Milbank Outsourcing Client Briefing:
A Year in Review

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INTRODUCTION

After several relatively quiet years for outsourcing, we are seeing a significant revival of major ITO and BPO projects. In part, this simply reflects the underlying strength of the core outsourcing model based, as it is, on: costs savings; access to specialist supplier expertise; service transformation; and allowing the customer to focus on its core business. But it is also clear that the outsourcing model is evolving and incorporating a number of newer features reflecting the impact of 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 but this has not proved to be the case. Of course, companies are adopting a number of different collaboration and commercial models in relation to the development and deployment of these 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.

The successful implementation of these disruptive technologies requires a number of significant changes to the traditional outsourcing contracting model. Each of these developments require specific new contract provisions and protections which in some, but not all cases, has led to 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

1. Cloud Services

The first major disruptive change in recent years 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 in relation to performance and operational matters. However, it does not necessarily follow that a standardised approach to operational matters should also lead to standard or uniform commercial terms and, in the right circumstances, customers have been able to negotiate improved positions on some of the most significant terms, including liability, termination, and exit support. The argument for accepting standard supplier terms are also much weaker in relation to private cloud services where the operational model and approach is much closer to a traditional outsourcing deal.

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

3. Blockchain and Smart Contracts

Over the next few years we will also see the widespread 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.

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THE DEVELOPMENT OF A NEW CONTRACT MODEL

Alongside the changes driven by the implementation of these new technologies, 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. These factors have come together to encourage the development of a more flexible and balanced incentive based contract model for outsourcing, in which there is a much greater emphasis on; (i) incentivising performance; (ii) remedies which are operationally focused; and (iii) more effective alignment of the commercial interests of both parties.

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 but there are some common features we see across the market:

- **Flexibility**: so that the service can manage the increase 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 fix 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;

- **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 properly align the parties' interests.

Taken together all of these developments are encouraging and suggest that the 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.