Chapter 8
Outsourcing Contract Structures

1 CONTRACT STRUCTURES

Consultants and the outsourcing press use a lot of jargon in describing the structure of outsourcing deals. From a legal perspective there are really only a few basic structures for domestic transactions, i.e., transactions in which services are to be provided in one jurisdiction only. These structures can be made more complex if the parties wish to use some form of joint venture structure. Multi-jurisdictional arrangements, that is, structures in which supplier entities in various jurisdictions are providing services to customer entities in various jurisdictions, give rise to different structuring considerations. Domestic and multi-jurisdictional outsourcings may entail the provision of services in an 'offshore' jurisdiction which is a further complexity. This chapter will describe the key structures used for domestic and multi-jurisdictional transactions, arrangements involving joint venture vehicles and, finally, will consider the structural issues arising from transactions involving offshore service provision.

All of these models may entail a transfer of assets, contracts and employees to the supplier. This is not always the case, given the increasing use of shared service centres and automation of processes. For completeness, however, it is assumed that these transfers are required.

In the pre-MCI Worldcom, pre-Enron, pre-Sarbanes Oxley world, there was an appetite for developing sophisticated financial structures in connection with outsourcing arrangements. That is no longer the case, not because there was anything of an improper nature about those arrangements, but because of the additional control and reporting complications that would arise. For that reason this chapter will not address financial structures.

http://www.pbookshop.com

2 DOMESTIC OUTSOURCING TRANSACTION STRUCTURES

Domestic outsourcing transactions can be structured in a number of ways, depending on the nature of the proposed relationship with the supplier.

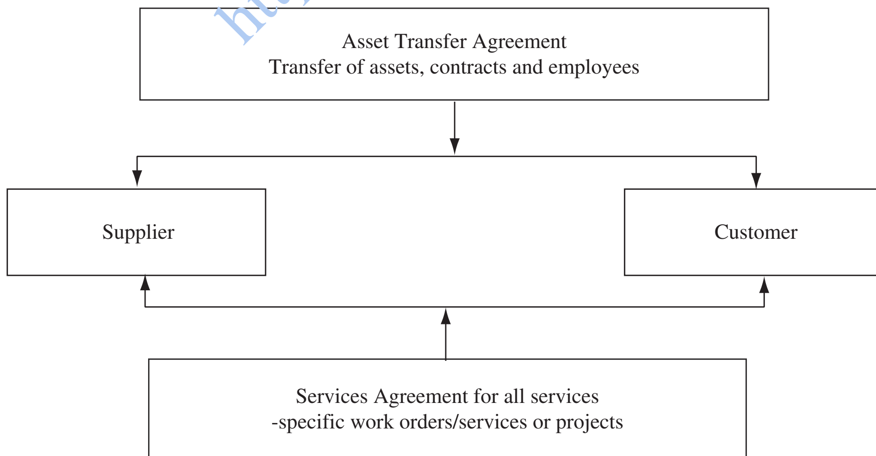
Figure 1 shows an outsourcing at its most basic. It involves the transfer of assets, contracts and employees from a customer to the supplier (generally done under an 'Asset Transfer Agreement' or 'Access Agreement'), and the provision by the supplier back to the customer of all services, usually under a separate Services Agreement.

This structure implies that the supplier will be (or at least is intended to be) the only supplier of the relevant services to the customer. This may not be the case contractually (the contract may not contain an exclusivity provision or minimum volume commitment from the customer), but the practical reality is that the customer will not retain the resources or personnel to provide services to itself. It may also be logistically impractical for a customer to source the same services from a number of difference contractors. Historically, this has been one of the most frequently used models for outsourcing transactions.

The customer receives services on its own behalf and, to the extent that other members of its group are intended to receive services, as a principal for the benefit of other group members. In this situation the customer will need to consider whether the other members of its group that receive the services should have any rights directly against the supplier. In some jurisdictions it is possible to give beneficiaries of the services direct enforcement rights without their being party to the contract (in the UK, for example, under

http://www.pbookshop.com

Figure 1. One-to-One (Domestic) Model 1: Basic Services Agreement and Work Orders



the Contracts (Rights of Third Parties) Act 1999). Whether or not direct enforcement rights are given, the agreement will (from a customer's perspective) need to clearly set out the customer's right to recover in respect of loss suffered by members of its group. The supplier must ensure that its exposure to customer group companies is limited by reference to the exclusions and limitations of liability in the agreement.

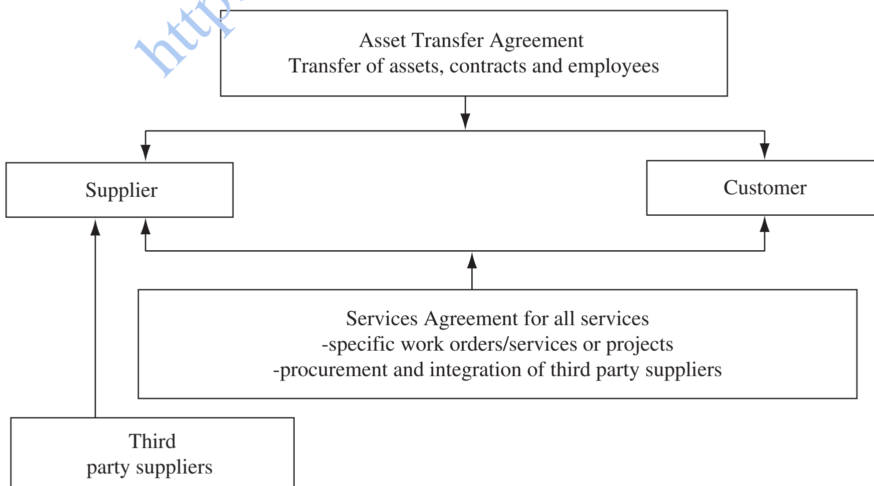
The agreement should also address the consequences if entities join or leave the customer's group. This is particularly important if the agreement contains an exclusivity commitment.

The services will (for the most part) be defined in the agreement itself, with service-specific terms and conditions set out in that agreement. As an alternative model, if the parties intend that the services may be ordered and/or terminated under separate work orders, the parties could put in place an agreed set of generic terms that could be worked into a series of separate contracts between the supplier and the customer in relation to each order. Whether this is appropriate will depend on the nature of the services being provided: frequently the services agreement will adopt a hybrid approach of operational or steady state services being specified in the services agreement, and one-off projects being dealt with in separate work orders. Either way, the agreement will need to address in some detail the interrelationship between the two.

The structure shown in Figure 2 is very similar to the structure used in Model 1. Model 2, however, expressly recognizes the fact that the supplier

http://www.pbookshop.com

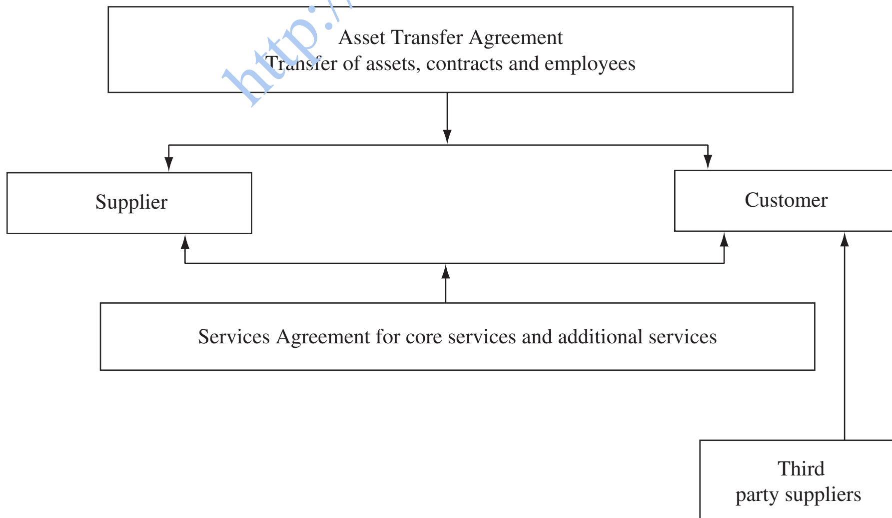
Figure 2. One-to-One (Domestic) Model 2: Basic Services Agreement with Sub-contractors and Work Orders



intends to outsource the provision of part of the services to a third party supplier. This would be possible under Model 1, absent any prohibitions on subcontracting in the services agreement. The structure in Figure 2, however, is designed to illustrate the situation where the customer is requiring the use of one or more stated sub-contractors. This could be either as a result of a consortium bid, under which the supplier has agreed to be the prime contractor, or the customer requiring that the supplier sub-contract certain services to third parties. From a customer perspective it is generally advantageous to be able to contract with a single entity, to avoid the customer having to be involved in a dispute as to who, between different suppliers, is at fault. The sub-contractors could be either the customer's existing suppliers (i.e., whose contracts with the customer are being transferred to the supplier at the start of the services agreement), or suppliers designated by the customer at a later point in time.

Figure 3 shows a model known as 'multi-sourcing' or 'selective sourcing', one which is increasing in popularity. In this model, the outsourced business operation is treated as a portfolio of services, rather than as a contained whole, with a separate decision made for each service component as to whether the supplier, an alternative supplier, or the customer itself is best placed, in terms of both cost and expertise, to be responsible for service provision. As might be expected, there are both advantages and disadvantages to 'slicing and dicing' in this way. On the plus side, multi-sourcing results in less customer dependence on a single supplier, and makes transition of services from the supplier on termination a less daunting prospect and for

Figure 3. Multi-sourcing (Domestic) Model 3: Portfolio of Services



http://www.pbookshop.com

that reason, tends to 'keep the supplier honest'. It also gives a clearer picture of how costs are allocated between service elements and enables benchmarking or market testing of service elements to be carried out more easily.

The principal risk of this approach is that by dividing responsibilities, it may be difficult for the customer to establish which supplier is responsible for a service failure as each supplier may blame another. The model relies on the fact that all parties will work together cooperatively and pursuant to a detailed set of operating level agreements that leave no doubt as to where each party's responsibilities start and end.

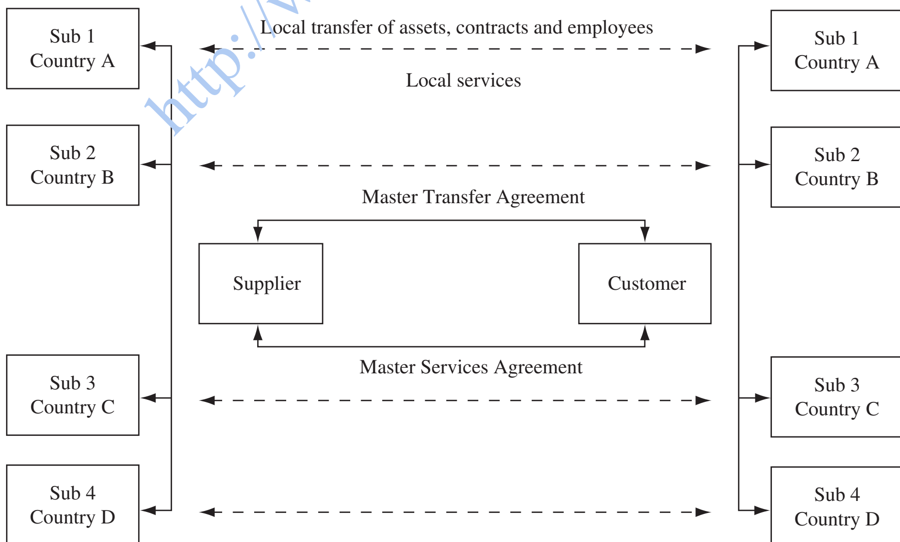
3 MULTI-JURISDICTIONAL OUTSOURCING TRANSACTION STRUCTURES

Multi-jurisdictional outsourcings raise a number of additional challenges at both a legal, contractual level and also at a practical, operational level. Figure 4 sets out a commonly used structure.

In multi-jurisdictional transactions it is important to recognize the need for both central control and for local implementation. It is of course possible to have a series of separate, independent agreements for each country or region involved in the transaction, but this would undermine the customer's aim of global or international consolidation, and will in most cases be inconsistent

http://www.pbookshop.com

Figure 4



with the supplier's approach to the services as an integrated whole, in terms of both price and service delivery.

Equally, it would be possible to have a single global agreement, but again this would be of limited value as it would be unable to cope with local law, tax and regulatory issues, or any 'local variations' on which the parties will inevitably agree.

Many multi-jurisdictional transactions have therefore adopted the solution shown in Figure 4, utilizing a combination of central and local agreements. In this model the customer and the supplier will enter into a master services agreement in relation to the services to be provided and a master transfer agreement covering the transfer of assets, contracts and employees. The master agreements will contain the key commercial terms and govern the overall relationship between the customer and the supplier. It would be possible to have a single master agreement.

It is important that the parties agree at an early stage on the matters to be addressed at a global level and therefore contained in the relevant master agreement only. These could include, for example, reserved governance matters, and consent to changes of certain types or involving cost above a certain threshold. This is particularly important where the customer wishes to maximise standardisation across jurisdictions.

Equally, the parties should consider which matters are to be measured on an overall basis and which should be measured at the local level only. In particular, the parties should be clear as to whether any service levels and service credits, minimum fees, minimum volumes, benchmarking and caps on liability will be applied on a global, regional, or country-by-country basis.

Another issue that parties encounter in multi-jurisdictional transactions is whether the master services agreement is to act as the local services agreement for the 'core' country in which the customer's operations are based. This approach is often taken, but can cause complications when the time comes to create the other 'local' agreements, if the relevant 'local' provisions are not clearly identified. In terms of drafting simplicity, it is generally simpler to leave the master services agreement as a genuinely 'framework' document, and attach to it a template set of terms that can be used as the basis of, or incorporated by reference into, each local services agreement.

The parties should determine at an early stage what law should govern each local agreement. It may be that for practical reasons it is helpful to group service commitments on a regional basis covering a number of jurisdictions, but it is always important to consider whether there are local law requirements that arise which would lead to a need to document certain provisions in local country specific agreements or as amendments to the regional agreement which should apply on a country-by-country basis. Decisions as to whether to implement regional or local agreements will depend on a number of factors, including, critically, tax considerations, any requirements to address

http://www.pbookshop.com

employee issues at a local level, the features of the local legal regime – for example, regulatory considerations, either general or customer/supplier specific – the robustness of protection of property rights (and in particular intellectual property rights), the degree of flexibility allowed to the parties in determining the terms of their contractual arrangements and enforcement issues.

4 JOINT VENTURES

Joint ventures in outsourcing transactions are set up to address specific business objectives. Here are a couple of examples.

4.1 Joint Venture Model 1: Multiple Suppliers in Joint Venture

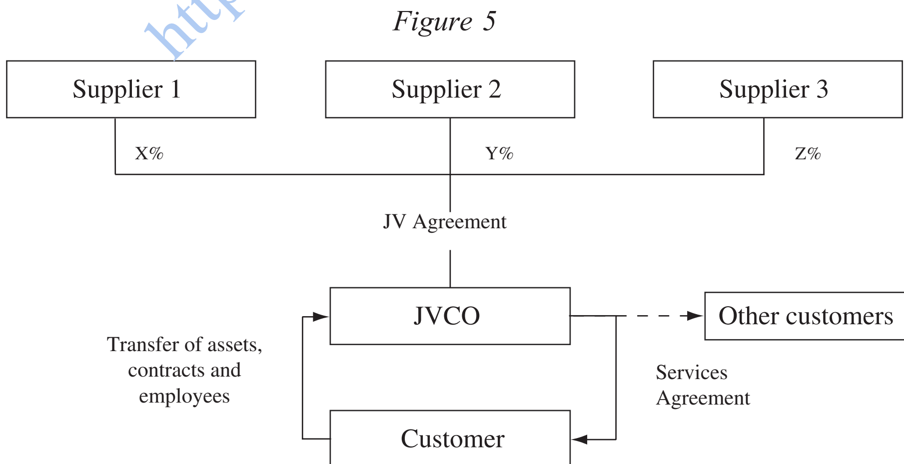
There have been occasions where a single supplier is not able to service all the needs of a customer and therefore two or more suppliers have been prepared to enter into a joint venture. In some cases the joint venture is set up to provide services to a single customer while in other cases the joint venture becomes a new business in its own right servicing the needs of several customers. This structure is shown in Figure 5.

The joint venture structure in Model 1 assumes that all the suppliers who are parties to the joint venture have a common business objective. The common business objective invariably is that the suppliers bring together complementary products or services, for example hardware, software and consultancy services.

From the customer's point of view there is the clear benefit of being able to deal and contract with a single supplier as opposed to several suppliers, as

http://www.pbookshop.com

Figure 5



there is less risk of each supplier side-stepping responsibility by blaming another for service failure. If the customer contracts with a single supplier joint venture company, transfer of the customer's assets, contracts and employees is much more straight-forward.

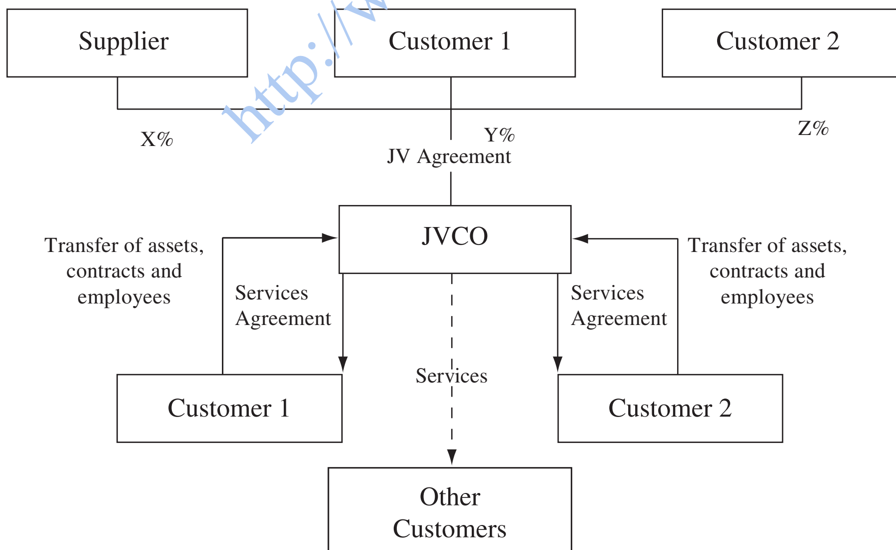
4.2 Joint Venture Model 2: Joint Venture between Supplier and Core Customer(s)

Under Model 2 the joint venture is between the supplier and one or more customers. The purpose of the joint venture is to provide services to those customers who are also parties to the joint venture. Customers may also set up this structure if they wish to use the joint venture company as a vehicle for new business. By using the same assets and resources, services could be provided to other customers, thereby providing both the supplier and customers with a return on their investments. This structure is shown in Figure 6.

4.3 Pros and Cons of Joint Ventures

What are the motivations for establishing a joint venture vehicle in outsourcing transactions and could those motivations be achieved through a simpler structure?

Figure 6



http://www.pbookshop.com

4.4 Motivations for a Customer in Opting for a Joint Venture Structure

From a customer's point of view, there is a common view that if it invests in a joint venture supplier vehicle, it will have greater control, although sometimes this is more perception than reality. Control arises through the customer's greater involvement in the management of the services through the joint venture governance structure. It is important, however, that the customer avoids micro-management and allows the supplier to provide the services that it has been contracted to provide through the joint venture company. The customer may have certain rights of veto over key or strategic decisions, for example, whether or not the supplier can provide services to other customers.

Sometimes a joint venture between a customer and a supplier is established to address employee sensitivities arising from the transfer of employees. It is sometimes easier to 'sell' the outsourcing proposition internally by promoting the arrangements as still being within the customer's group as if the customer has a significant interest in the joint venture company.

Joint ventures in outsourcing arrangements also reinforce the principle of 'partnership' between the supplier and customer in that a joint venture establishes more of a strategic alliance between the parties.

The joint venture vehicle can facilitate the transfer back to the customer (or a successor supplier) of the assets, contracts and employees as well as the associated services following the termination of the outsourcing arrangements. This would be achieved by the customer taking over full ownership and control of the joint venture vehicle from the supplier, or alternatively transferring the supplier's ownership interest to the successor supplier. There are, however, likely to be complexities on exit as a result of a joint venture structure, which are described further below.

Finally, a joint venture enables the customer to concentrate on its core business by ring-fencing the outsourced services in the joint venture company.

http://www.pbookshop.com

4.5 Motivations for a Supplier in Agreeing to a Joint Venture Structure

A supplier may not always see the benefits in establishing a joint venture but because of the customer's concerns it may be forced to do so to secure the customer's business. However there may be some up-sides. The supplier may obtain equity investment for the venture that it would otherwise have to find elsewhere. The supplier may also be able to obtain access to the customer's technology which may supplement the supplier's technology. In relation to

joint ventures that have as their business objective the intention to provide services to other customers, this structure will give the supplier a business opportunity that would otherwise not be available to it.

4.6 Issues to Consider on Joint Venture Structures

The reasons for establishing a joint venture for outsourcing arrangements should be carefully considered. As noted above, often a joint venture is entered into because the customer believes that it will offer it greater control. Many of the customer's concerns can, however, be adequately addressed through appropriate provisions in the services agreement. Joint ventures also involve additional complexity and additional customer management time. They do, however, attract greater senior management attention as equity investments often require a different decision making process and joint ventures can be seen as being more strategic than operational.

In addition, by entering into a joint venture, greater complexity in relation to exiting the outsourcing arrangements will inevitably arise. Although the assets may neatly be in one place and the customer may be able to acquire a controlling interest in the joint venture company, which is the supplying entity, there will be numerous forms of exit and the parties will have to consider each type of potential exit carefully. What happens, for instance, on a termination by the supplier of the outsourcing agreement for the customer's breach or on a termination for convenience? In each case the answers will depend on the factual circumstances. If the joint venture company has other customers, the supplier will wish to retain its interest in the joint venture company and may not wish to incur the cost of buying the customer out. In addition, issues as to valuation arise if the outsourcing agreement is one of the major assets of the joint venture company as the value of the joint venture company and the shares in that company will be affected by the termination of the outsourcing agreement.

http://www.pbookshop.com

5 OFFSHORING TRANSACTIONS

Put simply, offshoring is an arrangement whereby outsourced functions are performed from another country. The term is also used where a customer sets up a subsidiary in another country and obtains services from that subsidiary. The associated term 'near-shoring' describes the movement of work to a 'nearby' country (for example, in the case of the USA, to Canada or Mexico). US consultants also now speak of 'farm-shoring', whereby services are provided from low-cost regions of the customer's own country. This is perhaps one linguistic step too far.

The key drivers for offshoring are essentially the same as the drivers for outsourcing generally. The offshore location is generally chosen because of its lower costs, in particular labour costs. In addition, some offshore locations have large numbers of highly qualified and motivated staff with specialist expertise – for example, software developers in India. As an additional benefit, the exploitation of different time zones can increase turn-around times, with service provision 'following the sun'. For EU-based customers, the existence of less stringent labour laws in offshore locations is an added advantage.

The provision of outsourcing services is a big business for many of these offshore locations and some governments offer significant incentives, in the form of subsidies, tax holidays, relaxed export and import requirements and customs duty exemptions.

5.1 Structures for Outsourcing Transactions Involving Offshore Service Provision

http://www.pbookshop.com

5.1.1 Captive Entities

The customer may set up and acquire services from a wholly owned subsidiary or 'captive' offshore company, a model also known as offshore in-sourcing. This approach is perceived as enabling the customer to retain a greater degree of control. It also means that the customer may be able to extend its existing technology licences and other third party contracts to cover its subsidiary rather than having to pay, through the service charges, part or all of the cost of a third party supplier obtaining its own licences and taking over or entering into third party contracts.

A captive model will result in the customer group benefiting from all savings from the lower-cost environment (but, on the other hand, the customer group also bears all of the associated risk). It also enables the customer's 'culture'/management style to be exported to the newly created entity. A further advantage is that the customer group retains the ability to monitor confidentiality and security of sensitive business information and the ownership of intellectual property.

On the down side, setting up a captive centre is likely to require significant up-front investment and the lead time for implementation is likely to be longer than when entering into an outsourcing agreement directly with a third party supplier.

5.1.2 Offshore Joint Venture

The customer may set up a joint venture with a local offshore partner, so as to leverage that partner's established infrastructure and local knowledge and

credibility. There may also be tax advantages in structuring an arrangement in this way. Many of the issues and disadvantages with a conventional model 'on-shore' joint venture arise in this model.

5.1.3 Traditional Services Agreement with Offshore Entity

The customer may outsource to a third party supplier in the traditional way. This model is likely to involve lower set-up costs, and although involving the payment of a margin to the supplier, will crucially place performance risk and local compliance risk onto the supplier. Inevitably, however, this model will involve a loss of control, with the risks higher than usual because of the unfamiliar environment and potential lack of visibility.

Most well-known outsourcing service providers (such as Accenture, EDS, IBM) include an offshoring element in their service solution particularly if one of the key drivers is cost savings.

6 CONCLUSION

http://www.pbookshop.com

As this chapter has explored, there are numerous ways of structuring outsourcing transactions and which structure is appropriate depends very much on the factual circumstances:

- Is the transaction domestic or multi-jurisdictional?
- If domestic, does the customer want a simple arrangement or to mandate a sub-contracting structure? Would a framework agreement with work orders be appropriate to the nature of the services? Should the customer opt for single supply or does a best of breed 'multi-source' structure fit the circumstances better?
- If multi-jurisdictional, how should the parties distinguish between centrally controlled issues as opposed to local requirements? Is there scope for regional agreements?
- Is a joint venture appropriate? Would a joint venture assist with risk sharing or enable the customer/supplier to enter a new market? Could the attractive features of a joint venture be achieved with a less complex structure?
- Do the parties wish to take advantage of offshore pricing? If so, what is the most appropriate structure for the customer's risk/cost profile: a captive arrangement, a joint venture or a traditional services agreement?

All of these issues should be considered carefully at the outset of the relationship and advice sought at an early stage. Tax, data protection and

human resources issues should all be considered when determining the appropriate structure. The time invested at the outset, however, will reap dividends later in achieving an appropriate structure for the parties' commercial objectives which takes into account any legal, tax and regulatory considerations.

http://www.pbookshop.com

http://www.pbookshop.com