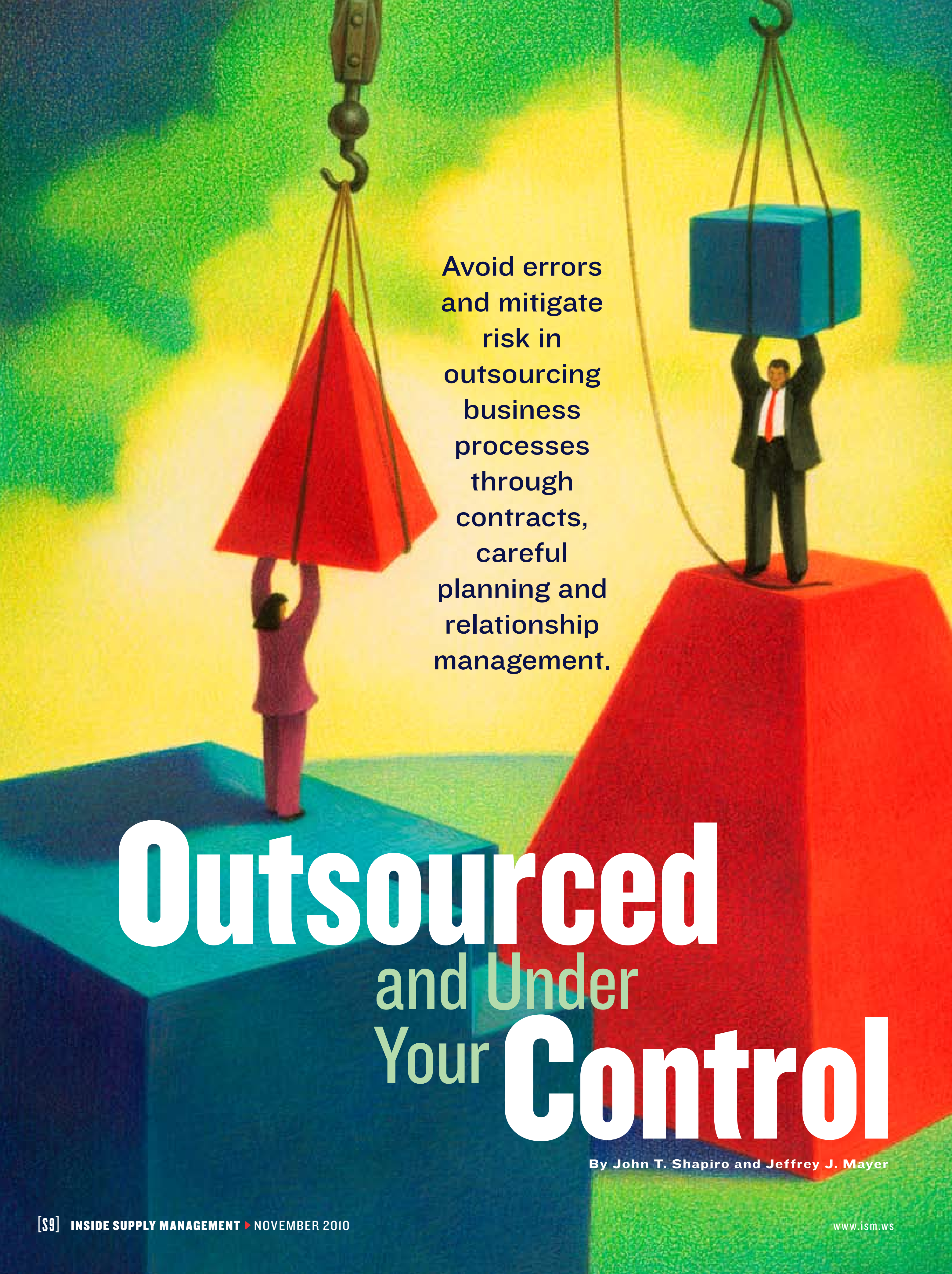
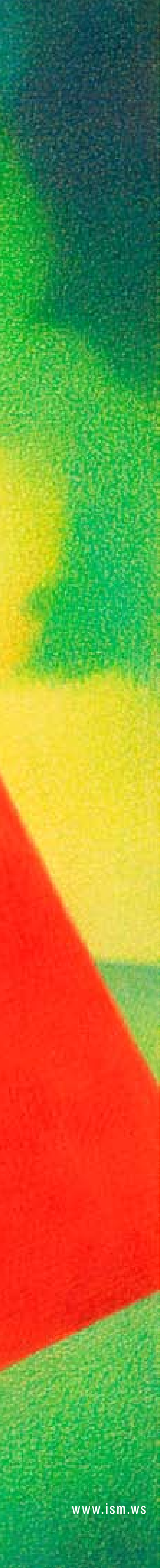


Outsourced and Under Your Control

Avoid errors and mitigate risk in outsourcing business processes through contracts, careful planning and relationship management.

By John T. Shapiro and Jeffrey J. Mayer



As organizations of all sizes continue to make efforts to reduce costs, business process outsourcing (BPO) is becoming more routine for the supply management function. These outsourcing initiatives often add new layers to the responsibilities of procurement professionals, including developing outsourcing contracts and managing the nuances of outsourced relationships.

As with any sourcing arrangement, there are instances in which supply relationships may fall into dispute or face potential business disruptions. However, when an entire business process function is outsourced, the potential risks for disruption and damage are magnified. This is especially true if the outsourcing relationship is inadequately planned or is damaged. A failure in critical functions of the overall business or misuse of sensitive information can be catastrophic.

What can an organization do to avoid errors and mitigate outsourcing risk? The answer is threefold:

1) Diligently prepare for the outsourcing relationship
2) Thoughtfully negotiate and a precisely draft the outsourcing agreement
3) Carefully manage the outsourcing relationship.

Given the complexities of outsourcing relationships, each aspect of error avoidance and risk management is quite complex. This article provides an overview by highlighting key strategies and issues that will help supply management professionals avoid errors and mitigate outsourcing risks.

Diligent Preparation

Preparation for the outsourcing relationship requires two assessments. First, a company must perform an internal assessment to determine how the process to be outsourced fits within the overall operation of the business. It is prudent to consider any issues unique or critical to the function where outsourcing may pose a concern.

For example, suppose the outsourced function involves accounting rules subject to requirements such as the generally accepted accounting principles (GAAP). The company retains responsibility for compliance with GAAP by ensuring that the supplier is aware of the GAAP requirements, addressing the supplier's obligations to comply with the requirements and enforcing the penalties for the supplier's failure to comply with those requirements.

Second, a company should perform due diligence on potential outsourcing suppliers before selecting one and commencing contract negotiations. To that end, a company must develop clear but comprehensive selection criteria, including operational, technical and financial metrics to measure potential suppliers. Also, careful due diligence involves reviewing the laws, customs and conditions where the prospective outsourcing supplier is located. This includes a review of natural conditions (such as environmental factors and accessibility) and manmade conditions (such as politics and government, labor pool, and energy and telecommunications infrastructures) that govern and influence the locale in which the prospective outsourcing supplier is located.

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While supply management professionals play a key role in performing due diligence, there are also important legal implications regarding some aspects of outsourcing relationships. Information obtained from due diligence will influence the structure and content of the controlling legal documents. Unless your organization identifies its critical business needs and communicates them to its supplier, the organization will not have the necessary information to translate those needs into an effective outsourcing contract.

Thoughtful Negotiation and Precise Drafting

A well-negotiated and well-written outsourcing contract is critical to forming a productive outsourcing relationship. Although certain concepts pertinent to outsourcing arrangements may be boilerplate and common to most relationships, the specific terms and conditions are more likely unique to the agreement. When effectively drafted, an outsourcing contract should:

- Clearly identify the supplier.
- Ensure that the supplier is solvent and collectible.
- Specify the services to be provided by the supplier.
- Contain an appropriate warranty of the supplier's performance.
- Define the metrics by which the supplier's performance will be measured.
- Specify how and when the metrics will be shared with the supplier.
- Specify the incentives and penalties for the supplier complying with or breaching the performance metrics.
- Provide for a clear and understandable method of declaring breach, cure (resolution) and termination.
- Define the manner in which disputes will be resolved.
- Eliminate, mitigate, or otherwise anticipate and address potential risks to the company that cannot be avoided altogether by limiting and defining the supplier's rights.

Given the complexities of an outsourcing relationship, there are a number of potential issues to address for it to be successful. Key considerations include the following areas.

Protection of proprietary information. If outsourcing the business function requires a company to provide the supplier with intellectual property or other information proprietary to the company or its customers, protecting that information is critical. Therefore, the contract should clearly address protection of that information. Also, in cases where the supplier creates new proprietary information, the contract must clearly specify who will own that property. The contract should also address nondisclosure and noncompete obligations of the supplier, as well as the ability to enforce those obligations directly against employees of the supplier.

Quality of service. To ensure quality of service, an outsourcing agreement should:

- Define rigorous quality assurance (and, if applicable, regulatory compliance) standards with enforceable service warranties.
- Require regular compliance audits.
- Include a mechanism to address and resolve identified problems, including response time expectations if an issue arises.
- Ensure a provision for monetary damages, and perhaps even liquidated damage amounts, payable to the outsourcing company.
- Provide for the right to reduce the scope of the services provided, or the right to terminate the relationship, if the supplier does not meet the requirements.

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Flexibility. Business needs and strategies addressed at the outset of the outsourcing relationship may change over time. Among other measures designed to ensure flexibility, the terms of an outsourcing agreement should:

- Be short in duration, but provide the company with the right to renew.
- Provide the company with the right to review the contract in light of changed business needs or extraordinary events (natural disasters, plant closures or other events).
- Address service and quality in the case of a force majeure event, either limiting the supplier's rights to a true disaster or allowing the outsourcing company to terminate if the supplier cannot perform.

Exit plan. Broad termination rights are critical to an effective outsourcing agreement. Therefore, an agreement should provide the company with termination rights tied to inadequate services or changed circumstances that materially affect the economies or efficiencies of the outsourcing relationship. The agreement should also protect the company's rights to transfer data, software, equipment and IP, and, if necessary, the right to hire the key personnel the former supplier used to perform the outsourced function.

At the same time, to reduce the risk that the supplier may prematurely terminate the agreement, the agreement should allow the supplier to exit only for limited reasons and provide the company with damages in the event of wrongful termination. Similarly, the company should not assume the supplier's business risks, and the supplier's right to claim damages for lost profits should be eliminated or capped.

Dispute resolution. Should a dispute arise, the outsourcing agreement should specify a mechanism for dispute resolution. Typically, outsourcing suppliers want to avoid becoming enmeshed in litigation in a foreign jurisdiction governed by laws and procedures unfamiliar to the company. Therefore, it is critical that the agreement clearly detail the mechanism by which disputes between the company and the supplier will be resolved. This should include a clear statement of the parties' obligations pending a dispute resolution to ensure the continuation of services, if appropriate.

Equally critical, the agreement should contain a choice of law and forum provision, providing for the law and venue of the company's choice. To mitigate the risk that the supplier will seek the protection of the court in its own jurisdiction, especially when the supplier is located in a different country than the company, the preferred means of international dispute resolution is likely arbitration. Moreover, many countries are signatories to the New York or Panama Conventions on arbitration awards, which makes an arbitration award easier to enforce in a foreign jurisdiction subject to the Convention, compared with a court judgment.

Careful Management

Even with an effective agreement in place, supply management professionals must still closely manage the supplier relationship. Many times, companies underestimate the staffing needs that come with managing outsourcing relationships. Be sure that there is adequate staff within your organization, not only to manage the relationships but also to ensure knowledge is retained in the organization.

The outsourcing agreement itself must provide the company with an appropriate level of oversight and control over the supplier's operations, such as conducting audits and the ability to communicate directly with key supplier personnel.

While BPO may create greater efficiencies and reduce costs, potential savings may be eclipsed through poor planning, contracting and oversight. Ultimately, the company could risk irreparable damage. Thus, it is the responsibility of supply management professionals to manage all the nuances of outsourcing relationships. And when it's done well, it will help the overall organization succeed. **ISM**

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