



Outsourcing Governance

Part 2 – Using the Contract Tools

1. Introduction

Successfully managing an outsourcing contract requires customers both to include the right governance tools and mechanisms in their contracts and then use those tools appropriately. Outsourcing contracts are not all created equal — the relationships they create can range from that of a customer purchasing a service from a supplier to something more akin to a partnership.

The governance tools a customer should include in its contract will vary significantly, depending on the type of relationship being created. Even where governance tools are included, the extent to which the contract needs to deal with each tool, either in particular detail or relatively short-form, will also vary depending on the tool's relevance to the relationship type. Part 1 of this whitepaper (see <http://www.lw.com/presentations/Governance-Whitepaper-Part-1>) described the types of governance tools that the customer should include in its contract and discussed the extent to which the contract needs to deal with each tool.

This part of the whitepaper analyses the potential impact on the relationship of actually using the governance tools described in Part 1. As stated in Part 1, while these contract tools provide the customer with leverage in managing the contract, customers should use the tools knowingly, with a view to the potential impact on the relationship.

2. Using the Contract Tools

Tools vary significantly in their triggers, outcomes, and impact on the relationship, as outlined in the following table:

Tool Functionality	Contract Tool	Relationship Impact ⁱ	Reason for Impact	Trigger	Outcome
Relationship management	Committees	Medium	Committees are a key forum for addressing issues and heading off disputes.	Ongoing process	Customer and supplier steer relationship and resolve issues.
	Representatives	Medium	The daily interaction between the executives can head off disputes.	Ongoing process	Customer and supplier steer relationship and resolve issues.
	Key personnel	Low	In reality, both parties have an interest in maintaining personnel continuity (apart from unprofitable accounts).	Introduction or removal of personnel in key positions	Customer has right to approve new key personnel and require the removal of key personnel.
	Reviews	Medium	Although often underused in practice, reviews offer supplier the opportunity to head off future problems.	Every 6-12 months	Both parties identify possibilities for resolving issues and maximising opportunities.
Maximising savings	Risk/reward (e.g., gain-sharing)	Medium	Incentivises value-added behaviour.	Ongoing process	Both parties may see increased or decreased profitability of transaction depending on performance.
	Price/service review (e.g., benchmarking or market testing)	Medium	Threatens supplier's profitability, but enables Customer to keep its costs for the outsourced service at a reasonably competitive level.	Every 12-36 months	Impact on profitability and revenue as charges may be reduced.
Handling issues and escalations	Issues resolution	Medium	Success is measured by the lack of disputes, this works best when issues are resolved in a low key manner.	By either party when an issue arises	Both parties resolve issue(s).
	Dispute resolution	High	In practice, parties are often loathe to use this tool because of the implication that litigation might follow.	By either party giving formal notice of a dispute	Both parties resolve dispute or litigation option becomes available.

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Customer leverage	Service levels and service credits	High	Major service failure can lead to significant financial consequences. In practice, occasional credits can be expected to occur during the term.	Supplier fails to meet a service level in the month	Supplier pays service credits.
	Withhold payment	High	Withholding payment can cause a significant potential impact on supplier cash flow. Customer maintains leverage by continuing to hold the money.	Dispute of charges as a result of non-performance	Customer withholds disputed charges until dispute is resolved.
	Non-exclusivity and flexibility	High	The threat that the customer will withdraw services from the scope of the transaction can be a very effective tool to persuade vendor to address nagging problems to the customer's satisfaction. If used, this threatens both the profitability and revenue under the transaction.	Customer elects to remove services	Customer removes services and adjusts charges (subject to any contractual minimum commitment).
	Payment and liquidated damages on transition milestones	High	Significant money can be at stake, based on successful transitions.	Failure to meet milestones	Customer withholds transition/transformation charges and/or supplier pays liquidated damages to customer.
	Termination assistance	Low	Although creating a low impact on the relationship during the service term, the failure to include sufficiently robust termination assistance terms exposes the customer to being held over a barrel.	Termination of all or a part of the contract	Supplier provides the support necessary to move to a new supplier or back in-house.
Unexpected change	Contractual change management	High	The ability to manage this process is critical to successfully evolving the contract.	Change requested by either party	Either party implements change to the contract (with reasonable pricing impact).

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Monitoring	Reports	Medium	Reports can be an essential tool for the customer to monitor service performance.	Regularly issued by supplier	Supplier provides customer with information about status of services.
	Information requests	Medium	Allows customer to probe the status of the services with ad-hoc questions.	Customer requests information	Supplier provides information.
	Audits	Medium	May have some operational impact and allows the customer to probe beneath the surface of the operation.	Customer audit team gives notice of audit	Customer performs audit of site and information and requires supplier to address audit findings.
Maintaining contractual control	Approvals	Medium	Provide ability for customer to exercise influence over supplier operations and protect against detrimental changes.	Supplier requests approval	Customer gives (or withholds) approval of designated actions.
	Subcontracting	Low ⁱⁱ	In practice, although common to include subcontracting approval right, customers rarely withhold consent.	Supplier requests approval to subcontract	Customer has right to approve subcontracting.
	Personnel retention and removal	Low	In practice, rarely exercised by customers.	Customer raises objection to supplier personnel	Supplier either resolves concern or individual is removed from the account.
Maintaining operational control	Operational requirements	Medium	While often ignored post signature, these impose key obligations on supplier which, at least in the case of security requirements, do influence the supplier solution.	Ongoing process	Supplier complies with required controls.
	Operational change management	Low	Necessary to follow, but in practice, contractual controls of operational procedures can have low impact on behaviour.	Ongoing process	Supplier complies with the required steps to make changes in an orderly manner.

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	Step In	High	In practice, rarely exercised unless the circumstances result in, or are about to result in, a material impact on the business of the Customer who sees no option but to step into the services to try to mitigate the impact on the operational integrity of the services. Exercising the right will create a major impact on the relationship.	Material failure, or imminent material failure, by supplier	Customer takes over affected service or engages a third party to do so while supplier is given the opportunity to rectify the circumstances giving rise to the step in.
	Procedures manual	Medium	Offers the opportunity to fine-tune operational interrelationship between parties and impose reasonable controls over manner in which services are performed. The procedures manual also can be a useful tool when transitioning services away from the supplier at termination or expiration.	Ongoing process	Supplier documents and complies with required controls.
External facing	Working with third parties	Medium	Where relevant, can make or break complex multi-supplier solutions.	Ongoing process	Respective suppliers obliged to work together constructively and resolve any issues without customer “falling between stools” in practice.

3. Summary

Good governance sits at the heart of all successful outsourcing transactions; such governance requires not just the right tools in your agreement, but knowing when and why to use them, as well as how those tools will impact the customer-supplier relationship.

Recognising the importance of governance in outsourcing transactions, Latham & Watkins approaches outsourcing with a central focus on governance at the heart of outsourcing agreements. A future Latham white paper will describe the firm’s approach in greater detail. Please contact justin.cornish@lw.com for further information or to discuss this topic.

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ⁱ The level of the impact of each of these tools may change depending on the circumstances of the proposed transaction.

ⁱⁱ An example of changing impact level depending on the circumstances; the impact of provisions governing the supplier's use of subcontractors can change from Low to Medium or even High depending on the extent to which supplier's service delivery model relies extensively on the use of subcontractors.