

# Successful Outsourcing through Proactive Contracting – Strategy, Risk Assessment and Implementation<sup>1</sup>

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<sup>1</sup> This chapter is based on a presentation at the third panel – Managing Contracts and Risks – at the Nordic School of Proactive Law Conference 2005. The approach is practical and based on the author’s experience gained as company lawyer and project finance director at Fortum Corporation 1985-2005 and thereafter as consultant in the field of contracting, for contacts *see* “[www.kavaleffconsulting.com](http://www.kavaleffconsulting.com)”.

## 1 Introduction

In the Nordic countries many corporate activities are currently being outsourced to countries with lower production costs. Besides lowering costs, sourcing from third party suppliers is also claimed to increase flexibility and reaction speed to the market. Another important driver for outsourcing is to free capital and thus enable a higher yield on capital employed, which is perceived as a key success factor for stock-listed companies. Only recently analytical studies have pointed at some of the risks embedded in the outsourcing concept.<sup>2</sup>

Some degree of outsourcing of services and supplies has always existed in the manufacturing industry. Sub-suppliers have provided raw materials and transport firms have taken care of deliveries to the customers. What a couple of decades ago started off as buying supporting activities like canteen services and accounting from external providers have now turned into a major trend which even may involve outsourcing of the core activities of a company. Examples of activities now being outsourced include the entire production, the product development and provision of customer service, activities which involve strategic key competences of a company.

How do we define outsourcing? Outsourcing has been described as the abbreviation of the words **outside** – **resource** – **using**. Outsourcing is here defined as an external company's provision of the products or services previously carried out within the company or group of companies.<sup>3</sup> This definition distinguishes outsourcing from sourcing services to a group company either domestically or abroad, which also is commonly used. Neither do we cover outsourcing of a branch of a company (i.e. transferring assets and employees) which activity the term sometimes also cover.

A historical flashback makes the shift of emphasis of activities from corporate activities to the external market sphere and freedom of contract obvious. The corporate activities were in the "old" regime simple and easy to comprehend from a legal point of view: *company law* applied to the "in-house" activities and the decision-making was based on hierarchy. Raw materials were purchased, turned into products in the manufacturing process by people employed by the company (*labour law*) and comparatively standardized sale contracts governed the distribution of the products to the marketplace (*contract law*). Today a company outsourcing its production, to take one example, has a network of contracts to manage in the sourcing of components and services which each form their part of the supply chain. The outsourcing contracts are commonly with vendors in different jurisdictions with corporate cultures differing from the outsourcing company's. What may have taken place "by accident" is that the company also has "outsourced" *company law* and *labour law* since these legal disciplines are now at the vendor company's responsibility (in the jurisdiction where the vendor carries out business). The contracting

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<sup>2</sup> For example in Sweden following the publication of the report *Alternativ till outsourcing*. See Bengtsson, L. Berggren, C. och Lind, J. (red.) (2005). *Alternativ till outsourcing*. Lund, p. 146.

<sup>3</sup> Berggren, Christian and Bengtsson, Lars, *Rethinking Outsourcing in Manufacturing: A Tale of Two Telecom Firms*, *European Management Journal* Vol. 22, No. 2, p. 211.

strategy must take care of these “missing parts” in order to retain control and secure the success of the outsourcing. The outsourcing company cannot be indifferent how its sourcing is managed at the spot in the vendor’s country because issues like child labour and environmental compliance may unexpectedly creep to the surface. This means undoubtedly that the *contract law* part and contract management have become more complex.

This chapter discusses the need for a contracting strategy in outsourcing from the outsourcing company’s point of view and outlines briefly issues which may pose a challenge for such a strategy. The contracting strategy must focus on answering the question: *How is the outsourcing strategy best implemented by means of contracting in order to ensure the continuation of the business and secure the returns of the company?*<sup>4</sup>

The need for a proactive contracting strategy and the lawyer’s role therein is here in between the text illustrated with the following fictive case: A company called Phyllis Ltd. is outsourcing its manufacturing of a fridge called Mount Everest intended for the Asian market to a third party supplier called Frost Ltd. in India. The reason for the outsourcing is low production costs, proximity to the evolving Asian market and flexibility.

## 2 Outsourcing Strategy and Risk Analysis

There has been discussion among researchers on the strategic implications of outsourcing. It has been claimed that manufacturing is a critical competence of an industrial company which requires close integration with the company’s other core functions, like design.<sup>5</sup> Some studies also show that *ex post* costs exceed *ex ante* costs considerably due to various transaction expenses and delays.<sup>6</sup> These are risks which are to be evaluated when preparing the outsourcing strategy which will need to assess the processes required ensuring successful implementation.<sup>7</sup>

There are success stories, too. An obvious example of that is IKEA, the Sweden-based home furnishings retailer and manufacturer with some 150 stores in more than 20 countries. IKEA has almost from the start in the 1940’ies outsourced its production, but in doing so retained close control between its own designers and the vendors. Now IKEA uses a multi-tiered network of more than 2.000 suppliers around the world. In the management of the network it uses the

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4 About best practises in contracting, see Cummins, Tim: *Contracting as a Strategic Competence*. International Association for Contract and Commercial Management. 2004. “[www.iaccm.com/contracting.pdf](http://www.iaccm.com/contracting.pdf)”. September 26, 2005.

5 See Westin and Bengtsson, The significance of manufacturing – an analysis of outsourcing strategies in three companies, Proceedings of EuromaPoms 2003, June 16-18, Como, Italy, Vol. 1. p 9.

6 Berggren, Christian and Bengtsson, Lars, *Rethinking Outsourcing in Manufacturing: A Tale of Two Telecom Firms*, European Management Journal Vol. 22, No. 2, p. 221, Bengtsson, L. Berggren, C. och Lind, J. (red.) (2005). *Alternativ till outsourcing*. Lund, pp. 58-59.

7 Davenport, The Coming Commoditization of Processes, Harvard Business Review, June 2005, p 102.

Vertical net solution by means of which it intends to lower its supply chain costs by a further 20 percent.<sup>8</sup>

For the purpose of this chapter we leave the strategy considerations aside for a moment and assume that the management of the company has done its SWOTs<sup>9</sup> and assessed the strengths with outsourcing against the weaknesses and the opportunities against the threats. In most cases, the perceived cost benefits with outsourcing would have outweighed the threats.

This happened also in our example with Phyllis Ltd. and Mount Everest fridges are already being marketed in the Asian market place when the in-house lawyer Mr. Justus Foresight receives an urgent email.

He gets the task to draft a contract based on the agreement in principle concerning purchase of fridges reached with the vendor in India. As a basis for the discussions between the parties a standard Orgalime model agreement has been used. Justus Foresight is a prudent lawyer and he wishes to recapitulate the sequence of events having lead to the outsourcing decision. Ideally, this should have happened on beforehand and as a member of the project team assessing the outsourcing opportunity, broadly described along the following lines.

The questions relevant for the contracting strategy which would be put forward by a proactive, business minded lawyer include:

- Why do we outsource to external vendors (cost reduction? efficiency requirements? technology? free capital? etc) – would there be other means to achieve these objectives?
- What activities do we outsource (core activities? any other important activities? only routine activities? manufacturing? employees? equipment?)?
- To which country do we outsource (domestic vendors? international vendors?)?
- To whom do we outsource (subsidiary companies? external vendors? only short-listed companies? etc)?
- Does outsourcing involve disclosing or licensing of our Intellectual Property Rights (IPRs<sup>10</sup>)?
- Which is the vision of the relationship (long-term? exclusive? joint venture? case by case?)?

The answer to each of these questions has a bearing on the content of the outsourcing agreement. It may even lead to a changed focus of the outsourcing, in other words impact back on the outsourcing strategy and the processes required. In overseas outsourcing the project team will have to go through due

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<sup>8</sup> See Supply Chain e-Business – May 2002.

<sup>9</sup> SWOT= Strengths, Weaknesses, Opportunities, Threats, a procedure commonly used in benchmarking.

<sup>10</sup> IPR means here Intellectual Property Rights (like patents, trademarks, copyright etc.).

diligence steps which resemble that of establishing or acquiring a business in another country.<sup>11</sup>

Risk management should be on the agenda of the project team since it is a vital part of the implementation of the outsourcing strategy. Failures in risk management may impact detrimentally on the revenues of the business. We will not here present risk management in detail, but conclude that such a process involves *inter alia* identification of risks, evaluation of identified risks, allocation and mitigation of risks by contracting and other means (like for example insurance) and continuous follow-up and management of the risk management policy.

The following illustration of risk analysis steps have been developed for outsourcing companies from a model used by the author in projects abroad.<sup>12</sup>

### Risk analysis step-by-step

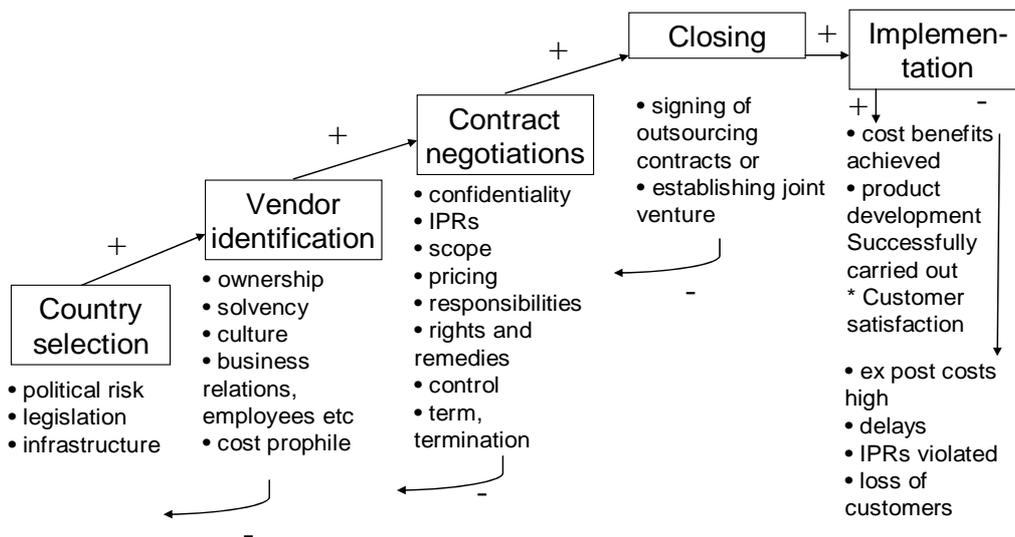


Figure 1, Risk analysis step-by-step

<sup>11</sup> Outsourcing of corporate activities to third parties abroad no doubt have some common features with acquiring a business or starting up a subsidiary abroad for cost benefit reasons. The cost driver is similar, components or products are being bought from another company. But the issue of control differs: the corporate vs. contractual control. Within a group of companies, the parent company has the benefit from the hierarchy and company law assist in implementing the outsourcing strategy. In a contractual network, the last resort is to ask the judge to implement the outsourcing contract, and that may be a lengthy, costly and unpredictable process. Thus even more emphasise must be put on the risk analysis in outsourcing to external vendors.

<sup>12</sup> See Kavaleff, *Project Finance: Contracting and Proactive Preventive Law*. Preventive Law Reporter, 2003 p 18.

Each step of the ladder is or should be a decision-making step. The decision-makers may vary depending on the authority required and the corporate governance of the outsourcing company. Some decisions may be taken by the project team or the project director, others may require decision by the steering group or board of the outsourcing company. Often the value of the transaction involved defines the powers, but the “down-side” ie. the negative value of the risk should also be taken into account in determining the authority.

A decision not to proceed or a failure to make a decision at a particular step forces the team to step down and reconsider its position in relation to the company’s strategy, country or partner selection (whichever is applicable). One of the tasks of the team is to secure the possibility to make the back-step and ensure that the company is not trapped into an undesired solution. Securing the back-step possibility would typically be the lawyer team member’s task. Another reason for the step-wise climbing is cost control. The due-diligence required for sourcing manufacturing or services abroad is costly and the spending on external legal and financial advice services should be in balance with the steps forward.

In the following we will briefly present some issues to be “screened” at each of the above steps.

## **2.1 Country Selection**

The political system, availability of workforce, legislation and infrastructure (communication, energy etc.) of the country where the outsourced activity is intended to take place impacts naturally on the decision.<sup>13</sup> Unstable political conditions means that the legislation is unpredictable and may also imply difficulties for the vendor with sourcing of workforce and raw materials. Infrastructure, like secured electricity supplies, is a precondition for the manufacturing industry. It may be important to assure whether our property (tangible like production equipment to be sent to the vendor and intangible like our industrial know how) can be secured and to know how? How would the company’s other legal and contractual rights be secured through the legal system? How is work-force issues dealt with? Which is the level of wages and how would the expected increase in those levels impact on our outsourcing contract? Does child labour occur etc? If the answers to the questions are unsatisfactory, the fall back strategy may have to involve outsourcing from another country.

In our case the above questions may not be a problem, but the culture in India is certainly different from the European country where Phyllis Ltd.’s headquarter is. One issue which Phyllis Ltd. should have taken care of before becoming active in the Indian market place was to register its IPRs in India. It so happened that Mount Everest had recently been registered in India by Mr. Smart, whose business is to spot valuable trade marks and register them in his own name before that is made by the owner of the respective trademark. Due to the implementation

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<sup>13</sup> Institutional Investor News provides country information and ranking which is useful also for sourcing activities, see “[www.iinews.com](http://www.iinews.com)”.

of Mr. Smart's business plan, registration of Mount Everest was not possible outright.

As a first step, the company would evaluate some few critical issues to check in addition to the general circumstances for carrying out business with a vendor from the target country. These issues depend on the business intended, but if we for example deal with branded products, securing your trade names and trade marks would be paramount. If we intend to outsource the administration of a client data file, we would have to assess the data protection rules of both the sending country and the target country etc. These are matters that cannot be left to the outsourcing contract alone since they belong to the legal infrastructure. The parties to the outsourcing contract cannot bindingly agree on them as they may involve third party rights. Some of these issues would have to be dealt with at an earlier stage with the relevant official bodies. Tax and other administrative issues like permits, customs charges etc. must also be addressed in advance since they may impact substantially on the intended schedule and the cost structure of the product.

In our case with Phyllis, the intention was to export an old machine to be used in the manufacturing to Frost Ltd. Fortunately Justus Foresight checked the customs rules and found out that the custom duties for importing the machine to India far exceeded the value of it.

## **2.2 Vendor Identification**

The criteria for selecting outsourcing vendor will depend on the activity being outsourced: is it a core business or a supporting activity? Is the protection of industrial know how linked to the outsourced activity vital for our company? Is the vendor the company's only partner or are other vendors used to perform the same activities? As pointed out in the introduction, the outsourcing arrangement would have to resemble activities previously carried out within only one company. This puts emphasize on communication and control issues which must be dealt with in the outsourcing agreement. But before discussing the agreement the company must be convinced that it is safe to trust its activities to the vendor company. Obviously the vendor would have to be credible and financially sound. Some degree of due diligence with the assistance of financial and legal expertise would be necessary to assess these objectives. The due diligence would include analysis of the ownership of the vendor, financial statements, existing outsourcing contracts (any with competitors?), any litigation pending etc.

Even if the outcome of our analysis of the vendor company was favourable we may in our risk analysis need to assess how vulnerable we are if for example our industrial know how is being further developed and sold to competitors by employees of the vendor company. How much information can we safely provide to our partners and can we prevent them from utilising our know-how for own business purposes? These are core issues in starting an outsourcing relationship, which ideally, when trust has been built up, could turn into a partnering arrangement (sharing upsides and downsides).

Some business information must naturally be disclosed in order to assess the opportunity on both sides. At such a stage the parties should exchange confidentiality undertakings being, however, aware that such undertakings would not protect our rights if the vendor has a malign agenda.

In our example case Phyllis Ltd. trusted Frost Ltd. with the registration problem which had emerged due to Mr. Smart's intervention. Justus Foresight got acquainted with Ms. Quicky, Frost's external legal consultant, who rapidly de-armed Mr. Smart using the same arguments as in recent Indian cases in the pharmaceutical market<sup>14</sup>. This was a wise move since, besides curing the problem with Mr. Smart, the relationship between the parties was tested and trust was built.

### **2.3 Contract Negotiations, Issues to be Dealt with**

When the parties have reached an agreement in principle on the commercial issues, they would start negotiations on the outsourcing agreement. The conclusion of the outsourcing agreement (or agreements) may be a long and ongoing process since trust is built over time. The contractual arrangement should anticipate adjustments and changes as well as the possible discontinuation of the arrangement in case of a failure. It is important to assess and document which parts of the contract are intended to remain fixed and which are allowed to be flexible and subject to changes.

It would be helpful if the outsourcing contract could be standardized like supply contracts often are. But there are no, to all cases applicable, outsourcing contract models. There is, however, a lot of useful information and experience sharing out at the web.<sup>15</sup>

The structure of the outsourcing agreement is a key issue because the functions to be performed are strategically important and the relationship between the outsourcing company and the vendor is usually of a longer duration and greater intimacy than the relationship created in other commercial contexts.<sup>16</sup> The relationship has in fact many similarities with a joint venture and to some extent a degree of corporate decision making and control has to be factored into the outsourcing agreement.

In summary the contract has to define the relationship between the parties, it has to be business orientated and document the outsourcing business plan

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<sup>14</sup> Cf. The pharmaceutical market is becoming increasingly competitive, with more and more market entrants trying to pass off their goods under the name of established players in the industry. Therefore, it has become imperative for industry players to protect their trademarks effectively and to understand how the Indian courts deal with such disputes. (Read article "[www.internationallawoffice.com/?l=2ZW5N&i=59887](http://www.internationallawoffice.com/?l=2ZW5N&i=59887)").

<sup>15</sup> See e.g. "[www.businesslaws.com](http://www.businesslaws.com)", "[www.outsourcing.com](http://www.outsourcing.com)", "[www.glscs.com](http://www.glscs.com)" and "[www.verticalnet.com](http://www.verticalnet.com)".

<sup>16</sup> We focus here on a contractual relationship which is intended as long-term. Outsourcing is also used as a term for divestments of assets which may include transfer of personnel. These divestments require other processes than the long-term outsourcing and we do not cover them here, just note that they may be complex, too.

(including to the extent applicable pricing, performance criteria, potentially with upside/downside sharing), it must define the scope of the outsourced activity, it has to deal with strategic considerations such as exclusivity, duration etc; it has to define responsibilities, rights and remedies; it has to define who owns the rights to the results of joint work and it needs to govern the termination situation and different jurisdictions just to mention a few examples. The last two issues: the exit strategy in case of termination and the jurisdiction and choice of law cannot be overemphasized.

In our case Justus Foresight did not agree to Indian laws nor did he agree to resolving disputes in Indian courts. Although successful, the trademark battle was enough for him and Frost Ltd. had some sympathy with that. The parties settled at choosing Swedish law and ICC arbitration in Stockholm.

Outsourcing contracts have sometimes been criticized for being penalty based only and giving no incentives for outstanding performance. This is unfortunately true, because standard purchasing agreements intended for one time deals are often used in outsourcing contracting. This is partly due to lack of time and involving the legal aid too late, if at all. There are then not enough resources to develop the business process and how best to achieve the results. Bonuses would, besides penalties, be a natural ingredient in an outsourcing contract and a natural step towards a closer relationship. Harmonizing the contracting parties' business processes require attention to a lot of details, too.

In the contract negotiations the team of Phyllis Ltd. was struggling with something that easily could be misjudged as a small detail: the quality processes and how to document them in the contract. There was a corporate decree requiring the same processes as used in Phyllis Ltd.'s European factories, but the ISO 9000 were not transferable as such to Frost Ltd.'s factory. Justus Foresight emphasised that the quality requirements would be of paramount importance. Furthermore, he demanded the requirements not only to be described in the contract, but also to be implemented by means of training of Frost Ltd.'s personnel and audited with regular intervals. If a quality problem occurred Phyllis Ltd. may lose its customers. Therefore early detection of quality problems is important and Phyllis Ltd. must be able to react, mitigate and, if necessary, transfer the production to another supplier. Phyllis Ltd. may need to terminate the relationship with Frost Ltd. This may not be possible unless Phyllis Ltd. is able to show that the products were not conforming to agreed quality requirements.

Before signing, the company must assess whether the contract secures its rights and whether its business objectives are capable of being achieved by means of the contract. The emphasis on contract networks replacing corporate foundations with built in safety nets is challenging: how to secure the business (IPRs, revenues etc.) by contracts only – is it possible at all? The result of the due diligence should address whether a contractual relationship is enough or whether the outsourced activity requires an ownership based relationship like a joint venture? In the latter case the complexity would increase and contract

negotiations would be prolonged. Such an approach may not be possible or even realistic outright.

## 2.4 *Closing and Implementation*

Despite the many steps before achieving signing and closing it may sound as an anti-climax to claim that in outsourcing the focus is on the implementation, not on the detailed contract provisions. The objective of the contract should be more than being just a risk allocation paper. The function of steering the activity towards achieving the mutual business objectives is of importance both in outsourcing contracts and in a joint venture. This involves flexibility and adaptation to changed circumstances. It would mean starting up of joint processes. The implementation of the cooperation should take place on different levels in both the outsourcing company's and the vendor's organisations. A good cooperation model which has been suggested in outsourcing of it-activities can be described as follows:<sup>17</sup>

1. The higher management of both the outsourcing company and the vendor form a steering group which meets 1-4 times a year. The steering group is entrusted with the outsourcing strategy.
2. The management of the outsourcing at the company and the management of customer relations on the vendor side meet once a month and review quality and service level issues.
3. The operative management organise the work, form several issue based working groups with representatives of both the outsourcing company and the vendor and meet on a weekly basis.

A cooperation plan should be made part of any outsourcing contract. Such a plan could mitigate the risks frequently mentioned in relation to outsourcing, namely lack of sourcing plan, poorly defined projects and lack of skilled resources to execute the project.<sup>18</sup>

Phyllis Ltd. got, after all, a reasonable start of their outsourcing to India. The start of production was, however, delayed with 18 months due to the trademark process, but when it got started, the Vendor's team was ready for it and trained in the quality requirements.

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<sup>17</sup> See interview with Minna Eranka, Kauppalehti, 6.9.2005.

<sup>18</sup> See Cummins, Tim: *Outsourcing Governance: A Key To Business Success*. In *The Outsourcing Project – Achieving Competitive Advantage through Collaborative Partnerships*, 3rd Edition, Chapter 2: Governance. CxO Research Ltd, July 2005. "www.cxoeurope.com/documents.asp?d\_ID=58". September 26, 2005. The IACCM survey responses indicate that companies are not adequately prepared and lack internal coordination at the inception of their outsourcing projects. Business strategies are neither well defined nor understood, so contract negotiators miss critical service level and/or contingency provisions in contracts. These contract components would be captured in the contracts with better cross-company communications. This is reflected in reported issues such as the lack of a strategic plan, poor project definition and projects that are over budget and behind schedule.

### **3 Summary of Challenges in Outsourcing Contracting**

Outsourcing by means of a contractual network exposes the company to a myriad of risks which were not present when core activities were performed in-house. The coordination itself will take management time and add a cost layer on the structure. If a risk materializes in one of the contractual relationships, it is likely to have a bearing on all of them. Thus the structure itself creates a snow ball effect with unknown and unforeseen risks.

Mitigation of risks in outsourcing is a complex issue and may be costly. There is obviously a call for developing business processes and models in outsourcing which would assist companies in managing the supply chain and network. But these processes should ideally be joint ones, ie accepted by both outsourcing companies and vendors. If the outsourcing company creates a comprehensive compliance model for its vendors, they will no doubt incur additional costs in adhering to the model, costs which would be passed on to the buyer (ie the outsourcing company).

The company may also wish to consider various alternatives in outsourcing contracting. The alternative may involve be back-up outsourcing contracts with several vendors. The company may also consider acquiring the ownership of the vendor (or a minority stake of the shares). Such alternatives should be assessed taking into consideration the relevant circumstances of the case. The contracting strategy and its implementation are important in the management of outsourcing risks.

### **4 Concluding Remarks**

The creation and management of contract networks which replace core activities of a company (development, production, services etc) puts no doubt contract strategies into focus. Outsourcing of core competences puts pressure on the outsourcing contract network. A company would need some critical manufacturing knowledge in order to be able to focus its strategy and conduct design. The outsourcing company must ask whether activities performed through a network of contracts can replace the original approach safely enough. Discontinuation of manufacturing by a vendor partner leads to delays in the sales with potential loss of customers as a consequence. Outsourcing core activities may starve the company to death. These are risks which cannot be prevented by the outsourcing contract.

The more core activities the company is outsourcing, the closer the link between the company and its vendors needs to be. Trust takes, however, time to develop and the contracts must capable of following the development of cooperation between the parties. To conclude: it may be necessary to phase the outsourcing strategy and start with a looser, non-exclusive contractual relationship, which over time and after successful testing and joint process building may turn into a true partnership, even a joint venture.

Focus has here been on the outsourcing contract as part of the strategy. The outsourcing contract is a means to implement the outsourcing strategy. It is, however, also important to state that there is much more to be covered by the outsourcing strategy, not the least the internal organisation of the outsourcing at the outsourcing company and at the vendor. For the business it is fundamental that the strategy provides means to react to opportunities and changing business circumstances.

Our example case shows that companies intending to outsource activities have much to gain from involving their lawyer early in the process as a member of the project team. A proactive business lawyer is able to draw conclusions from other cases experienced and to use his/her legal intuition in order to prevent risks from materialising.<sup>19</sup> In an open atmosphere the members of the project team are keen to contribute to implement the outsourcing strategy in a way which ensures the business objectives and guides the project safely around the worst risks.

<sup>19</sup> On this subject see Helena Haapio, *Proactive Law in Practice*, chapters 2.3 Toward Good-quality Contracts: Minding the Gaps and Other Things that Matter and 3.4 Corporate Contracting Capabilities: A Plea for Cross-professional Research and Education.