When outsourcing turns sour

Julian S Millstein and *Sherman Kahn* of international law firm Morrison & Foerster explain how outsourcing disputes can be resolved with the minimum of fuss

Long-term IT outsourcing relationships invariably produce disputes involving scope, price, performance and delays, or changed requirements. Resolving these disputes is fundamental to good governance of outsourcing agreements. In most instances, alternative dispute resolution procedures (ADR) can provide a mutually acceptable pathway to dispute resolution.

The alternative – "see you in court" litigation – is expensive and time-consuming and, crucially, is inappropriate for addressing the business risks associated with resolving problems where the parties are continuing to work together. Also, by its nature, litigation creates a public record of a strong adversarial dispute: it is in neither party's interest to publicise their difficulties.

At the least formal end of the spectrum, the customer and IT service provider should adopt a process to escalate conflicts to higher levels of management if they are not resolved in a timely fashion. Sometimes it is helpful to involve executives from other business units – so-called distant executives – who have played no part in the activities leading to the dispute.

A second type of ADR is the use of mediation, where a neutral third party is called on to facilitate, but has no authority to impose a resolution.

Finally, binding arbitration by a single arbitrator or a panel of arbitrators provides a private forum instead of public litigation.

Arbitration can be essential when the outsourcing relationship crosses international borders. It is often very difficult to enforce a judgment in a foreign jurisdiction – and it may be necessary to do just that if the other party resides (or keeps its assets) in that foreign jurisdiction.

Many countries' courts are inhospitable to foreigners or insist on time-consuming procedures that make real relief untenable. International arbitration – a private procedure – can solve this problem, because foreign courts will enforce arbitral awards if the country, like most countries in the world, is a signatory to the New York convention.

Here are four key principles for the effective use of ADR in IT outsourcing disputes.

■ **ADR should be used routinely in managing outsourcing relationships.**

Disputes must be resolved quickly before they become toxic. Parties should follow contractual dispute escalation processes to the letter: a dispute often arises because the parties have failed to reach agreement on issues such as scope, performance or price. In those cases, the dispute may just mean it is time to nail that issue down. Perhaps one party has not disclosed to the other an important cost, risk or weakness that affects its performance. Active management of disputes, therefore, leads to more, not less, success.

■ **Use a neutral third-party facilitator to resolve disputes that cannot be resolved internally.**

Mediation is like marriage counselling: it can cut through communication difficulties about who said what to whom and assist the parties in addressing the real problem. Customers and providers can borrow from the playbook used by parties in joint ventures – business ventures where disputes must be settled between the co-venturers if the venture is to continue. Such ventures often resort to mediation by a mutually trusted person who understands the history and objectives of the venture. It is often useful to select this person in advance, so that the use of mediation does not, in itself, indicate a failure in the relationship. Individuals with knowledge of the likely technology issues can use that knowledge to help guide the parties to a successful resolution.

Mediators are trained to look for value that can be traded in such a way that an item that is valued highly by

one party, but not by the other, may be jettisoned for a reciprocal item. A mediator can receive confidential information from both sides, and, without disclosing it to the other party, use it to help reach an accord.

■ **Use binding arbitration to resolve other disputes.**

Binding arbitration ensures privacy. However, one potential downside is that the arbitral award may be appealed only on narrow grounds, generally the bias of the arbitrator. Arbitration clauses must be carefully crafted to deliver a fair and enforceable process, especially for trans-border agreements. Use of a panel of three arbitrators is preferable for high-stakes disputes; using a single arbitrator without appeal has more risk of a surprising result which then cannot be remedied.

It can be useful to employ a combination of both mediation and arbitration. A mediator can help the parties narrow a dispute. For example, with the help of a mediator, general displeasure with service performance may be tracked to a root cause, where both parties can find an agreed solution. Arbitration can then be used to determine the cost of the solution.

Even if your company believes litigation is best handled in court, arbitration is an important tool when a dispute needs to be adjudicated – or enforced – quickly. Thus a global deal that provides for litigation between the parties should contain an exception providing that arbitration can be used for disputes between certain local country affiliates. Similarly, agreements involving parties residing in countries where courts are unreliable, or unlikely to enforce foreign judgments, should include arbitration provisions.

■ **Include ADR provision in the original outsourcing agreement.**

No one wants to think about disputes when they are working on building a relationship. However, it always pays to incorporate a dispute resolution process within the outsourcing agreement.

If the agreement includes a step-clause (for example, negotiation, mediation, arbitration), ensure that the clause is clear regarding how each step is initiated and completed. Be sure to place time limits on all preliminary stages.

If the agreement provides for arbitration, ensure that it provides for a choice of substantive law, a place of arbitration, a language in which the arbitration proceedings will be conducted, a specific set of arbitration rules and, if applicable, an administering organisation. Be sure to specify that arbitration awards will be final and binding.

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Finally, ensure that the arbitration clause is sufficiently broad and consult with local counsel, if necessary, in the place you choose for arbitration, the place providing the substantive law of the agreement, and the primary places of business of all the parties. Some jurisdictions have special language that must be included in an arbitration agreement to make a clause enforceable. ■