

**BUSINESS TRANSFORMATION OUTSOURCING:
LESSONS LEARNED**

by

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Over the past several years, a number of prominent vendors have been encouraging businesses to consider a new form of outsourcing known as Business Transformation Outsourcing (“BTO”). In a BTO project, the customer retains the business unit (*e.g.*, the IT or Human Resources Department) and its employees and engages a vendor to improve the subject business unit (“SBU”) by leveraging the knowledge, experience and capabilities of the vendor. BTO is a response to the recognition that not all operations can be outsourced successfully; instead, a company must retain and improve certain functions to remain competitive.

How does the vendor transform the SBU? In BTO projects, the vendor provides a variety of services, including traditional outsourcing services, a significant mix of consulting services, and staff augmentation. In each BTO project that we have advised on, our clients sought bids from numerous vendors, and while all of the vendors approached the project from a slightly different angle, each vendor proposal and all of the eventual projects included the following combination of vendor services:

1. Traditional offshore outsourcing of IT or business processes. This portion of the project generated significant savings from labor arbitrage to permit an investment in the SBU.
2. A comprehensive review and analysis of the existing processes, procedures and tools used by the SBU. Following the analysis, the vendor proposed best

practices to be adopted by the SBU. The analysis phase can last for a number of years as new processes, procedures and tools are slowly introduced into the SBU. Essentially, this phase of the BTO project is a version of traditional consulting services on steroids.

3. Once the parties are prepared to implement the new processes, procedures, and tools, a significant number of the vendor's employees work side-by-side with the SBU's employees to ensure the SBU's employees understand and accept the new processes, procedures and tools. While working in the SBU, the vendor's employees often serve in low level, middle management and more senior management positions. In this capacity, the vendor's employees spend between 80-90% of their time on day-to-day SBU work (*e.g.*, software development or testing) and their remaining time serving as coaches and mentors to assist the SBU's employees with the take-up and mastery of the new best practices.

This article highlights the differences between a BTO project and a traditional outsourcing project. It addresses how the customer should approach the planning and negotiation of a BTO project based on these differences. It also highlights elements of the traditional outsourcing agreement that require significant modifications, including governance, vendor compensation and dispute resolution. These issues will be addressed in greater detail in future articles.

Differences between BTO and Traditional Outsourcing

A BTO project is different than a traditional outsourcing or consulting project in a number of significant ways. The level of customer responsibility is greater than in a traditional outsourcing project, where the customer turns over certain functions to the vendor and expects the vendor to get things right. However, the level of customer responsibility is significantly less

than in a consulting engagement, where the consultant conducts a study, makes its recommendations to the customer, but ultimately the customer is solely responsible for the decision on whether and how to implement the consultant's analysis. In a BTO project, the customer is intimately involved in the entire project. The customer and vendor must work together to identify the appropriate best practices for the SBU and to modify and adopt these best practices given the unique attributes of the SBU. Then, customer and vendor employees work side-by-side in the take-up and mastery phase of the project. Given the level of customer involvement in the BTO project, the customer bears significantly greater responsibility for the success or failure of the project than in a traditional outsourcing project.

A BTO project is different because the specific services to be provided are not entirely clear at the beginning of the project. Instead, a final goal has been established (*e.g.*, productivity improvements of 20% by the end of year five) and interim milestones or objectives may be established (*e.g.*, CMM level 1 by a certain date), but a detailed statement of work itemizing the services is not practicable. The description of BTO services more closely resembles the description of services found in a consulting agreement rather than an outsourcing agreement. In the BTO project, the parties work backwards. The customer and vendor agree upon a final strategic goal and establish existing baselines and mechanisms for measuring progress towards the goal. Then the parties complete the description of services over the course of the project.

Finally, in a BTO project, the vendor works itself out of a job. The vendor's work is done once the customer is able to build an organization that can adopt and learn best practices without assistance. Consequently, there is no renewal term in the BTO agreement if things go well.

BTO Planning and Analysis

These differences require additional planning and analysis by the customer before and during the RFP process. In order to make this type of complex project a success, the customer must know itself well. The customer's decision-makers have to know how the SBU will react to long-term change and how it will address employee resistance to the adoption of new processes, procedures and tools. BTO projects can impact multiple levels of an organization, and the customer must ask itself whether management of the SBU can work side-by-side with a vendor, accept constructive criticism from the vendor, and even share control of the SBU with the vendor. The customer must also consider whether other business units or divisions within the entire organization are affected by the project. For example, in a BTO project for the IT Department, how will its internal customers react? Moreover, many of the best practices, procedures and tools designed as part of the BTO project may impact other departments or require approval from another department. For example, are the customer's HR functions included in the IT Department? If not, representatives of the HR department must be made aware of the project, show flexibility in considering new approaches to employee compensation and retention and possibly contribute significant time and resources to the project. If other departments are not included in project planning from conception, they can raise significant road blocks for a variety of reasons, including budget or time constraints or spite.

In addition to knowing your own organization, it is critical to know the vendor. Each vendor will approach the BTO project from its own unique perspective. For instance, one prominent vendor almost always sees an organization's problem as a function of the technology used by the SBU, while another prominent vendor believes that inefficient or ineffective management lies at the heart of most problems. Which of these messages is more likely to

resonate within your organization and which is most likely to cause significant resistance? Examine the vendor's industry and subject matter expertise and visit other customer sites. Does the vendor have significant knowledge and experience in your particular industry? Also, examine its track record in BTO projects. Has the vendor successfully managed a BTO project? Has the vendor managed a BTO project for a similar type of SBU? Drill down into the details and understand the experience of the vendor's employees assigned to your project. Have the professionals assigned to your project worked on a successful BTO? Are you getting experienced BTO professionals or retreads? Finally, consider whether the culture of your organization and the vendor's organization mesh. A cultural mismatch can adversely affect both the best practices phase and the take-up and mastery phase of the project.

As you approach the negotiation of the BTO agreement, consider what steps can be taken to ensure that your employees are vested in the BTO project. Given the level of customer involvement in the project, the vendor will want the customer to ensure that employees are properly incented to make the BTO project a success. You should expect your vendor to insist on some form of contractual commitment on this point if its compensation is based in whole or in part on the success of the BTO project. As an aside, we would strongly recommend that the vendor's compensation be tied to the success of the BTO project; otherwise, you might as well engage a consultant and a staff augmentation firm with lower hourly rates than the vendors who offer BTO services.

Negotiation of a BTO Project

The customer must approach the negotiation of a BTO project from a different perspective than a traditional outsourcing project. First and foremost, the customer must know its long-term strategic goal. Do not allow the vendor to establish your goal, although allowing

the vendor to help refine the goal is acceptable. As you focus on your goal, remember that it cannot be about saving money in the short-term; this type of project requires a significant investment. Also, as you consider your goal, and the delta between your current situation and the goal, consider the future impact of existing or planned self-improvements. Do not give the vendor credit for these achievements. Second, a successful engagement requires collaboration by the customer and vendor. If the BTO project is not a win-win engagement, it will be a lose-lose engagement. It is difficult to establish a collaborative relationship if the parties engage in scorched earth negotiations. This does not mean the customer should roll over; instead, it should negotiate firmly, but it must be willing to engage in a win-win form of negotiation or the long-term objective of the project will not be clear, the method of measuring success will not be clear, the compensation system (and in particular the incentive formula) will not be clearly analyzed, and the governance provisions in the agreement will not be tailored for both organizations. Moreover, given the breadth of a typical project, the negotiation team for both parties must include the individuals who will live through the project. Scorched earth negotiations in this setting will seriously impede the development of the collaborative relationship that is essential for these individuals to work together during the life of the project.

Revisions to our Forms

All of these distinctions between a BTO project and a traditional outsourcing project require significant changes to our standard outsourcing forms. In particular, governance provisions, vendor compensation, dispute resolution, intellectual property, employee matters and exit provisions must be revisited.

The governance process for a BTO project is significantly more complicated and involved than a traditional outsourcing project. The parties are working together to make

difficult business decisions, such as how many employees are required for a task, which best practices should be adopted, which best practices should be implemented first, what is the timeline for implementing these best practices, and how are employees of both organizations incented to perform. These questions are more complex than the traditional issues that arise in an outsourcing agreement. How will differences of opinion between the vendor and the customer be decided on these types of issues? The traditional structure of a steering committee and escalation of disputes, while appropriate, is inadequate to address the foregoing types of business issues that arise during a BTO project. Moreover, these issues do not lend themselves to resolution by legal decision makers, nor do many organizations wish to trust the resolution of business disputes to an arbitrator or mediator. Thus, new methods of “dispute” resolution must be considered. Consequently, a mechanism must be agreed upon for final decision-making authority on business issues. We have always advised that final resolution of these business issues rest solely with the customer. However, once a decision has been made a mechanism must exist to assess the impact of such decisions upon other elements of the project. If the parties are unable to agree upon the impact of this type of decision, then the dispute resolution process should not be open ended. Instead, the decision maker should be given finite choices. The closest traditional arbitration approach is a “baseball” arbitration where the arbitrator selects one side’s proposal but cannot split the difference.

Vendor compensation is also equally complicated in the BTO context. While there are many ways to structure vendor compensation in a BTO project (*e.g.*, time and materials or fixed fee), the vendor will want a portion of its compensation to be based upon the achievement of interim objectives as well as the final objective. Likewise, most of our clients have insisted that the vendor back-up its promises by putting some of its compensation at risk. They have also

agreed to reward the vendor for over performance. Yet in this instance, the vendor is at risk for a variety of reasons beyond its control, including the performance or non-performance of the customer's employees or the failure of the customer to accept the vendor's recommendations.

Some issues are more easily addressed, such as the customer's failure to comply with explicit promises. For example, the customer could breach a covenant to provide two FTEs from the Human Resources Department for the term of the project. While the customer may be in clear breach of the agreement, the impact on the parties' ability to achieve the goals of the BTO project is less clear. If the vendor's compensation is tied to overall performance, the parties can resolve the impact of such breaches through a pre-agreed formula or wait and resolve the matter by mutual agreement of the steering committee or resolve the issue through the dispute resolution mechanism.

A more complicated situation arises when the customer rejects the vendor's recommendation for best practices. The customer is under no obligation to accept any particular process, tool or procedure, but the vendor may believe that the rejection adversely affects the parties' ability to meet or exceed their strategic objective. While these types of issues of joint responsibility arise in traditional outsourcing agreements (*e.g.*, who is responsible for a failure in migration when both parties have responsibilities), in the BTO arena, the differences are not simply questions of fact (*e.g.*, who did or failed to do something) but instead are questions of judgment (*e.g.*, should this best practice have been adopted). For these types of issues, any type of pre-agreed formula is virtually impossible to implement. Instead, some mechanism must be implemented to address and resolve these decisions and their impact on other elements of the project.

The ownership of intellectual property created during the BTO project must be addressed. Intellectual property in a BTO project may be categorized in two ways. First, the best practices created by the parties and second the work performed during the take-up and mastery phase of the project. In our experience, the vendor contributes significantly in the best practice phase of the project. This is the principal reason they have been hired. They bring industry knowledge and expertise and a broad awareness of what works at other companies. Without the right to replicate these best practices elsewhere, the vendor may not be able to continue its business. Consequently, ownership of these materials (at least the templates brought to the table by the vendor) by the vendor is appropriate. Ownership of modifications or revisions suggested by the customer is an appropriate area for the customer to insist upon ownership and then determine whether a license back to the vendor is appropriate. With respect to the intellectual property created by the vendor's employees in the take-up and mastery phase of the project, their work product is no different than the work product of the customer's employees. Ownership of this intellectual property should rest with the customer with no license back to the vendor. From the customer's perspective, the vendor's employees should be thought of as staff augmentation personnel.

A separate legal risk of "shared" or joint employment arises from the very nature of the BTO project. Management level and rank-and-file employees of both the vendor and the customer work side by side. At some level, vendor employees are supervising the day-to-day activities of the customer's employees. Likewise, the customer's management directs the work of the vendor's employees during the take-up and mastery phase of the project. This presents a possibility of joint employment, which the parties must be careful to avoid since neither party wants to assume legal responsibility to provide compensation and benefits to the other party's

employees or assume the legal risk for the actions of the other party's employees. The following steps can be taken to reduce the risk of a finding of joint or shared employment. As an initial matter, the contract between the customer and the vendor should expressly state that neither party shall act as or be considered the employer of the other party's employees. Such a contractual provision will carry little weight, however, if the parties do, in fact, act as employers with respect to the employees of the other. One of the strongest indicia of employer status is the authority to control workers. Therefore, to the greatest extent possible in the BTO context, managers supplied by the vendor should refrain from interviewing, hiring, disciplining, and directing the work of the customer's employees. These activities should be left to the customer's own managers, who should, in turn, refrain from exerting such authority over the vendor's employees. As a practical matter, it may be difficult for companies involved in a BTO project to establish clear-cut dichotomies between vendor employees and customer employees, but there are other measures the parties can take to reduce the risk of being found to be joint employers.

For example, the customer should not be responsible for reimbursing the expenses of the vendor's employees, should not supply equipment and business cards to the vendor's employees, and should refrain from paying the vendor an hourly rate for the work of the vendor's employees. The customer should not specify particular vendor employees who will work on the BTO project and should refrain from excluding particular vendor employees from its workplace. The contract between the parties should state that the services of the vendor's employees shall be provided exclusively with respect to the BTO project, and each party should be prohibited from hiring the employees of the other during the term of the BTO project and for a fixed period of time after its termination. The customer should not include the vendor's employees in any of its benefit programs, and it should check its benefit plans to ensure that the vendor's employees

working on the BTO project will not qualify for coverage under the plans. Even such seemingly minor factors as excluding the other party's employees from company social events and employee meetings can be relevant to a determination of joint-employer status.

Of course, joint-employment issues are not the only concerns the customer may have with respect to the vendor's employees. Given the intimate knowledge of the customer's business obtained during a BTO project, the customer should consider whether key vendor employees should be prohibited from working for the customer's principal competitors during and after the project.

As discussed above, a different type of exit plan is required for a BTO project. Upon completion of the term of the BTO project, the customer expects to be capable of analyzing and adopting best practices on its own. Accordingly, it should not contemplate a renewal of the agreement, transition to a new vendor or even insourcing. When it comes to an exit provision, the negotiation team's goal is to create a mechanism to ensure that the appropriate skills have been learned by the SBU. The successful exit criteria for the BTO project is the customer's ability to replicate the project on its own in the future and may require an exit plan on an employee-by-employee basis.

Once the BTO project has commenced, the customer can improve the likelihood of success by having the right people in place. The most critical positions are the employees staffing the project management office where the best practices are designed and where project governance takes place on a day-to-day basis. The customer's employees in the project management office must have significant project management skills, including the ability to negotiate with the vendor. Because the BTO services are not clearly defined, but instead evolve during the term of the BTO agreement, implementation of the project occurs in the project

management office. All well-run vendors understand this, and their project managers are skilled at project management; they also understand the nuances of the BTO agreement, in particular the roles and responsibilities of the parties and the formula for vendor compensation. Absent a strong-willed customer project manager, the vendor can substantially renegotiate the protections built into the BTO agreement without the involvement of the customer's entire deal team.