

THE LEGAL PITFALLS OF IT OUTSOURCING

As more companies outsource their IT and other business functions to managed service centres at home and abroad, FDs must be aware of the legal pitfalls that companies can fall into when agreeing outsourcing deals. The advice below draws on a white paper published in August by Martin Cotterill and Andrew Moyle of law firm Latham & Watkins.

When outsourcing deals go wrong, they are rarely publicised. But according to a Latham & Watkins white paper, there are two principal reasons for failure – poor construction and lack of management attention. The first is about getting good advice and running a strong process to deliver a balanced deal. The second is recognising the impact of an outsourcing transaction on the retained customer organisation, and planning for that impact and the corresponding investment needed to ensure its success. According to the white paper, key points for FDs to note are as follows:

Approaching a deal

1. Recognising the nature of the deal is the first hurdle. Outsourcing deals are not corporate disposal and lease-back transactions, but are long-term business service arrangements. To treat such a deal as an M&A-type of transaction is to miss the fundamental distinction that what you are transferring out and buying back is your own business. You are handing over control not ownership of the functions you outsource.

2. If you step back and analyse the outsourcing proposition, your organisation is usually asking a supplier to do the following:

- Run a part of the business that you understand better than they do
- Re-engineer the functions that are outsourced
- Do everything at a lower cost, usually after VAT

3. The culmination of the outsourcing process is the production of a contract that should reflect the dynamics of your transaction, particularly in the three main interlinked areas – scope, service levels and price. The finance function should be an integral part of steering the deal.

4. You are handing over control of a part of your organisation and the only constitution of this ongoing relationship is a written one in the form of your contract. The processes within and interfaces to the outsourced functions must be articulated and formalised, but these will not be written in a way that contemplates a different company operating them.

Doing the work up front

1. Many suppliers push for quick implementation of a contract, with minimal due diligence up front, leaving the verification of price, scope and service levels until after the contract is signed. This should be resisted as your negotiation leverage will deteriorate once the contract is signed, the business has transferred and your people have gone.

2. Entering into an outsourcing arrangement without performing a rigorous cost/benefit analysis, due diligence and careful construction

of the deal up front places too much reliance upon “partnering”, which can ultimately lead to a strain on that relationship. A clear contract will enhance both parties’ ability to maintain the relationship.

3. At the end of the term of the deal, your retained function will be focused on buying, not providing these services. The natural attrition in retained know-how over, say, a five or possibly 10-year term is therefore obvious. Accordingly, your ability, at the end of the contract, to re-transfer the functions elsewhere, either to a new service provider, or back in house, will be critical. So finance directors must do the following:

- Establish detailed exit management provisions, which include parameters for dealing with assets, subcontracts, personnel and information on a transfer
- Appropriate rights in the intellectual property created by the supplier during your contract term so that you can continue to run your business without paying a premium for securing the rights you need
- Agree a pre-defined price if you decide to exercise your right to terminate the contract

Building the base

1. An essential pre-contract requirement is to build the financial model of the deal so that an analysis of the costs over the term of the deal can be performed. There are three main factors in most outsourcing arrangements that will dictate the level of confidence you can place in your model. They are as follows:

- Suppliers will quote a price based on the level of detail of the scope you provide them and the performance levels you require
- Do the base case costs against which you benchmark include a quantification of all the factors built in to your outsourcing strategy?

- Since outsourcing deals don’t manage themselves, have you budgeted for the cost to the retained organisation of establishing your own contract management structure?
- 2. Have the questions below been answered to your satisfaction?
 - Which assets transfer to the supplier?
 - How do you want the supplier to upgrade the assets over the term?
 - If investment in upgraded assets is kept to a minimum, how does this affect the cost of maintaining progressively ageing assets?
 - If you operate in a regulated industry, have you complied with the requirements of your regulator?
 - The Transfer of Undertakings (Protection of Employment) Regulations 1981 (‘TUPE’) will apply to all outsourcing arrangements. Have the costs of such compliance been quantified and included?
 - Do you have any penalties or restrictions in your existing third-party agreements that will restrict your ability to outsource?

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A wide range of Briefings can be found at www.financialdirector.co.uk/briefing

Useful links

- A full copy of the white paper, *Outsourcing: What a CFO needs to know*, can be obtained by emailing Martin Cotterill at Latham & Watkins, martin.cotterill@lw.com
- Transfer of Undertakings Regulations are available at www.hmsso.gov.uk