Multi-jurisdictional outsourcing: transition and transformation issues

Hans Rudolf Trueb and Julia Bhend, Walder Wyss & Partners Ltd

www.practicallaw.com/4-385-0449

Outsourcing invariably means change, and change invariably means problems. Nowhere is this correlation more applicable than during the first months or even years of an outsourcing relationship. Frequently reported problems relate to excess costs and delays in the implementation of projects. Operational issues during or after the migration of services can also occur, which can range from minor performance problems to major outages.

In the case of a multi-jurisdictional outsourcing, the issues are multiplied. Often, the supplier cannot cover all of the customer locations or the work involved in the outsourcing itself, and must use subcontractors. Subcontracting introduces another layer in a relationship, creating further complications.

The reasons for disappointment in this early phase of an outsourcing relationship are numerous. However, mismatched expectations are the most common root cause of failure, leading to inadequate planning and poor relationship management.

In relation to multi-jurisdictional outsourcing, this chapter:

- Explains what the "transition" and "transformation" processes, which take place in the early months of the outsourcing, involve.
- Sets out, by way of a case study, how the processes of transition and transformation can fail (*see box, Case study: how the process can fail*).
- Explores some of the key legal approaches adopted in successful transitions and transformations.

TRANSITION AND TRANSFORMATION EXPLAINED

While the term "transition" commonly describes the transfer of activities as currently conducted (the current mode of operation) (CMO), transformation relates to implementing the end solution (the future mode of operation) (FMO).

Transition is nothing more (and nothing less) than the planning and handover of operational responsibility for the outsourced activities. It usually involves three main aspects:

- The transfer of assets, contracts, pending projects and staff from the customer to the new supplier.
- The establishment of the procedures for service delivery, service level reporting, invoicing and management mechanisms.
- The transfer of responsibility for the services to the new supplier, and the stabilisation of service provision.

Before such a handover, the parties must ensure that the supplier can meet service levels without disrupting the business and end users. They must also verify that the appropriate measuring and reporting tools are in place.

The term transformation usually describes the phase between the CMO and the re-engineered FMO. Once the FMO is achieved, the supplier implements its own technology and solutions, achieving both the desired improvement in service delivery and the economies of scale that will ultimately result in cost savings. For this and other reasons, both parties have an interest in moving to the FMO quickly. This phase should not, however, be rushed.

APPROACHES TO CONSIDER

During contract negotiations, the parties often have a clear idea of what they want to achieve, but do not fully know how to achieve it. If this issue is not sorted out during negotiations, it can lead to problems post-signing.

To avoid such problems, the following approaches to the planning and execution of a multi-jurisdiction outsourcing should be considered:

- Enhanced due diligence at the pre-contractual stage.
- Adopting a transition and transformation pilot.
- Defining certain assumptions regarding the transition and transformation process, for inclusion in the contract itself.
- Using other "soft factors" such as retaining key staff and providing internal training, as well as contractual terms to avoid some of the problems that typically arise in the transition and transformation phases of an outsourcing.

Enhanced due diligence

Due diligence rarely plays a key role in an outsourcing transaction. On the customer side, the relevant information on the supplier is not readily accessible and the resources to structure and organise a decent data room are not usually available. For the supplier, due diligence means costs, and costs should be avoided when an agreement has not yet been signed. This often means that the supplier has a poor understanding of the customer's current technology and operations. At best, there are some (usually outdated) lists of transferred equipment and related maintenance contracts, which are not particularly relevant to the transaction.

The parties should consider engaging in a more in-depth information exchange. This should include a discussion on the technical

Cross-border

CASE STUDY: HOW THE PROCESS CAN FAIL

Switzerland has a mature outsourcing market. A considerable number of international companies with a (close to) global presence have their headquarters there. The sectors that such companies commonly operate in include: finance, insurance, chemicals and pharmaceuticals, transportation, logistics, power and automation technology. All of these industries share a common denominator: their business is fuelled by accumulating and sharing sensitive data across the organisation.

In a recent transaction, a Swiss-based chemicals company outsourced its network operations (local area network (LAN), wide area network (WAN), voice and network security) to a pan-European service provider. Current analogue voice technology was to be migrated to internet protocol (IP) telephony between transition and transformation. Transformation was planned to take place country-by-country for more than 40 jurisdictions, with a firm end date. Transformation activities were described in a (high level) transformation plan with a related project plan setting the key dates for deliverables and the cut-off from the CMO.

Due to unforeseen complexity (both in the network layout and in the variety of technologies and handset types employed for various production sites, with advanced features such as "man-down" functionality and waterproof devices) transformation was substantially delayed. Accordingly, both the costs of the transformation project rose substantially and the savings from migrating to IP voice (using the existing MultiProtocol Label Switching (MPLS) network capabilities) were delayed.

As in most instances, shortcomings and failures at both the supplier and the customer end caused the delay. Most importantly, it took much longer than expected to establish a sound governance structure for the transformation phase. At this critical time, a number of things tend to happen simultaneously:

- Knowledge of the CMO and the business requirements must pass to the supplier. Such a knowledge transfer does not happen easily.
- The customer must accept the new roles and procedures. This can be a difficult and at times frustrating experience. In the case study above, for instance, before the handover, the customer's staff could call their internal telecommunication operations team informally when a problem arose; after the handover this was no longer possible.
- The supplier must adapt its off-the-shelf service provision to meet specific customer requirements. This requires flexibility and good communication skills.

Throughout all of the above, operations cannot be interrupted.

If transformation stalls or fails, the whole outsourcing experience becomes tainted. After the initial enthusiasm, the parties start the venture on the wrong footing, which can lead to early termination of parts or all of the agreement. Avoiding frustration is critical when it comes to planning an outsourcing transaction. Yet transition and transformation are often under-engineered in outsourcing agreements. The parties often define transition and transformation dates and core activities but neglect to describe transformation activities or defer this to some later, unspecified stage.

The above case study illustrates the importance of introducing both more realistic and more specific rules of procedure for the initial months of the outsourcing relationship. Enhanced due diligence (for typical sites), the establishment of sound governance structures that combine both technical knowledge and commercial decision-making power, and more detailed transformation planning would have helped to avoid the problems that arose.

architecture, system operation, the service levels to be provided, governance, security standards applicable to the services and local variances in laws, procedures and practice.

If services have not been outsourced before, they are rarely standardised across the customer's operations. In such cases, services and service levels usually vary across the organisation's operations (particularly if different jurisdictions are involved). While it does not make sense to examine in detail the customer's current operational set-up site-by-site, the parties should consider jointly reviewing typical sample sites by type of operation (administration, manufacturing and sales) and region.

Such enhanced due diligence helps to keep post-signing verification of the customer's operations (known as a true-up process) to a minimum. For example, in the case of a network outsourcing, if a thorough due diligence is done before signing the contract, true-up is limited to verifying:

- The volumes of network ports and users (the baseline for the pricing model).
- The value of the transferred assets.
- The costs of transferred personnel and contracts.

This in turn helps to avoid the possibility of negotiations being re-opened during the true-up process.

Transition and transformation pilot

A simultaneous or "big-bang" transition and transformation is rarely a good idea. A standardised and uniform takeover throughout all jurisdictions does not take into account that a successful global outsourcing requires the support of all local stakeholders, including the business units and affiliates. A big-bang approach often does not make sufficient allowance for local optimisation of services and individual or cultural requirements.

Instead, the parties should consider what is known as an iterative process or a gradual transition. At the outset of such an iterative process, one or several jurisdictions are selected based on criteria such as standardisation, costs of service provision, quality of service or affected personnel. These jurisdictions are transitioned first, with the lessons learnt from this phase fed to the next set of jurisdictions to be transitioned.

Under the iterative process, transformation starts off the same way, typically with one representative jurisdiction taking the lead. If this is done, errors and failures will be limited to one jurisdiction. Once the first jurisdiction is successfully transformed (as verified by appropriate testing and acceptance procedures), the other jurisdictions follow. Such a trial run identifies the obstacles involved in moving from the CMO to the FMO.

While new issues may come up as further jurisdictions are transformed, the pilot helps to ensure that each type of mistake is only made once. In addition, the transformation team can be kept relatively small and focused.

This staggered procedure invariably delays transformation. The parties have to structure their agreement to allow for a two-tiered service approach as the CMO and FMO may co-exist for up to 12 months. In the long term, however, this approach is likely to be more successful than a simultaneous transition and transformation.

In cases where services are to be consolidated into one or several service delivery centres, a simultaneous transformation can be highly problematic. This is particularly true for near- or off-shoring arrangements. While the cost savings involved in transitioning and transforming quickly may appear attractive, the operational issues this can cause may ultimately result in higher costs. Service consolidation requires a deep and sound knowledge of the customer's existing service structure and delivery methods.

Accordingly, the supplier's dedicated near- or off-shore delivery team should spend sufficient time within the customer's organisation, visiting its operational sites and working alongside the retained customer team to understand the customer's requirements and the "flavour" of its operations. Then gradual near- or off-shoring can occur, always with a sound fallback scenario for each step. Such a fallback scenario may comprise, for instance, the extension of the CMO, the temporary movement of service delivery to another supplier (known as step-in) or termination of the contract.

Defining assumptions

When time and costs are of the essence (which too often is the case and is never a good starting point), the customer should request that the supplier define a number of assumptions for the transition and transformation project to be inserted into the contract itself. Such assumptions may, for example, relate to the number of transferring staff by location, the value of the transferred equipment or the volumetric data on which the pricing calculation is based. The assumptions should be defined specifically and exhaustively, and negotiated between the parties.

The process of defining and negotiating assumptions helps the parties become aware of any issues involved in the transition and transformation, and should be followed by a pilot process (*see above, Transition and transformation pilot*). Once the contract containing the assumptions is signed, transition and transformation should be undertaken by the supplier, usually for a fixed price, and with clearly set performance targets and milestones.

When the parties are negotiating the assumptions, allowance should be made for the fact that actual costs or data usually differ from the assumptions. The supplier should be required to bear any costs or allowed to keep any gain made where the actual costs differ from the projected costs within a certain plus or minus band (of, for instance, 10% to 15%). Beyond this band, the gain (lower costs) or loss (higher costs) should be shared equally between the customer and the supplier. This way, both parties have an incentive to:

- Learn as much as possible about the transition and transformation details before signing.
- Complete projects as quickly and efficiently as possible.

Soft factors

As mentioned above, the root cause of a failed outsourcing is usually mismatched expectations. Cultural issues can also be a key cause of failure, particularly in multi-jurisdictional transactions.

Inadequate project support from senior management and poor communication can lead to local entities refusing to participate in the global standardised solution that the FMO will provide or in key (retained or transferring) staff not supporting it. Adequate expectations facilitate a supportive and positive attitude towards the changes.

The management of expectations faces its first real test when the customer has to bear the transitional costs of an outsourcing. In addition, a customer may risk a critical loss of knowledge, particularly if employees decide to leave the company instead of transferring to the supplier.

In addition, country-specific legislation and/or difficulties with trade unions may delay or hinder the introduction of the anticipated efficiency gains. Any uncertainty or low morale among affected staff and key employees who refuse to transfer may also negatively affect service delivery. In this event, the supplier should ensure that enough suitably skilled alternative staff members are available if existing staff are not transferring.

To retain control of the transition and transformation processes, and in view of the potential for failure of the service handover and the possibility that the services may need to be insourced again or transferred to a future supplier, the customer should retain adequate key management capabilities.

The roles of the retained team will, however, change. Instead of operating in a complex technical environment, the focus shifts to managing a provider. This requires different skills. Besides technical knowledge, the customer's management team must possess skills in the areas of communication, contract interpretation, service level management, auditing, accounting and so on. This in turn may require internal training.

Contractual terms

Well-negotiated contractual terms can smooth the way to a successful partnership beyond signing of the agreement. They also help to cope with any difficulties that may arise, and even failure of the outsourcing project.

Set out below are some of the key issues that should be addressed in the outsourcing contract in relation to transition and transformation.

Responsibility for project delivery. Most transition and transformation projects are legally characterised by some kind of services contract. Under such a contract, the supplier is responsible for the successful delivery and completion of transition and transformation as a general contractor for a fixed price and in accordance with defined targets. The relevant law on contracts often does not provide the customer with effective control rights and appropriate remedies, which makes it necessary to stipulate specific contractual rights and remedies.

If the scope or terms of the agreement need to be changed at any stage during the life of the outsourcing, the parties should agree a robust change management procedure involving the formal assessment of any change requests. The change management procedure should apply to the transformation phase of the outsourcing as well, and should ensure that this phase does not become perpetual.

Transition and transformation plans. The transition and transformation phases consist of various complex and interrelated activities. Detailed and specific transition and transformation plans (including a project plan) within the contract are vital and ensure that both parties share the same understanding of the processes.

The transition and the transformation plans should be broken down by country as well as by individual tasks and deliverables (services, products, results and performances to be delivered by supplier). They should identify any required customer resources and dependencies.

Although the transition and transformation plans will not include every detail when the agreement is signed, there should at least be an agreement on the key activities, deliverables and milestones of the transition and transformation, as well as on the further planning process. During transition, the provider should focus first on stabilising the CMO, rather than using its resources for the quick development of new, nice-to-have functions and reports that are not essential to a successful transition.

To assess whether or not a supplier has achieved the transition and transformation goals in accordance with agreed specifications, criteria defining acceptable achievement levels and the associated acceptance process involved in this should be set out in the agreement, at least in relation to key deliverables and the achievement of milestones. To be of value, acceptance criteria need to be measurable.

The customer must be sure which criteria have to be met before going live and/or before any milestone payments become due to the supplier. This requires a deep understanding of the CMO by the customer. Different remedies may apply if acceptance cannot be achieved due to material or minor deficiencies (*see below, Remedies*).

Service levels during transition. To avoid any negative impact on the customer's business from the service commencement date onwards, the supplier must achieve a level of service quality that is at least as good as that achieved by the customer or the current supplier before the handover to the new supplier. Where no existing service level agreements or other internal measurements are available from the service commencement date, the parties can agree on interim service levels that apply for a certain period after the service commencement date (*see box, Sample interim service level clause*).

SAMPLE INTERIM SERVICE LEVEL CLAUSE

A sample interim service level clause could be set out as follows:

During the first six months from service commencement date, the provider shall use best efforts to meet the "as is" service levels; however, no service level credits apply. The average performance during these six months (without taking into account the lowest result) will then constitute the minimum service level and the highest achievement will constitute the expected service level until the transformation project is successfully completed.

The FMO in an outsourcing can take at least 12 months to implement. As a result, it is important that a minimum service level be required while this phase of the outsourcing is taking place.

Outsourcing agreements often now require enhanced quality of service provision after the initial handover from the customer to the supplier (known as CMO+). While this may put extra pressure on suppliers, they often accept such requirements to win customer business. In any event, the real issue surrounding CMO+ service level commitments relates less to the commitment as such, and more to the available remedies in the event of breach (*see below, Remedies*).

Governance and risk management. The contract should contain a clear governance process with defined roles and responsibilities. It is advisable to have both a steering board for overall supervision of the projects and specific project teams (such as HR, solutions, finance, communications and security), with regular meetings and close communications between the parties. The supplier should be required to co-operate with customer and third party vendors to the extent that this may be required for a smooth transition.

To avoid any surprises at the first governance meeting after the contract has been signed, the contract should identify the individuals who are to assume the key roles during transition, transformation and service delivery. Such key personnel should be retained on the account for at least two years (the customer should not be expected to finance the learning curve of the supplier's transition and transformation team more than once).

Project management requires the management of risks in executing the transition and transformation project plans. The parties should address the identified risks early and define adequate mitigation measures. Risk management has become a standard agenda item for transition and transformation team meetings.

Remedies. An effective penalty and incentive mechanism in the contract should focus on key milestones and deliverables to keep the supplier's motivation up beyond individual transition and transformation milestones. For example, the supplier may lose interest in properly providing a deliverable if it is already in default and a one-off penalty is due with no possibility of earning back the penalty amount. In this situation, a credit mechanism can incentivise the supplier's motivation beyond the first default by multiplying the penalty payable if, after a specific correction period, the deliverable fails the agreed acceptance test a second time. This process should be repeated until acceptance is achieved.

If the supplier is in default or faces material problems in achieving the transition or transformation goals and deadlines, the customer often prefers to have a right to support and direct the supplier's efforts rather than (or before) terminating the agreement as a whole. Such enhanced co-operation may include the customer's right to assign staff to work alongside the supplier and to have full access to all information that is relevant for the proper performance of the affected services.

In addition, it is advisable that the customer have the right to suspend all or part of the affected services and transfer the services that impact on its critical business functions to a third party supplier. This right should only be a temporary solution and should be revoked once the supplier can take over again.

The customer must also ensure that fallback scenarios for failure and/or delay in the transfer of assets, contracts and staff, and in the service handover, are covered in the contract. If, for example, the key employees refuse to transfer to the supplier, despite the latter giving adequate guarantees to the transferring personnel, the customer should have the right to terminate either the whole agreement or parts of it. If the outsourcing relationship has to be terminated for other reasons, business continuity concerns require that all transferred items and personnel are properly re-transferred to allow the customer to ensure continued service delivery.

KEY COMPONENTS: PLANNING AND STRUCTURING

The transition and transformation phases are critical in an outsourcing project. They are also difficult: while on a steep learning curve, the customer and supplier must also master complex, large tasks. Once transformation has been successfully implemented, the risk of failure does not vanish, but it will be greatly reduced. Until then, careful planning and structuring of the transition and transformation phases are vital.

CONTRIBUTOR DETAILS

Hans Rudolf Trueb and Julia Bhend
Walder Wyss & Partners Ltd
T +41 44 498 98 98
F +41 44 498 98 99
E *hrtrueb@wwp.ch*
jbhend@wwp.ch
W *www.wwp.ch*