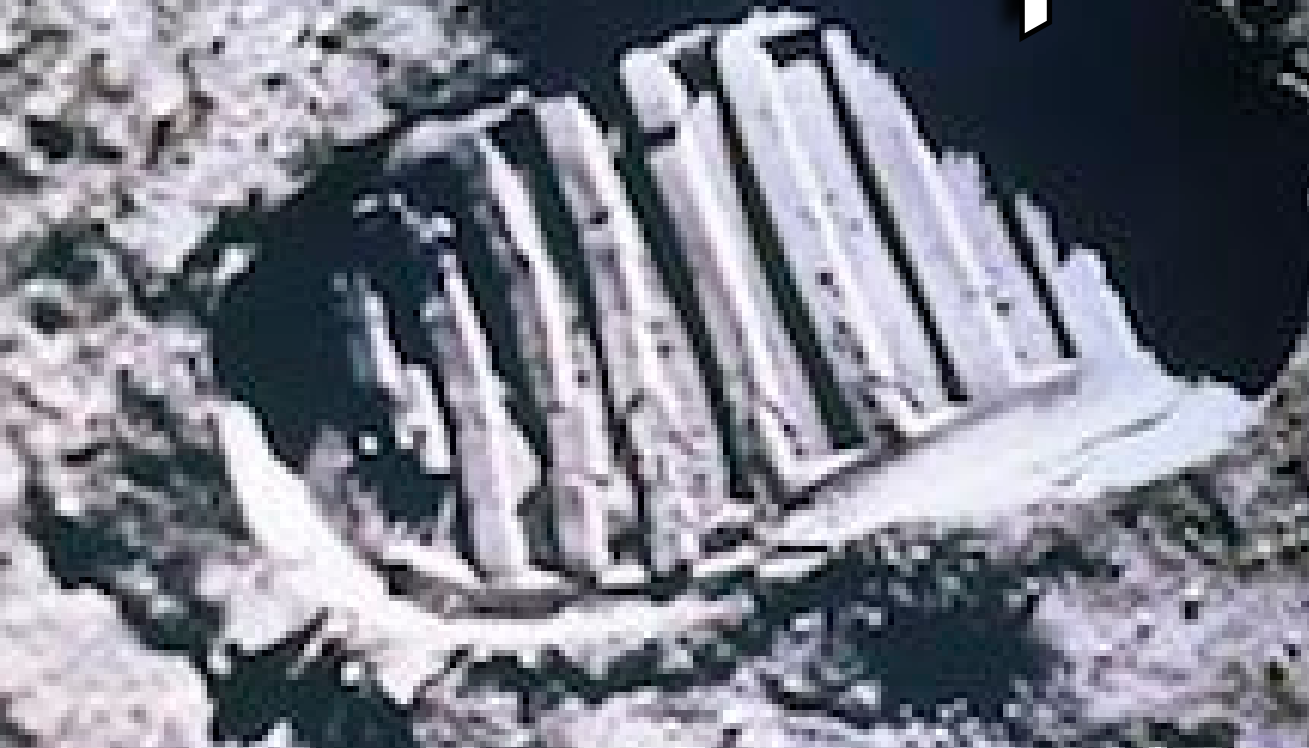


# First Step



# Outsourcing—Documenting the Relationship

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There is no standard definition for the term “outsourcing,” but a useful definition could be “*any long-term relationship where the performance of specified business or operational functions are delegated by one party (a client) to another (a vendor).*” Outsourcing relationships can cover a range of different functions, including HR, logistics support, finance and data processing. Investment managers (IMs) have outsourced specialized support functions related to pooled investment vehicles (such as funds) for decades, including custody, fund accounting, transfer agency and administration. Increasingly, IMs are also outsourcing other back- and middle-office functions, such as trade reconciliation and reporting and fulfilment.

There can be several reasons why a client may consider outsourcing: to enhance quality and efficiency by delegating functions that require technical expertise or expensive investments in technology platforms; to control and make costs more predictable; or to reduce overhead associated with staffing “non-core” functions.

Vendors want to be paid fairly for taking on the operational and other costs and risks incidental to performing the outsourced functions; to the extent the relationship will require a substantial investment of time and money, vendors also want to be sure that if they do their job to agreed standards, they will have the opportunity to recoup that initial investment over time (much as a landlord wants to recoup the cost of enhancements to leased premises).

Outsourcing transactions can follow two different models: a “lift-out” model or a “migration” model. The latter involves the migration of in-scope functions over time to the vendor’s employees and platforms. A lift-out involves the acquisition by the vendor of some (or all) of the client’s operational infrastructure, including (possibly) the transfer of physical assets (e.g., systems and premises), employees and/or the assumption of supplier contracts and other liabilities. A lift-out looks a lot like an asset acquisition in an M&A deal, with the concomitant need to conduct more extensive due diligence on the client’s operations, in addition to the operational due diligence/migration planning required in a migration. A lift-out may be attractive to a vendor that wants to break into a niche outsourcing business by allowing the vendor the opportunity to acquire not only the operational assets, but also—and at the same time—a paying customer. This potential upside is often matched by a similar degree of difficulty, however, and lift-outs require careful planning and risk allocation.

Whatever the reason and structure behind an outsourcing relationship, it is important to remember that the outsourcing contract is not the final step in the process, but rather the first important step. And as in any contract defining an ongoing relationship, a successful outsourcing relationship and contract is one where the costs, risks and rewards are allocated clearly—and, of greater importance—fairly. Any relationship founded on an unfair allocation is bound to fray and tear over time, and short-term victories during contract negotiations often prove Pyrrhic.

## Getting to the Contracting Stage

**NDA**s. Clients and vendors usually start with a non-disclosure agreement (NDA) to protect confidential information during detailed discussions. Since these exist to support discussions about a commercial relationship, terms related to non-solicitation and exclusivity (which are often found in NDAs related to strategic relationships) are onerous and best avoided.

**RFIs and RFPs.** Before choosing a vendor, clients often seek a competitive bidding process. These can maximize value for the client through competitive tension. Conversely, for vendors the bidding process can involve a huge amount of time and resources, and also sunk costs.

At an early stage in the procurement process, a client may issue a Request for Information (RFI) seeking information about prospective vendors and general details of their service propositions. The client can use the RFI responses to reduce an initial long list of potential vendors down to a short list, that are then invited to respond to a Request for Proposal (RFP). A client may also go straight to the RFP stage if the RFI stage is not useful or necessary.

RFPs are well-known to many financial industry professionals; IM clients that are fiduciaries are often advised to issue an RFP even if they have a preferred vendor or they are satisfied with their existing vendor. Drafting, responding to and assessing RFPs can be very time consuming and seems almost a cottage industry—and one could speculate about whether the law of diminishing returns is suspended given the verbiage they increasingly attract.

Clients may use the RFP process not only to assess a vendor’s operational and other capabilities but also its appetite for assuming operational, financial and other risks should the vendor be chosen. This is important and useful, but some clients—recognizing the leverage they have at this stage of the contracting process—may also use this as an opportunity to try and extract onerous risk allocations. Because most (if not all) RFP responses (or related Letters of Intent) are non-binding, this may seem like a good idea, but it can be counterproductive as some vendors may be tempted to “agree to anything” to get to the next stage. Extracting onerous terms at this—or any other stage of the outsourcing relationship—is shortsighted if a collaborative, long-term relationship is expected and intended.

## The Outsourcing Contract

For both the client and the vendor, the outsourcing contract is a business tool to manage commercial and operational risk. It is not just a document for lawyers. All service contracts define business relationships, allocate risks and create a mechanism for managing the relationship. Because they involve the delegation of operational functions, outsourcing contracts are service contracts with more detailed terms related to managing the relationship required by the length and concomitant malleability of the relationship.

The specific terms of any outsourcing contract are driven by several factors, including: (a) the types of service, (b) the complexity of the deal (e.g., a lift-out or a migration), (c) each party's relative leverage, and (d) the particular "commercial landscape" or "market" for negotiating the issues below (including applicable local law or regulations). Terms can therefore vary, but a thorough outsourcing contract will address the following issues by:

### Service and relationship issues

- Defining services, fees and adjustments to services and fees with provisions addressing some or all of the following: service schedules, change-control processes and, in some cases, benchmarking and exclusivity.
- Reassuring the client that service quality will be maintained and not interrupted with provisions addressing some or all of the following: audit rights, delivery of external audit reports such as SAS 70 Type II reports, service levels and credits, and disaster-recovery plan requirements and coordination of disaster-recovery capabilities.
- Reassuring the client that they will be informed of circumstances or events that could materially affect service quality or its reputation (notices of confidentiality breaches or similar events).
- Defining a process for managing the business relationship, including disputes about the relationship (steering committees, escalation and dispute-resolution procedures, and even governing law and venue clauses).

### Risk and "legal" issues

- Allocating operational risks for processes that require performance by different legal/organizational entities (liability clauses, standard(s) of care and exculpatory clauses, subcontracting).
- Allocating risks for foreseeable events (change-control procedures) and unforeseeable events (changes in law, force major events).
- Allocating financial risks (liability and indemnity clauses, costs-escalation mechanisms, and even the seemingly mundane right to charge interest on overdue payments).
- Allocating intellectual property ownership rights and responsibilities.

### Term and termination issues

- Specifying the term of the relationship, how it can be continued or terminated by either party (base term and "with" or "without" cause early termination clauses) and also post-termination obligations (termination payments, confidentiality, transition of operations and records, post-termination support).

In general, clients have the most leverage in relation to service-related terms but vendors will draw a line when clients ask vendors to assume operational and financial risks that the vendors cannot control. Both parties are usually interested in having a clear understanding about termination-related issues.

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The most important thing to remember is that most outsourcing contracts define the rules of the road for a long-term business relationship and that events and circumstances that could affect the relationship can be difficult to predict or control. The contract is primarily a risk-allocation mechanism, and negotiating the contract should not be left solely to lawyers or treated as an adversarial process where negotiating points are won or lost. Rather, investing the effort required to understand and document in a fair and balanced manner the principled concerns of the other party at the outset will help support a mutually beneficial, long-term relationship.