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The Role of the Outsourcing Contract in the Client-Vendor Relationship

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A good contract is important to outsourcing; this is an undisputable statement. The contract is the legal basis of the outsourcing agreement and therefore of fundamental importance. However, there are two different research-based views as to just how important the contract is.

The first view argues that the contract is the most important part in the client-vendor relationship. The contract provides a legally bound framework in which clients and vendors have a specification of their rights, duties, and responsibilities as well as the goals, policies, and strategies for the underlying arrangement.

The second view, while far from advocating that a contract is unnecessary, places its importance significantly beneath that of the relationship. The contract has its place, but it alone cannot produce results. An experienced contract management team focused on cooperation, common interests, and earning trust over time creates the results and efficiencies. A mere piece of paper cannot achieve such results.

Both views attempt to explain how success is achieved, and how to manage the ever persistent conflict of interest that exists between the vendor's need for profit and the client's need for cost efficiency. This *Executive Update* examines the support for both arguments.

In research performed by the leading academic team of Mary Lacity and Rudy Hirschheim, outsourcing customers all agreed that having a solid contract was the foremost tool to sustain a successful outsourcing relationship to establish the balance of power between parties.[1] The researchers concluded that a tight contract is the only mechanism to ensure that expectations of the outsourcing customer are met.

A few years later, another leading researcher in the field, Matthew Lee, examined the motivations of the contractual parties and argued that an outsourcing customer cannot expect the outsourcing vendor to act in the best interest of the customer due to the conflict of interest that arises between the vendor's need for profit and the customer's need for cost reduction.[2] He concluded that the written outsourcing contract is the most important instrument for defining the rights, liabilities, and expectations of both parties, which will also guide their behaviors for the duration of the contract.

More recently, in their work at Texas State University, Leah Platz and Cecilia Temponi presented research suggesting that the contract is central to the relationship.[3] Most problems within the supply chain were attributed to poorly designed or weak contracts. On the other hand, companies that planned the creation of the contract effectively maximized the benefits and minimized the risks of outsourcing, protected themselves from conflicts of interest, and provided a structure to the relationship. The key elements of the contract necessary for the success of the relationship found in that research were identified as:

- Performance standards for quality and service levels (and associated performance incentives and penalties)
- Communication and confidentiality
- Financial (costing and pricing)
- Human resources (transfer of staff)
- Legal (transfer of assets, intellectual property, liability, warranty, terms for disengaging, and dispute-resolution methods)

The view presented so far draws a picture where the contract drives the success (or otherwise) of outsourcing. This position also assumes that as soon as the contract has been signed, it lasts for the entire agreed-upon duration. Accordingly, the contract governs the relationship, all problems can be anticipated, and its effective management should not be too difficult since the necessary mechanisms should have been built into the contract, according to Lee.[4]

However, such a view ignores two basic conditions: first, by believing that a good contract is capable of managing itself and not requiring much investment in contract management (dubbed as the "ongoing self-management myth"), and, second, by believing that things will not change, thus ignoring the dynamic nature of IT as well as the dynamic nature of human relationships.

According to Linda Cohen and Allie Young in *Multisourcing: Moving Beyond Outsourcing to Achieve Growth and Agility*,[5] most organizations that enter outsourcing contracts do not budget and plan adequately for the ongoing management of the relationship and the services that are provided. This is very problematic. For example, many companies outsource because they are unhappy with the performance of their internal IT departments. However, that dissatisfaction is primarily the result of their own lack of involvement, according to research by Petter Gottschalk and Hans Solli-Saether from the Norwegian School of Management.[6] This is a quite a perverse turn of events, since a lack of involvement is also the typical starting point for managing outsourcing agreements. Consciously or unconsciously, outsourcing companies assume that investing in governance processes over the contract's lifetime is unnecessary. New governance competencies and processes — as well as new metrics for performance management that are necessary to ensure that the services are delivered at adequate levels (which could be very different from what was acceptable years, or even months, before) — are ignored.

Cohen and Young further observed that companies tend to believe in the myth of stability "steady state," simply assuming that once the contract has been signed for a specific term, the service-level agreement (SLA), pricing structure, and service options cannot and will not change.[7] In reality, however, contracts are often renegotiated, and companies must consider this when entering the original agreements. Even with the most comprehensive contract and favorable terms, there will soon come a time when the client will be asking the provider for support that has not been officially included in the contract, all a part of the dynamic nature of IT.

Unfortunately, those outsourcing contracts that assumed a steady state actually impeded change. Many outsourcing contracts cannot handle change in an efficient manner. Rather, they include terms and conditions that make it very difficult, time-consuming, and expensive to accommodate change. This is quite ironic, as one reason outsourcing became so popular in the first place was so that companies could be more responsive to growth and changing business needs.

By nature, outsourcing contracts must change and therefore must accommodate change. They must adopt new pricing models and SLAs that anticipate and accommodate change. They must be regularly and frequently reviewed and refreshed as business and technology change dictates. In such an environment, it is irrational to let the contract govern the entire relationship. In reality, someone must manage the contract and sustain the relationship to encourage strategic cooperation.

Although researchers Lee and Platz and Temponi see the standards written into contracts as important drivers of success, legal academia is deemphasizing the role of contract.[8] In the legal literature, there has been an evolution of thought during the last decade away from contracts and legal theories as the cornerstone of contracting behavior. Rather than fixating on the contractual frame of reference, a growing body of work suggests priority should be given first to the business relationship, secondary attention to the economic deal, and the contract should be relegated to a peripheral role.

In this dynamic world, customers must learn to find ways to align their interests with the provider so that efforts can be focused on their common goals, beginning with a focus on the establishment of trust and perceptions of common interests. Moreover, once a close relationship and earned trust develop, this may reduce the need for detailed monitoring of the vendor over time.

In their book about contractual theory, Gottschalk and Solli-Saether present a picture of outsourcing that portrays a tight relationship among contract, cooperation, and performance.[9] Contracts and cooperation are not substitutes but complementing factors to performance.

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A contract alone is insufficient to guide the outsourcing evolution and manage its performance. The outsourcing contract is unlike any other service contract because of the complex nature of what is being outsourced and the extensive length of the contact. By nature, lengthy contracts tend to be more incomplete. Gottschalk and Solli-Saether go on to say that not all contracts should have the same level of "completeness," as they all depend on the provided service and the industry involved. They also add that contractual completeness should refer to contingency and adaptability.

Overall, the trend in research, both outsourcing and legal, is toward a much more dynamic view of the outsourcing contract and relationship. The success of any outsourcing deal requires a well-constructed and dynamic contract that anticipates change, coupled with an experienced contract management team that ensures a communications environment in which each party feels free to exchange views about how both are contributing to the success of the contract as well as the sharing of information, ideas, aims, and business objectives.

Only through agile contracts and close relationships among clients and vendors can we achieve long-term success in IT outsourcing.

ENDNOTES

[1]Lacity, Mary, and Rudy Hirschheim. "Implementing Information Systems Outsourcing: Key Issues and Experiences of an Early Adopter." *Journal of General Management*, Vol. 19, No. 1, 1993, pp. 17-31.

[2]Lee, Matthew K.O. "IT Outsourcing Contracts: Practical Issues for Management." *Industrial Management & Data Systems*, Vol. 96, No. 1, 1996, pp. 15-20.

[3]Platz, Leah A., and Cecilia Temponi. "Defining the Most Desirable Outsourcing Contract Between Customer and Vendor." *Management Decision*, Vol. 45, No. 10, 2007, pp. 1656-1666.

[4]Lee. See 2.

[5]Cohen, Linda, and Allie Young. *Multisourcing: Moving Beyond Outsourcing to Achieve Growth And Agility*. Harvard Business Press, 2005.

[6]Gottschalk, Petter, and Hans Solli-Saether. *Managing Successful IT Outsourcing Relationships*. IRM Press, 2006.

[7]Cohen and Young. See 5.

[8]See, for example, Vincent-Jones, Peter. "Contractual Governance: Institutional and Organizational Analysis." *Oxford Journal of Legal Studies*, Vol. 20, No. 3, 2000, pp. 317-351; and Collins, Hugh. *Regulating Contracts*. Oxford University Press, 1999.

[9]Gottschalk and Solli-Saether. See 6.

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