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Structuring Multi-national Outsourcing Contracts

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Outsourcing is increasingly used to help consolidate global businesses, either as part of routine streamlining or after mergers, acquisitions or divestments. By outsourcing on a multi-country basis, businesses can achieve a higher degree of standardisation. However, the outsourcing arrangements must provide for local variations, while ensuring that these operate within the confines of the global deal. Multinational companies use a variety of outsourcing arrangements to achieve this aim. This Alert examines the main contractual structures used in multi-jurisdictional outsourcings and the key issues that arise in such projects.

Multi-country outsourcing occurs where the outsourcing takes place over a number of jurisdictions, outsourcing the services in each jurisdiction to a local supplier or, in some cases, to a shared services centre. The key distinguishing feature of such deals is the complex network of contractual and service delivery relationships.

Choice of Approaches

Choosing the right structure for a multi-country outsourcing project requires a careful balancing of competing needs; in particular, balancing the desire for centralised control against local requirements. The success or failure of multi-jurisdictional deals often depends on how successfully the parties impose control on the network of relationships that they create. Ideally, the arrangement should control certain key issues centrally: those key issues being, in particular, costs, performance and legal/commercial risks.

The parties can choose from a range of contractual options to achieve their aims i.e., a single contract, a master agreement or individual service contracts.

Option 1 - Single Contract

In this arrangement, the customer and supplier enter into a single contract which governs the entire global arrangement (see attached chart, pdf).

This structure is suitable where the services, service levels and other terms are fairly uniform and will be centrally provided or managed and where a high degree of consistency is required and local variation minimal. However, there are a number of issues with this structure.

Local variations - Typically, each location will have specific requirements, for example to reflect local legal/regulatory requirements, and variations in services (e.g., different hours of operation). It may require extensive due diligence, and a high level of project management, by the customer to ensure that all local requirements are reflected. In addition, the customer will need to ensure that the contract is sufficiently flexible to deal with local changes going forward.

Enforcement

- The customer will be responsible for enforcing contractual provisions on behalf of its subsidiaries. This can cause difficulties. For example, privity of contract principles may mean that it will be difficult for the parent company to bring damages claims on behalf of group companies, and that a group company will be unable to bring a legal action against the supplier directly as it is not a party to the contract. These issues can be dealt with in a number of ways. For example, by the supplier indemnifying the customer for losses suffered by the customer's group companies, or third party rights being granted in favour of the customer's group companies.
- In addition, as neither the customer nor its group companies will have a direct contractual relationship with the supplier's group companies, the customer may require some or all of those supplier group companies to provide collateral warranties to the customer and its group companies in respect of the services the supplier group companies provide.

Flowing down supplier obligations - The greatest advantage to the customer of the single contract model is that the supplier is responsible for all aspects of performance, whether these are sub-contracted to its own subsidiaries or third-party providers. The customer should consider the degree of control that it requires over any sub-contracts. To increase control, it can attach the agreed sub-contracts to the main contract, set out minimum sub-contract requirements in the main contract (whether in the form of a template contract or agreed 'flow-down' terms) or by approving all sub-contracts. The relevant mechanism will depend on the degree of control that the customer requires.

Step-in rights - As the arrangement will involve multiple subsidiary contracts, the customer should consider reserving step-in rights if the customer's business operations risk being compromised. The parties will need to address whether such rights are practical (which will depend very much on the nature of the services being provided).

Option 2 - Master Agreement

In this arrangement, the customer and supplier enter into a master agreement, which sets out generally applicable terms and conditions, general services and key commercial principles (see attached chart, pdf).

The master agreement will then typically include a template local agreement to be used in each country. The terms of the master agreement will be incorporated by reference into the local agreement (except to the extent varied in that local agreement).

This form of contract is popular with customers seeking to take advantage of their bulk purchasing power, retain centralised control and keep local flexibility restricted but give local group companies a degree of independence and direct rights and remedies against the supplier. The following issues are of particular importance to this project structure.

Local flexibility - This model allows a certain degree of local flexibility as each local entity can negotiate its own contract under the master contract framework. Such flexibility may be required where the services required differs from jurisdiction to jurisdiction or where local factors are relevant (e.g., local laws and regulations, tax considerations, costs of labour and materials, etc).

Governance - One of the greatest risks of this model is fragmentation of the central relationship. To avoid this, the local agreements should include strict governance procedures to ensure that group companies do not engage in disputes without reference to their parent company, and the change control procedures should include escalation procedures to ensure that local variations do not undermine the master agreement.

Option 3 - Individual Service Contracts

In this arrangement, the customer's group companies each sign a contract with the supplier's parent company and/or other entities (see attached chart, pdf). The main difference from Option 2 is that the parties do not agree a master agreement, although a memorandum of understanding may be agreed as a basic platform from which to engage in individual negotiations.

This model may be appropriate where the supplier proposes to use material sub-contractors or a joint venture partner to service a location in which it would otherwise not have a presence, or to provide for specialist requirements. This model can also be useful where the services have very little in common, but the supplier is bidding on a global price. From a customer perspective this model may be attractive because each group company will have a direct relationship with the relevant supplier. In addition, use of this model may prevent overdependence on a single entity. However, there are issues with this model, for example, in respect of fragmentation and provision of the services.

Fragmentation - All the contracts will need to be negotiated up-front to take advantage of bulk purchasing power. This can involve difficult multi-party negotiations and will require tight control over concessions made and the application of underlying commercial principles. Failure to keep control is likely to result in the contractual arrangements fragmenting. The customer should also be aware of the impact the contractual structure has on the liability taken on by the supplier and the customer's remedies, particularly where the liability limits are divided on a country-by-country basis, which may not take account of overriding global losses.

Services - Complications can arise if services requirements are not rigorously drafted. Accordingly, the customer must ensure that all of the required services are adequately reflected in the contract, and that the various suppliers are under contractual obligations to co-operate with each of the customer's group companies and each other in respect of the services and the investigation of any problems and issues.

Practical Considerations

Agreeing on the most suitable structure can be a lengthy and complicated process, particularly as the objectives of each group company may vary. The customer will also need to take into account the following considerations.

Key commercial terms - The deal structure must achieve a number of aims including:

- flexibility to cover future reorganisations, divestments and acquisitions and to allow for adjustments to reflect political, economic, legal and/or regulatory changes in the relevant locations;
- providing for enforceable contracts which properly reflect the rights and obligations of each party; and
- providing for adequate remedies (both directly in the contract, and indirectly through governance).

Technical considerations - The customer will need to consider whether any technical solution will be delivered on a local basis or delivered remotely. In addition, the customer will need to consider local requirements in terms of disaster recovery, business continuity and hours of operation.

Tax - Multi-jurisdictional outsourcings raise a number of complex tax issues, for example, issues in respect of the transfer of assets, permanent establishment, VAT and transfer pricing. The customer should identify the relevant issues early on in the planning stage and structure the transaction to remove or reduce any problems.

Exit - Arrangements must be developed as part of the contract and take account of the multiple jurisdictions involved.

Corporate activity - The customer should ensure that it has sufficient flexibility to allow for divestiture and acquisition activity within its group, without incurring prohibitive termination costs. This will include having the right to require the supplier to continue to provide services to a divested entity for a run-off period following the divestment.

Contract management - Each party must achieve local buy-in in the various jurisdictions. From the customer perspective, the goals and objectives of the global project must be fully understood by local managers. In addition, the ongoing contract management costs of these types of complex deals can be considerably higher than the usual 5% of budget. To ensure these deals are successful, sufficient focus must be placed on contract management. In particular, the customer must retain sufficient know-how within its retained function to manage performance of the contract, administer changes, and manage the customer's internal stakeholders.

Multi-jurisdictional outsourcing can bring with it many benefits but, as we have outlined in this Alert, due to its complex nature, time and effort must be taken to structure and manage the outsourcing to ensure that those benefits can be realised.