. As far as labor costs are concerned it's obviously the issue labor arbitrage, which I think is getting smaller, but the customer has the threats of regulation of the economy forcing up costs, the living wage issues around the world and those are factors. There's legal restrictions which apply to the labor which the supplier and the customer is using and actually parking that risk with the supplier in exchange for a known labor cost is probably a beneficial aspect of outsourcing.

Tech licensing is the second point. The concern here is whether the customer is the best person to manage the tech licensing estate and minimize the risk of being pursued in hard times by a supplier or a software licensing business which thinks it can generate revenue by conducting an audit of its customers and producing an unexpectedly large bill for the customer, again, outsourcing to a supplier who then takes on the licensing responsibility and buying a service, that removes a risk which can be a significant sum if the licensing practices have not been as effective as they might be, or as the software licensing organization required.

The third area to consider in the sort of overall cost, and this is really looking at it from a sort of legal perspective is that the cost of data protection, compliance and cybersecurity is rising all the time, and cybersecurity is a c-suite issue, and it may well be actually that by getting an outsourced service provider who is providing a top class service to a range of clients can get you more world-class cyber compliance at a lower cost than doing it yourself. And so that's another example of a kind of elements of the total cost, which you should consider in the context of whether or not outsourcing represents a cost saving or value in your world.

Julian Dibbell
Great. And of course, as lawyers we're also always helping reduce cost by guarding against costly legal pitfalls, right? Brad, what are some key lookouts there?

Brad Peterson
If we are putting together a cost-focused or value-focused outsourcing deal, the business team will likely drive down the price also—perhaps through a competition, perhaps through hard bargaining—and the supplier thus will be probably under its preferred margins and be looking for opportunities to claw back.

Unless you have a very clear, firm commitment to deliver the services you need in compliance with your legal requirements and your other business requirements at some reasonably firm price, you'll find that the cost savings that look great on the business case will tend to evaporate. And that's why, if anything, it's more important to have a tighter contract when you're trying to get to a cost-focused or value-focused contract and it's even more important to have a tight contract if you're pursuing an innovative approach where there are a lot of opportunities for future change orders or adverse surprises.

Julian Dibbell
A tight contract to ward against those moments where things go wrong and disputes arise, but the flip side of disputes is again collaboration and working together and that's kind of the purview of the governance aspect of the contract. Mark, what have we seen about ways to maximize value on the governance front?

Mark Prinsley
I do not know if this really is about maximizing value, but I do think that there are a range of governance models, some of which are fantastically complicated and can be quite expensive to operate. What I would say is that the world of outsourcing and the world generally has had two big shocks over the last two or three years. First, there was COVID and now there is the Ukraine conflict. We know that both of those have had a big impact on some outsourcing arrangements and businesses have had to be much more flexible than anybody would have imagined in the way they operated the business. The interesting thing is you know when it really matters, the customers and the suppliers have managed to find a way through things. So actually, maybe simplified governance is the way to go and not spend massive amount of energy having masses of committees, but recognize that actually you know governance does happen, you find a way through it and for the big stuff, probably the interests of the supplier and the customer are largely aligned and focus on simplifying governance probably will save money as you run a contract and that is a value-saving thought.

Julian Dibbell
Jon, you've heard the lawyers weigh in. I'll give you the last word to give the business perspective and reaction.

Jon Lightman
Two points, one to build on Mark's point about incentive alignment, you know, we didn't really talk about one of the key ways to reduce cost is to frankly reduce volumes because in any PxQ model, if you can reduce the "Q" then you're going to reduce the cost more effectively than just reducing the price part of it. Even in managed services there's a tremendous amount of discretionary spend and there's a tremendous amount of spend that can be controlled. In many cases the provider is not incentivized because they're paid on volumes and reduction volumes means they get paid less. So aligning the commercial model to make sure that they are incentivized to help throttle demand for discretionary spend, to put processes in place that ensure that applications are effectively rationalized, that cloud compute doesn't just act as an automatic ratchet up and that there is control over how much capacity is spun up by the client. Those are also areas where the provider can add a tremendous amount of value in wrapping some process around some of those things and help to drive the client to better adherence to only spending the money that they need to spend.

Finally, I would say that we focused on a lot of complicated issues here and there are obviously many legal aspects that relate to outsourcing, but don't forget that when the lawyers leave the room, these contracts tend to be managed by vendor management organizations or procurement organizations and complexity can be a hurdle because they don't necessarily understand all the bells and whistles of what has been done at a contracting level. Simplicity is also an outcome that you should look for and being effective, but also being simple and being easily understandable is actually the hardest job of lawyers. It's easy to show how smart you are by creating incredibly complex and nuanced contracts, but it is harder to create effective contracts that are actually simple and easy to manage. And again, back to Mark's point about keeping the governance side of things small. So I would close by saying a lot of points to take into consideration, but the end result needs to be a contract that can actually be managed by the enterprise.

Julian Dibbell
Well, words to live by, for sure, for all of us business lawyers. Thank you, Jon, and thank you, Mark and Brad for all of your insights today and thanks listeners for listening in. If you have any questions about today's episode or an idea for an episode you'd like to hear about, anything related to technology and IP transactions and the law, please email us at techtransactions@mayerbrown.com.

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