SIX BIGGEST MISTAKES IN OUTSOURCING CONTRACTS

STEVE SEMERDJIAN

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Nearshore Americas

While outsourcing has become commonplace in today's business environment, the contracting process will, rightfully so, continue to challenge even the most senior outsourcing veterans. For instances, as an outsourcing customer, have you ever really looked at how much it would cost to kill a deal and back out? There are undoubtedly dozens of mistakes you and your team can make trying to make an outsourcing relationship work for the long-run. In this article, you will find the six biggest snafus to watch out for.

1) Failing to Build a Complete Business Case. Building a complete and thorough business case will help any outsourcing transaction run more smoothly. As an initial matter, a solid business case helps the business to organize the details of the proposed transaction and analyze and understand the mechanics of the deal, most importantly as it relates to the financials (including pricing and the customer's retained costs). It also exposes gaps in the transaction and issues which require additional diligence to ensure that both parties have a complete understanding of the details of the deal. Failing to conduct proper internal due diligence and produce a comprehensive business case can lead to a variety of problems, including improper scope, pricing that doesn't properly reflect the anticipated business deal, and post-contractual price adjustments which more often than not will increase the cost of the deal.

2) Lack of Deal Scalability. When an outsourcing contract does not contemplate the impact of fluctuations in the customer's business (such as acquisitions, divestitures, and business downturns) on the pricing of the deal, the customer may end up having to either pay more for the services it is receiving or constantly have to renegotiate pricing to reflect the then-current state of its business. Pricing must therefore be structured in a way to support any such foreseeable fluctuations. This is commonly achieved through the implementation of volume based pricing, where the customer pays a set fee for a contracted volume of services, with a mechanism to adjust the fees based on increases or decreases in those volumes. Such increases or decreases will invariably be capped by the vendor to a certain percentage of the contracted volume, and exceeding that cap will typically lead to a pricing renegotiation.

3) Not Knowing the True Cost of Getting Out of the Deal. While much time and effort is often spent analyzing the financial impact of entering into an outsourcing contract, many customers fail to pay equal attention to the costs of getting out of the deal. In addition to any wind-down or termination fees that the customer may be required to pay to the vendor to exit the contract, customers also need to consider the costs it will incur to replace that vendor, including the cost of: (1) negotiating with, and transitioning to, a replacement vendor; and/or (2) bringing back the services in-house, including the hiring and training of replacement employees, acquiring office space for such employees, and acquiring replacement infrastructure (including equipment and software). To help analyze these costs, a well thought out exit strategy developed at the outset of the contract will prove invaluable.

4) Ineffective Change Management. Change management is an integral part of every outsourcing contract as it dictates the terms under which the parties will implement post-contractual changes to the deal. These changes may be as simple as a change to a vendor process, or as complex as a removal of

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a service from the scope of the contract. The key issue to tackle in an effective change management process is to set detailed guidelines on when a change has a financial impact on the deal, allowing the vendor to charge additional fees or the customer to pay less fees. Failing to do so will often lead to protracted discussions (and most likely differences of opinion) as to whether any given change impacts the financials which will delay or possibly inhibit its implementation.

5) Too Much Reliance on Benchmarking. Most customers will spend substantial time and effort negotiating a detailed benchmarking clause with the assumption that they will be able to fairly easily implement the clause during the term of the contract to drive down the vendor's price. In reality, however, because they are so heavily negotiated, many benchmarking clauses become difficult, if not impossible, to implement in practice due to (1) the lack of information in the marketplace regarding comparable deals against which to benchmark and (2) most vendor's reticence to automatically implement any price reductions based on the results of the benchmarking. As a result, while potentially a useful information gathering exercise (which the customer is free to initiate on its own whether or not included in the contract), benchmarking is not a panacea for driving down the price.

6) Insufficiently Detailed Services Description. The devil is in the details when drafting a services description and far too often customers do not spend enough time detailing the services to be provided by the vendor. Although "sweeps" clauses are very useful to capture inherent services which are not explicitly memorialized, taking the time to work through the business needs and to describe the services in the most granular way will be more helpful in avoiding scope disputes as the contract moves forward. And the more detailed the services description, the less often the parties will need to resort to change management discussions.

Steve Semerdjian is partner in the Technology and Outsourcing Practice Group and is based in the New York office of Loeb & Loeb LLP. He can be reached at ssemerdjian@loeb.com or 212.407.4218.

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