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Outsourcing

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Introduction

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INTRODUCTION

Milbank LLP is recognised as a leading global adviser in technology and outsourcing transactions. Over the past 20 years the firm has represented clients on more than 600 outsourcing transactions, in over 90 countries with a combined deal value of more than USD150 billion. The firm advises on a wide range of transactions involving AD&AM, networks, helpdesk, HR, procurement, asset management, finance and accounting and research. Clients, from interna-

tional banking giants to growing telecom leaders, trust the team to lead the way with significant market innovations relating to deal structure, the procurement process, risk transfer and contract management. Lawyers are involved in renegotiating, renewing and terminating commercial contracts and sourcing relationships, handling some of the largest renegotiations and disputes in the sector with minimum disruption to clients' businesses.

Contributing Editor



Laurence Jacobs is head of the firm's Technology & Outsourcing Practice. He advises a wide range of clients, across many different business sectors, on all types of complex outsourcing technology projects including: technology

development and innovation projects; licensing; strategic alliances and collaborations; IT and BPO outsourcing; and cloud services. Laurence also has considerable experience in renegotiations and dispute management in this area.

The global outsourcing market has undergone a number of significant changes in response to a wide range of technology developments but has continued to perform strongly and has shown a considerable flexibility in responding to these developments.

In part this simply reflects the underlying strength of the core outsourcing model, based on cost savings, access to specialist supplier expertise and service transformation. At the same time, outsourcing providers have adapted to the new technology environment to enhance the value they can provide. Outsourcing has become one of the main routes to access and implement a range of disruptive technology changes (including, most notably, cloud, AI, blockchain and smart contracts).

There had been some thought that these disruptive technologies would limit the role of outsourcing to more standardised commodity services or less well-developed regional markets but this has not proved to be the case. Of course, companies are adopting a number of different collaboration and commercial models to develop and deploy new disruptive technologies but in significant part they are also adopting the traditional outsourcing model to access capabilities and services in these areas as part of an overall sourcing strategy.

These developments have led to a number of significant changes to the traditional outsourcing contracting model. For some time, customers and suppliers have been concerned by the essentially adversarial nature of the traditional outsourcing contractual model but have been reluctant to modify their approach in any significant way. This is now changing as the implementation of new technologies, as part of either IT or business process outsourcing, requires the parties to introduce new, specific contract provisions and protections and this has encouraged a shift to a more flexible and balanced incentive-based contract model. Ironically, it is precisely this shift which we have been advocating for almost all outsourcing transactions to help manage risk and deliver value, but it is only now, perhaps as a result of greater receptiveness to new business models for innovation and transformation, that this new approach is becoming more widely adopted.

The Impact of Disruptive Technologies

Cloud services

The first major disruptive technology change which impacted the outsourcing market was the deployment of cloud services in the place of traditional infrastructure services. The adoption of cloud services led to a significant change in contracting models and terms as suppliers sought to contract on their standard terms (much like COTS licences). For public cloud services this clearly makes sense, as the risk profile, cost and operational management of public cloud services is quite different from traditional infrastructure services.

As these services have been maturing, and as the market has become more competitive, customers have been able to negotiate improved positions on some of the most significant terms, including liability, termination and exit support. What is clear is that these negotiations have thus far been focused on a small group of key issues to the benefit of both supplier and customer, though the scope of negotiated terms is expanding as regulators focused on data protection and cybersecurity are becoming less accepting of cloud service providers' traditional resistance to transparency and risk-sharing on those issues.

It should be noted that the argument for accepting standard supplier terms is much weaker in relation to private cloud services where the operational model and approach is much closer to a traditional outsourcing deal.

Agile development

The Agile methodology, with its iterative and collaborative approach, has a number of clear benefits for software development and has been widely adopted by software companies and in-house project teams. As a result of its success, many companies also want to base any outsourced software development on this approach. But, in order to do so, they need to make a significant change to the traditional contract model, based as it is on closely defined requirements and specific remedies for non-performance.

The Agile manifesto quite rightly states that we should value "working software over comprehensive documentation" and "customer collaboration over contract negotiation" but customers are, understandably, looking for more than just a time and materials relationship which leaves all of the risk with the customer. The most successful models have addressed these concerns by combining new pricing approaches (story point billing and target cost models) as well as a more flexible and incentive-based contract.

AI and robotics

Innovations in AI and robotics look set to be the next major disruptive change and these services are increasingly being implemented as part of outsourcing services. This will have a significant impact on several key aspects of the outsourcing relationship:

- scope (with a greater focus on input requirements rather than output-based services);
- charges;
- change management;
- IP ownership and data management (how to avoid IP leakage);
- liability; and
- exit arrangements.

Whilst the full impact of these changes will only be felt in the future, it is critical that companies prepare for these develop-

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ments now and that new contracts have sufficient flexibility to address these changes as they arise.

Blockchain and smart contracts

Over the next few years we will also see the greater adoption of blockchain and smart contracts for a range of middle and back office operations. This will also require significant changes to BPO contracts, which will need to cover the criteria for when you can use smart contracts, service levels and performance obligations, charges, change (how do you deal with a change in terms as smart contracts are by definition immutable – this remains a significant issue), IP, audit and reporting, confidentiality, liability, termination (in particular, around frustration if it becomes impossible to perform the contract), and exit.

The Development of a New Contract Model

As noted above, customers and suppliers have, for some time, been frustrated by the rather adversarial nature of the traditional outsourcing model and the absence of effective incentives to develop a constructive long-term relationship. The adoption of new technology solutions as part of outsourcing for IT and BPO services has forced both suppliers and customers to address these concerns about the traditional contractual model with far greater urgency, encouraging the development of a more flexible and balanced incentive-based contract model. This new model involves much greater emphasis on:

- incentivising performance;
- remedies which are operationally focused; and
- more effective alignment of the commercial interests of both parties.

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This new contract model is clearly deal-specific and depends on the nature of the services involved and the relationship of the parties. It cannot be applied in a standardised or prescriptive way and its adoption and implementation will vary across international markets, but there are some key common features:

- *Flexibility*: so that the service can manage the increase in range and scope of change, particularly with the implementation of agile software development and the implementation of the new disruptive technologies discussed above.
- *Operational remedies*: there is a growing recognition that remedies should focus on operational matters and service recovery, with a “fix first” approach to fixing issues at an early stage, rather than the more traditional commercial and legal remedies which, while important in termination scenarios, are rarely used in practice.
- *Inter-supplier co-operation*: as customers work with an increasing number of strategic suppliers, coordination between suppliers (and not just between the customer and each of its suppliers) becomes increasingly important and should be contemplated in service agreements.
- *Incentives*: customers are increasingly looking at ways to incentivise good performance rather than protecting against non-performance - shifting the balance to the “carrot” from the “stick”. The best incentives are, of course, financial, (for example, potential new business opportunities for the supplier and margin-sharing on projects) and these work particularly well in a multi-sourcing environment. At the same time, the parties must be careful that these incentives are not over-relied on by the customer or exploited by the supplier, and that they do align the parties’ interests properly.

Taken together, all of these developments are encouraging and suggest that the global outsourcing market will continue to flourish with a more balanced and flexible contract model which, in itself, should enhance the overall performance and value delivered through outsourcing.