

## **Outsourcing - What is it and what can it do for you?**

**By Murali Neelakantan**

### **What is it?**

**out-source** (*out'sôrs', -sôrs'*)      **out-sourced,**      **out-sourc-ing,**      **out-sourc-es**  
*To send out (work, for example) to an outside provider or manufacturer in order to cut costs.*

The simplicity of the above dictionary definition betrays numerous complexities and misunderstandings about this area of business. While conceptually simple, the task of outsourcing one or several corporate functions is often difficult.

Well-run companies always look at ways of increasing the bottom line, whether through better marketing, better products or intelligent resource management. It is in the latter discipline that outsourcing comes into play. Lowering the cost base of a particular corporate function, without sacrificing control over the output, is an attractive proposition for every manager. With the advent of a globalised market sharing a common business language and the onward march of technology, the barriers to outsourcing have been falling dramatically over the last 10-15 years.

Outsourcing comes in all shapes and sizes. From a simple IT support contract to a multi-billion pound drug development programme, all tastes are catered for. Typically, companies will seek to enter into one of two broad categories of outsourced services:

(i) "Knowledge process outsourcing" (KPO) - using the skills and workforce of a third party to enhance or replace skills currently deployed in-house. Typical KPO services include research and development, technical analysis, legal services, business analysis and media services. In KPO-type arrangements, the focus is more on skills than process; and

(ii) "Business process outsourcing" (BPO) - using the workforce of a third party to take over a company's existing business process including call centres, IT services, human resources, accounting and payroll. In BPO-type arrangements, the focus is more on process rather than skills.

In some cases, customers will look at "onshore" providers - companies who will market cultural and physical proximity as a benefit, usually at the expense of cost. However, more often than not, customers will look to "offshore" providers - companies who will market their services as a positive combination of flexibility and low cost.

### **Offshore Outsourcing – Typical Key Issues in Negotiation**

The key to a successful contract with a provider of outsourced services is achieving the right mix of the rationale for the offshoring and flexibility, enforceability and cost. A contract must be seen as the document that allocates risk between the parties. It falls to the customer to identify the risks in the first instance and be honest about which party is best suited to deal with such a risk. It is only when all the risks are identified that the contract can allocate them between the customer and the supplier in a manner that is appropriate for the risks.

So what are the key areas of risk?

**"Offshore Fatigue"**: The skill-set and motivation of the supplier's staff are some of the keys to a successful outsource. Unless the contract deals with employment and service level issues creatively, there is a risk that factors such as attrition levels may increase the burden

on the customer of maintaining the contract. If the parties can agree on specific service levels to address specific performance targets, there is no reason why they cannot extend the agreement to cover other “soft” factors such as attrition. Other tools for mitigating “offshore fatigue” include reducing the term of the contract to a manageable length or rotating the supplier’s contract management team across tasks.

**Compliance with applicable law:** One of the key clauses in any contract is the requirement that the supplier complies with all applicable laws, regulations, codes of practice etc. as the contract evolves in time. In “onshore” arrangements, the issue is no less controversial particularly when customers operate in regulated industries. Customers will argue that the supplier, as an expert provider of services in the customer’s industry, should have the requisite knowledge and experience to ensure that its provision of the services will not lead to the customer breaching its own regulatory requirements. Conversely, most sophisticated suppliers will argue that because customers are responsible for managing those risks, they are best placed to own them in the contract.

**Data Protection and privacy:** Even in well-established offshore “hubs”, suppliers may not have the requisite systems and processes in place to take on and manage data protection and privacy risks. As recent high-profile cases in this area have shown, suppliers have demonstrated a rather cavalier attitude to knowledge of, let alone compliance with, these fairly basic requirements.

**Tax:** It seems that most customers, suppliers and their outsourcing lawyers feel that it is sufficient to have boilerplate provisions that are intended to ensure that the charges do not include any VAT and will be paid nett of any withholding taxes. However, the offshoring may cause tax liability to increase - for example, VAT in the case of financial services. Most suppliers are unaware of this issue and the customers either miss it out completely or just add it on as a transaction cost. In almost all cases, very little is done to explore tax structures that could result in potential savings.

**Liabilities:** Lawyers will often focus much of their collective energy on the apportionment of liabilities between the customer and the supplier. While one should always expect senior management and insurance companies to take an interest in this part of the contract, negotiators should not be fooled into thinking that an advantageous exclusion clause will buy them contractual invulnerability. For instance, what use is an unlimited indemnity if the supplier doesn’t understand the risk nor has the funds to pay out under it? In offshore arrangements where cultural differences can lead to fundamental misunderstandings, this is a grave risk indeed.

**Intellectual Property Rights:** In knowledge-rich industries such as IT and pharmaceuticals, ownership of intellectual property rights will often be a key provision of the contract. In KPO-type arrangements, the issue becomes even more important. Is the worker in India developing the output for his employer or for the customer? The answer should be clear, but contracts often don’t reflect this and a failure to address these points exhaustively in a contract can lead to great difficulty for customers.

**Exit Management:** The issues around the transferability of intellectual property rights bring the issue of exit management into sharp focus. For example, the transfer of the software “asset” will only occur if and to the extent the supplier has built the code from the ground up strictly for the purposes of servicing the particular customer. This is extremely rare, and so in the majority of cases (i.e. where there is no transfer in the ownership of intellectual property rights), the onus will be on the customer to identify in the relevant exit management schedule what it wants to keep at the end of the deal. This principle can extend to any “asset” used to deliver the services, such as background intellectual property rights, tools, code libraries, licenses, buildings, hardware, furniture etc.

## **Conclusion**

It is no accident that the growth in the market for outsourcing continues apace. The expertise and price-competitiveness offered by outsourcing firms remain as attractive today as they did a few years ago. However, the collective experience of customers in this market is starting to show that many of the common pitfalls seen in this space can be addressed through a pragmatic and well-researched pre-contract process.

If the lessons are learnt, there is little doubt that the outsourcing phenomenon will continue to grow for a good while longer.

**Murali Neelakantan** is a partner at Arnold & Porter, an American law firm with offices in Washington DC, New York, Brussels and London