

“Outsourcing will continue to grow as organisations accelerate their drive to increase efficiency and reduce costs.”

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# update

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### “No surprises” works best

Outsourcing will continue to grow as organisations accelerate their drive to increase efficiency and reduce costs.

While the customer and SP will be understandably eager to get an anticipated deal signed up quickly, time spent negotiating the exit arrangements ultimately helps both. It assists with building an open and frank relationship from the start and beds down procedures which can help avoid future disputes. More certainty and fewer disputes equals cost savings and less use of management time.

If the parties focus on ensuring that a “no surprises” relationship is reflected in the contract then that relationship will be much more likely to stand the test of time.



By Dean Oppenhuis, Senior Associate

## Outsourcing: exit strategies as relationship building

New Zealand companies are part of the global growth in the outsourcing of IT functions – a move some predict will be the rule rather than the exception by 2010.

In fact, one industry analyst estimates that by the end of this year 80% of organisations worldwide will have outsourced at least one operational IT function. But along with this rise has come a fair share of “outsourcing gone wrong” headaches. There’s a good chance these may have been avoided – or at least prevented from migrating to migraines – with an upfront outsourcing health check. In particular, a clear plan to deal with an ailing outsourcing relationship – and in the process actually help build a healthy one.

In this article we examine some of the key issues to consider in an outsourcing agreement when it comes to the potential need to sever the relationship – and the positives of dealing with these upfront.

### Why outsource?

Outsourcing is essentially an arrangement in which a customer carves out certain services that it has been providing internally and engages a specialist service provider (SP) to provide those services (usually for several years). As organisations recognise their core and non-core competencies, they often opt to outsource non-core activities to increase efficiencies and reduce costs. The SP will have greater expertise in the outsourced activities, and economies of scale usually exist through its ability to leverage resources across a wide customer base.

Some of the most common areas for outsourcing are information technology (IT),

infrastructure maintenance and non-core functions such as accounts and claims processing. IT is often at the top of this list, partly because it can be difficult and costly to source and retain IT talent. The relatively large amount of capital and resources required to fund new technology projects can also make outsourcing appealing because the costs can be spread out over the outsourcing term.

Negotiating and preparing contract documents for outsourced business activities is markedly different from routine services agreements.

In essence, outsourcing is all about building relationships. The contract underpins that relationship building process, at the start during negotiations and after contract signing, through interpretation of the contract documents and contract changes. The longer term nature of shifting work activity to a SP through outsourcing brings into sharper focus matters such as transition planning, scoping of services requirements, performance measurement, disaster recovery and exit strategies.

### Dealing with the “ugly” side of contracting

If it is done right, outsourcing can achieve the all important “win-win” for the customer and SP.

At the start of negotiations, both sides are naturally positive – the customer is keen

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# “Outsourcing is all about building relationships.”

## “It is in the interests of service providers to proactively address exit strategies in a detailed manner in the contract.”

to achieve cost savings and better service; the SP to close another deal.

The reality is that a good many outsourcing projects do not go the distance. The reasons are varied and may include a change in market conditions, a shift in the customer’s focus or poor performance by the SP. Even in successful outsourcing, there will eventually come an end point when a contract is not extended.

Outsourcing is a dependent relationship. It is usually the case that if an outsourcing agreement is terminated, the customer cannot immediately switch SPs or perform the outsourced functions internally. Once a party has exercised its right to terminate, the contract should provide a clear road map of each party’s responsibilities and costs in exiting and the period of time for the exit to take place.

Customers have become increasingly sophisticated and driven in their approach to dealing upfront with this “ugly” side of the outsourcing contracting process – planning for exit.

It is in the interests of SPs to proactively address exit strategies in a detailed manner in the contract. It shows that they are not attempting to “box in” the customer and understand the customer’s concerns. A proactive approach from a SP can actually boost the relationship building process. And if the relationship is strong then that should ultimately reduce the likelihood of exit provisions being used “in anger” before the contract expires.

### Exit provisions

There are several main matters to deal with in exit provisions to ensure that there is an orderly and timely migration of responsibility to a new SP or back to the customer, with minimal (if any) disruption to business, including:

- appointment of an exit manager;
- preparation of a detailed exit plan;

- ownership/licensing of intellectual property; and
- transfer of physical assets, contracts and employees.

At exit time the relationship is coming to an end, and it can be unrealistic to expect a SP to be highly motivated to provide high quality exit services. Carrots and sticks can be built into the contract to deal with this. The SP should be paid reasonable fees for providing exit services. If appropriate, payment could be held over until completion of exit services.

### Exit manager

The SP should appoint a suitably experienced and qualified person as exit manager. He/she will also usually be a senior representative of the SP’s regular customer service team. The exit manager is responsible for ensuring that the SP complies with exit terms and is the key liaison with the customer during the termination and exit period.

### Exit plan

A well thought out exit plan helps parties to identify what is needed for a successful exit. Work on this should begin as part of negotiations so that at least the framework is in place by contract signing. The exit plan is often completed after the transition phase so that all key actions and outcomes are captured while still fresh in the parties’ minds. This involves writing down, in an agreed form, a plan which records what has just happened for transition, but in reverse for an exit years down the track. Otherwise, if there are staff changes over the long term of an outsourcing contract this invaluable practical knowledge from “learning through doing” may be lost.

The exit plan should be reviewed regularly and updated to ensure that it reflects the realities of the services being provided.

The plan should also set out the process by which the customer may re-tender all or part of the services in the future. This could

include specifying information that must be prepared and regularly updated so that a tenderer would have access to all relevant information following an invitation to tender. The SP should also provide reasonable assistance in the tendering process, including access to information and other resources as appropriate.

The exit plan will also often provide for:

- maintaining the current level of services and applicable resources (including employees) until the actual exit date;
- rights of access to the SP’s personnel;
- hand-over plans, including for specific assets used to provide the services;
- any consultancy and training support services to be provided by the SP; and
- rights of access to any premises which are owned or leased by the SP and used in the provision of the services.

### Intellectual property

The contract IP provisions will usually expressly address the ownership and licensing arrangements for IP in existence at the time of entering into the contract and IP developed or improved during the term. The contract also needs to address the licensing of IP and assets which are required for the provision of the services following termination or expiry of the term. This includes determining whether the SP will charge the customer a fee for use of its IP after the term.

### Assets transfer

The exit arrangements need to deal with the issue of whether the customer or a new SP will be transferred the people, physical assets and/or contracts (including software licences, subcontracts and sometimes property leases) on exit. The customer, in particular, will not have the knowledge base or the infrastructure to deliver the services.

The transfer costs may be difficult to specify in advance, but it should be clear that the customer is not paying for any assets as part of the charges during the term and then paying for those assets again on exit. The cost of any third party consents required to assign or novate contracts, particularly software licences, should be specified. Software suppliers do not readily pass up the opportunity of a new sale.

The transfer of assets and employees can be problematic. Some of the mitigation strategies available are:

- the customer retaining control of certain physical assets used to provide the services and leasing them to the SP (this only really works where the assets will have a life beyond the outsourcing term); and
- the SP sets up a special purpose vehicle (SPV) company to provide the services and the customer has a “golden share” in that company with the ability to take control of it on exit or the customer has a call option over the shares in the company which is exercisable on exit.

The “golden share”/call option approach tends to occur only in major outsourcing deals where an SPV can be justified. The SPV will typically be set up with a constitution restricting the business it can conduct and the liabilities it can incur.

This approach avoids many of the problems associated with the transfer back of assets, with the customer taking control of an SPV with the people and assets the customer needs to provide the services.