Outsourcing: key legal issues and contractual protections

Paul Jones | May 2009

Introduction

As the economic climate becomes more challenging, organisations in all sectors are looking to drive efficiencies within their businesses and cut unnecessary costs. One issue under debate is whether the outsourcing industry will benefit from this or not. While some outsourcing specialists have cut revenue forecasts, others see opportunities. For clients, however, cost can only ever be one factor among several in deciding whether to take the plunge, and strategic factors should be paramount.

"Outsourcing" is a term loosely used to cover a wide range of relationships, but is distinguished from simple sub-contracting by the transfer to a third party of the operation of a service or function (often with staff) which would otherwise have been fulfilled in-house. The rationale is that a specialist can provide a higher standard, more cost-effective service than might be achieved internally. Other benefits of outsourcing include flexibility (often clients want the ability to increase, reduce or alter the scope of a service, at relatively short notice) and a reduction in the amount of time and resources spent on non-core activities.

However, outsourcing should not involve a delegation of management or strategic responsibility: it is primarily a means of accessing expertise and economies of scale. While operational risk is passed to the contractor, strategic risk is not. The outsourcing contract is critical in managing that risk. This note aims to set out an outline of the key legal issues to consider where services are being outsourced, and set out briefly how the key legal risks which arise on an outsourcing of services can be covered in the contract with the service provider.

(For the purposes of this note, we use the term "client" to refer to the recipient of outsourced services.)

The outsourcing contract

When an organisation outsources a service or function, it will want to cover certain key risks. These will include: the risk of poor performance by the contractor; unforeseen fees or charges; property damage or data loss; potential liability to staff and the public arising out of an act or omission of the contractor and employment liabilities (both in terms of incumbent staff affected by the transfer of services and staff employed by the contractor). In addition, the client will want to set out clearly how the outsourcing will work in practice (including any transition phase at the start of the process and day-to-day management) and how it will be managed when it comes to exit (allowing for the service to be taken back in-house or given to a replacement contractor). To cover such issues, the client should ensure that a robust contract is put in place with the contractor who is being engaged.

There is no set rule as to who is responsible for preparing the contract. More sophisticated contractors have their own contractual documentation (although such contracts are usually slanted heavily in the contractor’s favour – so should be treated with a degree of caution) but more often than not the onus is on the client to prepare the contract. Often, a contractor takes initial responsibility for producing certain contract schedules – if this happens, they need to be provided promptly for review with the remainder of the contract. Having the two separated for too long can cause difficult issues for both sides both conceptually and in terms of drafting and retaining a bargaining position.

Where services are put out to tender, it is good practice to include a draft of the contract in the tender pack which is sent to potential contractors. This puts the contractor on notice of the client’s proposed terms and helps to flush out any queries relating to the contract terms at an early stage. This proactive step can also help to anchor negotiations in the client’s favour.
Key points to cover in the contract:

1. **Standard of service**

   It is vital that the outsourcing contract describes the services clearly, sets out the minimum levels of service which are acceptable and provides the client with remedies and/or a right to terminate in the event that such standards are not met. Otherwise, a client may find itself tied into a long-term contract with an underperforming contractor and/or may suffer a loss without having an adequate remedy under the contract. To cover the risk of poor performance, the contract should contain:

   - a clear description of the services – this is the lynchpin of any outsourcing contract. This is normally achieved in a service schedule or specification which is annexed to the contract. Producing the service schedule will often be a joint effort, shared between the client and the contractor (depending, that is, on how prescriptive the client wishes to be). Legal advisers can help structure this service description, but the contents are generally developed by the parties’ commercial teams. In fact, it may be the case that in pre-contractual exchanges certain documents are created (such as a Request For Proposal (RFP) and a supplier response) which will carry a lot of useful content for the requirements/service description;

   - service levels - setting out the standards to which the services must be provided and KPIs, the key performance indicators that can be used to measure and to assess whether the standards have been met (eg, if website hosting is outsourced then a KPI on availability might be, say, 99.5% on a 24 x 7 basis). All outsourcing agreements should require the contractor to perform the services in accordance with a set of service levels;

   - termination rights - to apply in the event that core service levels are not met; and perhaps also

   - service credits - ie a refund mechanism which will apply if certain services are not supplied in accordance with the required service levels (to apply without prejudice to the client’s other rights or remedies under the contract or otherwise, and in particular any rights to terminate the contract); the instigation and implementation of correction or service improvement plans to remedy certain failings or the root cause of any poor performance; and step-in rights allowing the client or a third party to temporarily replace the contractor in providing the services where the contractor is failing or underperforming.

2. **Liability and insurance**

   Given that the contractor may well have access to the client’s premises and/or be fulfilling its task as a representative of the client it is vital to ensure that the contract provides the client with protection in the event that the acts or omissions of the contractor cause loss or damage to property, to data or injury to persons.

   Such risks are normally covered by requiring the contractor to indemnify (ie protect and reimburse) the client in respect of any costs, claims or losses arising as a result of the act or omission of the contractor (and indeed any subcontractor operating on the contractors’ behalf). When taking an indemnity, one needs to bear in mind the ability of the contractor to meet the costs of any claim made (the indemnity only being as valuable as the party giving it). To avoid the risks of a contractor having insufficient resources to meet a claim, the contract should oblige the contractor to take out and maintain suitable insurance (in respect of both public liability and employer’s liability, and such other risks as may be relevant in the circumstances) to cover any such risks.

   Any limitations or exclusions of liability requested by the contractor should be scrutinised carefully – particularly where the contractor is seeking to limit or exclude liability for damage to property or for injury to persons (although, of course, any attempt by the contractor to limit its liability for death or personal injury caused by its negligence will be unenforceable). Where services are critical to the operation of the client’s business, the losses the client may suffer if the supplier fails to provide the services may be significant. It is not uncommon for different types of loss to be given different treatment in terms of the liability offering. So, for example, liability for property damage may be limited to £10 million (in line with the contractor’s public liability insurance cover), liability for IP infringements is unlimited and liability for (other) breach of contract losses is limited to the contract value (or a multiple of it). This, however, is not set in stone and the liability provisions are often subject to some intensive negotiation.
3. Prices and fees

The contract should include a clear and comprehensive pricing mechanism setting out what the contractor will be paid for providing the services, what costs and disbursements the contractor will be able to recharge to the client (if any). A client should seek to ensure complete transparency on all costs and charges being made to it (even to the extent of third party costs that are being passed on). If one of the key drivers for outsourcing a particular function is to make cost savings when compared to keeping the same function in-house, then retaining this transparency will be absolutely critical to validating the entire exercise. Depending on the nature of the agreement, one might also include an agreed procedure for variation of the charges, if the client agrees that the fees may be varied.

Often, with longer term contracts, it might be beneficial for the client to push for the inclusion of a benchmarking mechanism, under which the contractor’s charges (and possibly also any service levels) are market tested, on an annual basis, say, so as to ensure that the client is not paying above market rate, ie that the charges/service levels represent "good value"). This is particularly relevant where increased competition may lead to a reduction in the market rate. Conversely, the contractor may request the right to vary its charges on a periodic basis in line with a given index (such as RPI or CPI). The client will need to consider whether it is appropriate to accept this or whether to push for fixed charges.

4. Employment issues

A number of staff-related issues may arise upon an outsourcing of services. The contractor will be responsible for its staff and the client will want a degree of certainty from the contractor that they are suitable to carry out the work. The client is likely to want to some degree of control over who is providing the services and may want to include a provision to enable it to require the contractor to stop using a particular individual. This will need to be built into the contract.

Another important employment issue is that the Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE") may apply where an organisation outsources a service or function or makes a "service provision change" involving either (a) an initial transfer (e.g. from the client to an external contractor); (b) a subsequent transfer (e.g. from the first external contractor to a different external contractor); and (c) the bringing back in-house (e.g. from an external contractor back to the client). Broadly, TUPE imposes various obligations on the parties in relation to staff affected by the transfer, has the effect of automatically transferring the contracts of employment of staff employed in the provision of the transferring service to the new service provider, and affords the same staff protection against dismissal (provided they have one year’s service).

We do not propose to discuss the TUPE regime in any detail here (for further guidance on TUPE please see our website here: www.farrer.co.uk/how-we-help/employment-issues/tupe), other than to say that the contract can be a useful way of confirming each party’s responsibilities. The contract will normally include warranties in relation to, for example, existing terms of employment, employee consultation and the provision of information, and will provide general employment warranties in relation to potential TUPE liabilities. A fairly robust contractual approach – from a "client" perspective - is to require the contractor to reallocate staff upon the termination or expiry of the term, and/or to indemnify the client and any successor service provider (which is important, because liability may fall to the successor service provider, and the client) against any costs arising in relation to the termination of any transferring employees’ contracts of employment upon transfer.

One would normally expect the outsourcing contract to cover a range of other risks and liabilities relating to the contractor’s staff, not least health and safety responsibility, which might remain with the client as owner or occupier of the premises when the services are carried out. The contract would normally confirm the contractor’s responsibility for staff competency, behaviour and compensation (plus any tax or National Insurance due) and provide the client with a degree of protection in respect of any claims brought by such staff members.

5. Other Provisions

- Logistics of transition. In the event that the services are being transferred from an in-house department or another contractor (note: TUPE issues on "entry" will need to be considered). Bear in mind whether transition (or other implementation) costs should be paid up-front (upon satisfactory completion of the transition) or whether they should be spread over the life of the contract.
• **Term of the contract, and termination rights.** The client will need to consider the optimum period for the outsourcing, and whether or not to include a break clause permitting one or either of the parties to terminate the contract early. Or indeed whether the client can request a contract extension, and on what terms.

• **Change control.** Longer term outsourcing arrangements should include a mechanism under which changes to the services and/or the terms of the contract can be altered as the outsourcing relationship evolves. The importance of such clauses is often underestimated by clients, who then find themselves in a relatively weak position when requesting changes to the contract. Ideally the change control provisions should compel the service provider to make any requested change (rather than simply leaving any changes "to be agreed") and if possible provide a mechanism for costing any such change (e.g. by requiring any additional fees to be calculated on the same basis as the existing fees under the contract).

• **Continuous performance improvement.** Where appropriate, the client should think about making sure the contractor is committed to introducing improvements to the services during the term. Such improvements may come about from internal improvements arising in the marketplace (e.g. in light of technological developments).

• **Exit management and cooperation on termination.** It is prudent to include an obligation requiring the contractor to cooperate upon the termination or expiry of the contract, so as to ensure a smooth transfer of the services to a successor service provider and/or back in-house to the client. Other relevant consequences of termination should also be covered (e.g. what happens to the equipment used by the contractor, or how the site should be reinstated upon the contractor’s departure). Devising (and maintaining) an exit plan early on in the life of the contract could be very helpful to this process. Again, if costs can be agreed in advance, that strengthens a client’s position.

• **Client’s responsibilities.** The contract should set out what, if anything, will be required of the client in order to enable the contractor to provide the services (for example, access to the client’s premises, the provision of electricity, gas, water, etc).

• **Equipment.** The contract should specify who is responsible for supplying the equipment required in order to provide the services, plus any other specific terms relating to the supply of equipment (in relation to ownership, suitability, maintenance, replacements, risk, etc).

• **Contract management and dispute resolution.** How will the relationship between the client and contractor be managed, from day to day? Often, outsourcing contracts prescribe a management and reporting structure, as between client and contractor, providing, say, for the appointment of a "contract manager" and a minimum frequency for reporting meetings.

• **Key individuals.** The client may wish to be consulted and/or have rights of approval over the appointment and retention of key personnel of the contractor, so as to ensure that the client’s needs are properly met and key knowledge retained by the contractor. Organisations often overlook the cultural impact of an outsourcing of services. In terms of the cultural "fit" of the client/service provider, the emphasis will be on the client to consider this during any tender or selection process, but having the right to approve key staff can sometimes help (although obviously any such discretion needs to be exercised carefully and lawfully).

• **Sub-contracting.** The client should consider whether it is prepared to allow the contractor (often selected after an intensive tendering process) to sub-contract the provision of the services, or any part of them. Even where the sub-contractor is permitted the contractor should retain primary responsibility to the client under the contract for the provision of the services and the performance of the sub-contractor. This may be sufficient for the client in many outsourcing contracts, but often the client will wait to reserve approval rights over proposed sub-contractors and dictate some of the terms on which an approved sub-contractor is appointed by the lead contractor. Many outsourcing contracts include a schedule which sets out a list of sub-contractors that are "pre-approved" by the client.

• **Third Party Contracts.** In some outsource contracts the contractor is taking over responsibility for existing contracts the client has in place that relate to the business function now being outsourced. Thought needs to be given to how these are dealt with and the contract can be used to set out how the third party contractor is to be dealt with, particularly if it is proposed that the third party contract is to be assigned or novated to the contractor or it is to be managed by the contractor on the client’s behalf. A schedule might be included in the contract giving a
preliminary indication as to how each third party is to be transferred to the contractor and the contract can spell out the parties’ responsibilities in connection with such transfer and the ongoing performance of the third party contract.

- **Force majeure and disaster recovery.** The contract should ideally include a term prescribing what will happen in the event of the performance of the services being prevented or delayed due to some unforeseen event (for example, a fire at the client’s premises). Consider, too, including an obligation on the contractor to draw up and (if necessary) implement a disaster recovery plan, to ensure continuation of the services in the event of such an event.

- **Parent company guarantee.** If the contractor is not the main trading entity on its group or does not have sufficient assets to meet its potential contractual liabilities, then a parent guarantee may be required to afford the client with a sufficient degree of potential in the event that the contractor defaults under the contract.

- **Boilerplate.** The contract should also cover issues such as confidentiality, data protection, ability of the sub-contractor to assign the contract, etc.

*This note is meant as a non-exhaustive, overview of some of the key issues to consider when an organisation outsources one of its functions or services. If you would like specific advice on any of the issues discussed in this note, or require assistance in relation to a particular contract, please contact Henry Sainty (henry.sainty@farrer.co.uk), Paul Jones (paul.jones@farrer.co.uk) or David Copping (david.copping@farrer.co.uk) in our IP & Commercial Team on 020 3375 7329.*

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