Vested Outsourcing: The Path to a Long-Term, Win-Win Contract

By developing outsource agreements that include 10 specific elements, firms learn by doing, employ their best talents and resources to the tasks at hand, and transition their thinking from the adversarial to the truly collaborative.

By Kate Vitasek and Jeanette Nyden

Some outsourcing business deals are struck on the back of a napkin, and others go through an arduous request for proposal process, but at some point during the first blush of excitement that you've selected the right outsourced service provider to help you solve your tough business problems, or simply perform non-core work, harsh reality sets in and you begin to formalize your business deal in a contract to actually implement those hopes and plans. If you are like most companies, the collaborative efforts turn to arm's length as you begin the formal contracting and negotiating processes.

Constructing a successful outsourcing contract does not have to be the legal equivalent of going to the dentist for a root canal. There is a better, more user-friendly way of getting to a sound outsourcing agreement; one uncovered by researchers at the University of Tennessee (UT). UT researchers (originally funded by the U.S. Air Force) studied some of the most successful outsourcing agreements, including P&G, Microsoft, and McDonalds. They also studied the most successful government deals such as the Department of Energy's Rocky Flats environmental cleanup and the State of Minnesota Department of Transportation's rebuild of the 135 Bridge. In all cases, these highly successful outsourced relationships received awards, such as Microsoft's back office procure-to-pay contract with Accenture that has won awards from the Shared Services Outsource Network, the International Association for Outsource Professionals, and the Outsourcing Center.

UT's research found that successful agreements operated differently—they moved away from traditional buy/sell, arm's length contracts and instead used a relationship-based approach based on achieving business outcomes in a dynamic environment. Researchers coined the approach of these successful deals "Vested Outsourcing"[1] because buyers and sellers collaboratively crafted contracts that were steeped in mutual advantage, binding each party to a win-win approach and creating strong governance structures that enabled the parties to stay aligned long after the initial handshake or contract was signed. In essence, the parties in the contract were *vested* in each other's success.

The UT findings support what the legal scholar Ian R. Macneil[2] observed back in 1968: "Somewhere along the line of increasing duration and complexity, [the contract] escapes the traditional legal model."[3] He argued that contracts are rooted in the classical approach to contract law, and thus crafted to address transactions and legal protections such as pricing and price changes, service levels, limitation of liability, indemnification, and liquidated damages. Macneil advocated that contracting should instead focus on being instruments for social cooperation.

Unfortunately, most companies use highly conventional approaches to contract law, where the buyers and supplier are arm's length, using tactics, leverage, and power to shift risk. An April 2010 study by the International Association of Contracting and Commercial Management (IACCM) concluded that contract terms remain mired in the classical legal and transaction-based approach of contract law, which focuses almost exclusively and hierarchically on pricing, limiting liability, indemnification, service and transaction levels, risk mitigation, and liquidated damages.[4] The ideas of innovative collaboration and sharing value are not major parts of the contract or its governance provisions.

Recent academic research supports the premise that a more flexible, friendly approach to getting to a contract is needed. The Nobel Laureate Oliver E. Williamson suggests businesses should adopt a highly adjustable or adaptable approach, rather than one that prescriptively outlines detailed transactions, rigid terms and conditions, statements of work, and working relations.[5] Why? Williamson points to the fact that all contracts will be incomplete and not having a flexible framework to deal with "maladaptations" can cause tensions and put a wedge between buyers and suppliers. We agree—that's because, as we often say, "business happens," constantly and unpredictably. The 21st century needs to embrace the fact that contracts can support the dynamic needs of business in a fair manner using mechanisms that help both parties stay in alignment after the initial contract is signed.

UT has established a "Vested Outsourcing" contracting model to help companies build a solid, cooperative foundation for sharing value—together. The Vested approach is a highly integrated, outcome-based business model using value incentives to maintain mutual advantage.

The 10 Elements of a Vested Outsourcing Agreement

UT's Center for Executive Education teamed with the IACCM on *The Vested Outsourcing Manual: A Guide for Creating Successful Business and Outsourcing Agreements*.[6] The manual is a step-by-step guide for developing collaborative business-to-business contracts and working rules that will facilitate successful and long-lasting business relationships based on mutually desired outcomes.

The Vested Outsourcing Manual builds extensively on the groundbreaking work done by UT. It outlines 10 elements to include when developing an outsourcing or business contract. Think of the elements as signposts directing the parties along the right road to the desired destination: a successful, long-term Vested relationship.

The 10 elements are keyed to implementing the "Five Rules of Vested Outsourcing,"[7] as outlined in **FIGURE 1** on page 48. The elements and their interaction with the five rules are briefly explained as follows.

Rule #1: Focus on Outcomes, Not Transactions

Element 1: Business Model Map

This first step is to understand and document an outsourcing business model. It is vital for the parties to spend some time and map potential outcomes. They will see how well they are aligned to each other's goals. Jointly mapping a model will pinpoint the transactions of value between the parties, leading logically to collaboration, loyalty, and mutual satisfaction, market share, and sustainable profit. Use the model jointly to compare results. "Element 1" also fashions a culture in which the company and the service provider maximize profits by working together more efficiently, no matter who is carrying out the activity.

Element 2: Shared Vision and Statement of Intent

With the business model understood and mapped, the parties then work together on a joint vision that will guide them for the duration of their Vested relationship. A cooperative and collaborative mindset opens a conversation between the parties. The result is that they share what is needed, admit to gaps in capability, and aim to focus on the benefits that the other party can bring to enhance any gaps in capability. That vision and alignment forms the basis of a statement of intent drafted by the outsourcing teams.

Rule #2: Focus on the What, Not the How

Element 3: Statement of Objectives/Workload Allocation

This element lays the foundation for the parties in the Vested partnership to do what they do best. Depending on the scope of the partnership, the company transfers some or all of the activities needed to accomplish agreement goals to the service provider. Together they develop a statement of objectives, which is very different from a standard statement of work. A statement of objectives describes intended *results*, not *tasks*. Based on the statement of objectives, a service provider will draft a performance work statement that defines in more detail the work to be performed and the results expected from that work.

Rule #3: Clearly Defined and Measurable Outcomes

Element 4: Top-Level Desired Outcomes

To have an effective, successful Vested Outsourcing relationship, the parties must work together to define and quantify desired outcomes. This element is a centerpiece of the whole enterprise because without mutually defined desired outcomes in place, a Vested agreement cannot go forward. Outcomes are expressed in terms of a limited set of high-level metrics. It is imperative that the parties spend time—jointly and collaboratively—during the outsourcing transition and particularly during contract negotiations to define exactly how relationship success is measured. Once the desired outcomes are agreed upon and defined, the service provider proposes a solution that will deliver the required level of performance at a predetermined price.

10 Elements of a Vested Agreement	
Rule 1: Outcome-Based vs. Transaction-Based Business Model	
Element 1	Business Model Map
Element 2	Shared Vision Statement and Statement of Intent
Rule 2: Focus on the *What*, not the *How*	
Element 3	Statement of Objectives/Workload Allocation
Rule 3: Clearly Defined and Measurable Desired Outcomes	
Element 4	Clearly Defined and Measurable Desired Outcomes
Element 5	Performance Management
Rule 4: Pricing Model Incentives are Optimized for Cost/Service Tradeoffs	
Element 6	Pricing Model and Incentives
Rule 5: Insight vs. Oversight Governance Structure	
Element 7	Relationship Management
Element 8	Transformation Management
Element 9	Exit Management
Element 10	Special Concerns and External Requirements

FIGURE 1. 10 ELEMENTS OF A VESTED AGREEMENT

Element 5: Performance Management

Once desired outcomes, statements of intent, and statements of objectives are in place and the agreement is implemented, the parties then measure performance to determine if the desired outcomes are achieved. These include high-level performance management measures that are easily understood by business stakeholders and all parties involved in the process. The metrics will help align performance to strategy.

Rule #4: Pricing Model Incentives that Optimize Cost/Service Trade-offs

Element 6: Pricing Model and Incentives

In order to attain their desired outcomes, the parties must have a properly structured pricing model that incorporates incentives for the best cost and service trade-off. The approach of many procurement professionals to outsourcing is perennially stuck on one thing: getting the lowest possible service and labor pricing. The strategic bet—and paradigm shift—of the Vested model is that the service provider's profitability is directly tied to meeting the mutually agreed desired outcomes. Inherent in this model is a reward for service providers to invest in process, service, or associated product that will generate returns in excess of agreement requirements. Higher profits are not guaranteed (and no business model can (or should) claim that), but this element provides service providers with the authority and autonomy to make strategic investments in processes and product reliability that can generate more value and a greater return on investment than a conventional cost-plus or fixed-price-per-transaction agreement might yield.

Incentives are a key component of this mix because service providers are taking on risk to generate larger returns on investment. An incentives package delivers the most commercially efficient method of maintaining equitable margins for all parties for the duration of the relationship. Pricing models using a method called "margin matching" are recommended for use in the Vested agreement. The margin matching approach is used to adjust pricing points by establishing trigger points that reset prices when that point is met. For example, the inflation rate might be a trigger point for resetting inventory carrying cost charges.

Rule #5: Insight versus Oversight Governance Structure

Element 7: Relationship Management

A relationship management structure creates joint policies that emphasize the importance of building collaborative working relationships, attitudes, and behaviors. The four elements associated with "Rule 5" provide the tools for parties to manage and operate the Vested agreement. The parties monitor the agreement within the framework of a flexible governance structure that provides top-to-bottom insights into what is happening. The Vested agreement is not based on transaction counting!

Element 8: Transformation Management

This is a new relationship model—people and company ecosystems are changing; the parties are doing things differently and probably not operating in familiar comfort zones. Managing this transformation, including transitioning from old to new—along with change management once the new agreement is up and running—is often difficult and complex to implement. It is imperative to preserve as much continuity as possible among personnel and teams as the transition progresses into day-to-day implementation and operation. The focus here is on end-to-end business metrics, mutual accountability for desired outcomes and the creation of a culture that rewards innovation, agility, and continuous improvement.

Element 9: Exit Management

Sometimes the best plan simply does not work out or is trumped by unexpected events. Did I mention that "business happens"? Companies should have a plan when assumptions change. An exit management strategy can provide a template to handle future unknowns. The goal is to establish a fair plan and to keep the parties whole in the event of a separation when the separation is not a result of poor performance.

Element 10: Special Concerns and External Requirements

Governance frameworks are not one-size-fits-all, especially in more technical or complex global relationships. The final element recognizes that all agreements are different and that many companies and service providers must understand and adhere to special requirements and regulatory protocols. Thus, a governance framework may need to include additional provisions that address specific market, local, regional, and national requirements. For instance, in supplier and supply chain relationships involving information technology and intellectual property, security concerns may necessitate special governance provisions outside the normal manufacturer-supplier relationship. Supply chain finance and transportation management are other areas that often require special handling under the governance framework.

Conclusion

If your outsourcing strategy is not flexible and nuanced enough to deal with the risks and uncertainties of today's marketplace, then it's long past time for a change in the way your outsource and/or business contracts are thought about, negotiated, and managed.

Serious engagement and implementation of the 10 elements embody a modern, logical approach to contracting in the 21st century: A contract that focuses on the positive and uses the expertise that all the parties bring to the table. The result? A Vested contract designed through collaboration and trust to achieve the win-win—not an old-fashioned document steeped in legalese that strives only to shift liability or avoid risks at all costs. Completing the 10 elements enables progressive companies to change their mindset and challenge old-school approaches by establishing a dynamic, modern business-to-business agreement.

By developing outsource agreements that include the 10 elements, firms learn by doing, employ their best talents and resources to the tasks at hand, and transition their thinking from the adversarial to the truly collaborative. They move beyond simply paying lip-service about "collaboration," "partnership," and "trust" to creating a win-win agreement and an atmosphere that drives transformative change. **CM**

ABOUT THE AUTHORS

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ENDNOTES

1. *See* www.vestedoutsourcing.com.
2. Macneil was the John Henry Wigmore Professor Emeritus of Law at Northwestern University School of Law. Macneil died in February 2010 after devoting his life to advocating that contract law needed to be approached from a collaborative rather than an adversarial approach.
3. Ian R Macneil, *Contracts: Instruments for Social Cooperation* (Hackensack, New Jersey: F. B. Rothman, 1968).
4. "Contract Negotiations Continue to Undermine Value," IACCM Ninth Annual Top Ten Terms Report (April 2010).
5. Oliver E. Williamson, "Outsourcing: Transaction Cost Economics and Supply Chain Management," *Journal of Supply Chain Management* (2008): 5–16.
6. www.vestedbook.com.
7. *See* www.vestedoutsourcing.com/category/5-rules.