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Because Change Happens - How to Ensure Flexibility in your Outsourcing Arrangements?

January 2008

by Susan McLean, Alistair Maughan

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In these fast changing times, many technology outsourcing arrangements seem to be out-of-date almost as soon as they are signed. Strategic changes, market changes, technology changes, and legal and regulatory changes could all mean that your hard-fought outsourcing deal no longer meets your needs.

It is widely recognised that all outsourcing arrangements need to build in a level of flexibility to ensure that they meet the customer's evolving needs over time. But this may be easier said than done. How do you put a level of future proofing into your contract, what types of changes do you need to consider when drafting and negotiating the contract and how do you manage the contract to make sure that it is as flexible as possible?

Change Control

At a bare minimum, the outsourcing contract should include a robust change control mechanism, detailing what should be included in each change control note (CCN), impact analysis requirements, pricing for changes, turnaround times for CCNs, *etc*. Ideally, you should also include a standard template CCN, to ensure consistency of approach from day one.

Customers typically worry that the change control schedule becomes the vehicle for every small change that happens over the life of the relationship. In terms of material changes, that can often be true. But it may also be possible to agree in advance a series of "non-chargeable changes" which don't attract an extra fee.

Some potential changes are predictable in advance – and to the greatest extent the parties will want to consider whether to pre-agree the consequences of such events. Changes in this category included changes in volumes (which can arise many different ways – mergers/acquisitions/divestures, changes in business strategy, changes in requirements, *etc*). To avoid extensive restructuring of the outsourcing arrangements when change happens, the following types of change should be addressed when negotiating the contract.

- **Volume change**. Detail how any ramp-up or down in volumes will be implemented (including planned and unplanned peaks) and any related impacts.
- **Pricing Structures.** Use unitised pricing structures (*e.g.* pricing on a per user or per transaction basis) to give greater flexibility. The customer will know in advance the pricing impact of any changes in volumes and such changes can be implemented without having to renegotiate the pricing.
- **Corporate Re-organisation.** The contract will typically cover a restricted category of service recipients – *e.g.* the customer and its group companies. But the contract should also make clear that where the company divests any business within its group, the service provider will continue to provide the services to that divested entity for a run-off period. Otherwise, there may not be any guaranteed continuation of services following the divestment, which would make the company's ability to divest more difficult or risky (and potentially more expensive if the service provider's co-operation is subject to additional

charges).

- **Break Option.** Business change may mean that the customer wants to exit from the contract early (whether to move to a new supplier or in-source the services). Accordingly, the customer will need a right to terminate for convenience. This should not be a "get out of jail free" card. The service provider is likely to attach a cost to early termination. To ensure that the customer is aware of the impact of exercising this termination right, the contract should set out the termination fees that would be payable. Ideally, this would be on the basis of a sliding scale with the termination fees reducing over the length of the contract. At the very least, the categories of costs of that the service provider could recover in this situation (for example, irrecoverable third party costs, set up costs, *etc*) should be set out in the contract. The hardest negotiations in this area usually centre on the extent of recovery of "lost" future profit.
- **Change in Control.** The customer should also consider changes that may affect the service provider during the term which may impact on the customer or the customer's desire to do business with the service provider. For example, it's common to include change of control provisions which allow the customer to terminate the contract if the ownership of the service provider changes in a way that adversely affects the customer.
- **Duration.** Have a fixed term, but with extension rights for the customer. Some customers are considering "evergreen" contracts that simply roll-on after an initial term: flexibility both ways in pricing such contracts is important.
- **Exit.** Include detailed termination assistance procedures. The customer should try to ensure flexibility over the length of the termination assistance period (*i.e* by having the ability to require a period of assistance which can then be extended) and options (rather than obligations) to purchase assets and have third party contracts novated *etc.*
- **Emergency Changes.** Consider allowing the service provider to make certain temporary emergency changes without having to go through the full change control management procedure. However, if you do so, be very clear in the contract as to the circumstances in which the service provider could make such changes (*eg* where making such change would be in the customer's best interests) and any related issues, for example, who bears the costs of those emergency changes.
- **Service Level Agreement.** It is important that the Service Level mechanism is flexible. The Service Level should be regularly reviewed and revised to meet the customer's needs. Also, the customer should have the right to amend service credit weightings over time. For example, at the time the contract is signed a particular service level may be considered critical to the customer, but later on it may become clear that a different service is more critical. Having the flexibility to change the weightings of service credits will help focus the service provider's attention always on those service levels that are most key to the customer.

Technology Changes

Another area that it very likely to change over the life of the outsourcing deal is technology. The customer will be keen to ensure that the service provider takes advantage of any technological efficiencies and improvements. Accordingly, the contract should incorporate appropriate technology refresh provisions and the service provider should be under an obligation to inform the customer of technology improvements, ideally via regularly scheduled improvements meetings. At a minimum, it should be clear what technology changes are "priced in" and what will only occur through subsequent change and investment.

Change in Law

It is wise to consider how changes in law and regulations will be dealt with in the contract: in particular, who will bear the costs of any changes in law and regulations. Depending on the nature of the services, the customer may ideally want all such responsibility and cost to be borne by the service provider. However, the service provider will argue that, prior to the outsourcing, this was the customer's risk and so the service provider should not absorb all of this risk simply because of the outsourcing. They will also argue that they have not built in the costs of changes in law and regulation into their cost base and therefore cannot be expected to bear this unknown additional cost. A common compromise position can be to agree that all general changes in law and regulations that affect all businesses will be borne by the service provider, together with those changes in law and regulation that are relevant to the service provider's operations and services. However, changes in law and regulations that are specific to a customer and/or its industry – or that materially change the services requirement itself - would be borne either by the customer or by the customer, the service provider and its customers in the relevant industry in equitable parts.

Managing change is critical in an outsourcing arrangement and the above mechanisms and processes can help the parties deal with change. However, flexibility is not solely about accommodating change. Having a shorter contract term, having a non-exclusive arrangement (*i.e.* avoiding exclusivity, minimum volumes and first offer or refusal types of provision), including benchmarking provisions and reporting and governance mechanisms, and having framework agreements with various different service providers rather than just one (to give a best-of-breed choice, as well as maintaining competitive pressure), should all be considered for the flexibility they bring. Equally, including appropriate intellectual property and knowledge-transfer provisions and requiring the service provider to co-operate with your other third party providers will give more flexibility and help prevent the service provider being able to hold the customer to ransom.

No free lunch

Having talked about the importance of ensuring flexibility, it's also important to realise that there's no such thing as a free lunch. Changes (or certain changes, at least) cost money. One should try to identify which changes are likely to be expensive for a service provider to implement, and then make the decision as to whether that cost (which will be built into the price) is value for money.

As a general rule of outsourcing, it's important to make sure that the contract is considered a good deal by the service provider. There has to be a reasonable balance of risk and reward. If a service provider ends up signing what it considers to be a bad deal it is very unlikely to be a flexible and adaptable partner over the life of the contract. Moreover, the customer has to recognise that a balance will always need to be struck between flexibility and other commercial drivers. Flexibility may come at a price that the business does not want to pay.

Conclusion

Change will happen – it is how the parties react to change which will affect whether the outsourcing arrangements are successful over time. The best outsourcing arrangements account for change, and include (flexible, not rigid mechanisms) to help guide the parties through those changes and ensure the continued good running of the deal and the relationship.

Of course, true flexibility can never be achieved solely through contractual methods. Flexibility and adaptability need to be a mutual objective of both parties – and this is where, once again, good contract and relationship management is vital.