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Many companies and firms are currently looking into ways of managing their costs and tightening their financial belt in these challenging economic times. One way of doing so could be to outsource a particular function or activity to a specialist third party service provider. Outsourcing may even bring with it the added benefit of increased efficiency.

For those companies or firms which are already party to an outsourcing arrangement, there may be the possibility of renegotiating the existing arrangement in order to drive through potential cost saving measures (although the quid pro quo could be, for instance, an extension to the duration of the arrangement).

This article briefly considers some key issues to bear in mind in connection with re/negotiating an outsourcing arrangement.

Due diligence

Prior to entering into any new or renegotiated outsourcing arrangement, it is critically important to carry out a thorough due diligence exercise into the service provider to assess its financial strength and its competence.

If the provider is to carry on a regulated activity, it will need to be verified that the provider does have all necessary authorisations, licences and approvals. If the provider has a good track record of delivering services similar to those

proposed to be offered, then, no doubt, comfort can be taken from this. However, if the provider is a dominant player in a particular market, there is the possibility of a concentration risk (in other words, that the provider could become overstretched and not deliver the level of service expected). Further, it needs to be considered what mechanisms such a provider has in place to deal with any potential or actual conflicts of interest.

If the provider is based offshore, then the relevant country-specific risks will need to be thoroughly looked into. For instance, how stable is the country politically and economically? How well educated are potential staff? What are staff attrition rates like? How good is the infrastructure? What is the risk of terrorism or political upheaval? Two key issues are likely to be around data privacy and business resilience. There could also be a PR issue to manage if there is a risk that jobs could be lost in the home market but new jobs created in the relevant offshore market.

Fee model

The fee model which is to be agreed needs to be carefully considered. The model could involve a fixed fee, which provides certainty but is inherently inflexible. If the volume of work which is outsourced drops off, then it is likely that such a fee arrangement will involve the customer paying over the odds.



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An alternative is a variable fee model. This provides more flexibility, but a provider may seek to include a floor below which the fee cannot fall, in particular, in circumstances where it has acquired some employees from the customer and has assumed a certain amount of, in this case, employment-related liabilities.

A customer may also seek to negotiate additional protections, such as a right to benchmark the fees being charged (whatever fee model has been adopted). This benchmarking may take the form of instructing a specialist sourcing adviser to carry out an exercise comparing the charges of comparable service providers, or it may involve seeking quotes from competitor third parties. It could also involve the customer carrying out an open book inspection of the service provider's costs and margins, but, clearly, a provider is likely to strongly resist this option.

Finally, it may be that the customer will require the provider to agree to seek to reduce its costs year-on-year and then to pass any costs savings onto the customer. However, such a provision, assuming it is acceptable to the provider, may only amount to an agreement to agree and may not be legally enforceable.

Managing the relationship

It is very important for there to be a robust governance structure in place in order to manage the relationship between the customer and the provider. This will typically involve a regular programme of management meetings being held between representatives of the parties to discuss any issues which may have arisen, or which could arise, and ensuring that there is an escalation mechanism which can be resorted to, if required, to resolve any disputes arising between the parties.

In addition, as part of this governance framework, the customer will want to have the benefit of adequate monitoring/audit rights. Indeed, if the customer is authorised by the

FSA in the conduct of its day-to-day activities, it is essential that the customer has such rights in order to comply with FSA regulatory requirements - the customer cannot contract out of these requirements.

Such rights may well entitle the customer to regular service delivery or similar reports from the provider so that the customer can assess the extent to which the service provider is complying with its obligations (including service levels or key performance indicators). Moreover, the customer will usually insist on a right of audit, which the customer may choose to exercise at periodic intervals, or when there has been, for instance, a breach, or suspected breach, by the provider of any of its obligations. These rights will also typically include a right to review the results of any regular testing by the provider of its disaster recovery or back-up facilities.

Where there has been a breach or service failure by the provider, certain consequences will follow depending on what has been agreed by the parties. For instance, for non-material service failures, the provider may be required to draw up a report specifying the nature of the failure, why it has happened, and what steps can be taken to prevent it from happening again. If the failure is more serious, the provider may be required to pay a service credit to the customer. In even more serious cases, the customer may have a right of step-in or a right to appoint an interim provider in place of the incumbent provider.

The ultimate sanction for the most serious breaches will invariably be a right for the customer to terminate. This may not necessarily be a route which the customer will want to go down, as any migration of the provision of the services either in-house or to another service provider (assuming there is one) is likely to involve a great deal of effort and time and, no doubt, disruption to the business being serviced. From the customer's perspective, prevention is likely to be a much better option than cure.

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If a customer does not want to pull the plug on, and terminate, the arrangement (at least not yet), it could seek to renegotiate or restructure the arrangement, assuming, of course, that the customer has sufficient leverage to do so and the provider is willing to enter into new discussions. In the current climate, it is likely that a provider will be willing to enter into such negotiations in order to safeguard against the arrangement being terminated early.

Final thoughts

An outsourcing arrangement can clearly deliver real business benefits. However, there are a number of traps to be wary of from the customer's point of view.

It is very important that the customer in re/negotiating an arrangement is aware of the need to maintain a balance of risk and reward. Long term, very little advantage will be gained

by a customer if it secures a deal which is overly favourable to it. Such an arrangement could well result in the provider failing to deliver on agreed service levels and/or having to cut corners in order to avoid the arrangement becoming completely uneconomical for the provider. This situation would be in neither party's long term best interests.

Finally, an outsourcing arrangement will in many cases be intended to be a long-term one, and it needs to be flexible enough so that it can adapt to changes in regulation, market conditions and/or business needs. Again, an overly prescriptive and/or inflexible arrangement is not likely to be in either parties' long term best interests.

With careful planning and negotiating, these issues can be successfully managed.