

*"To improve outsourcing relationships, the parties should follow contractual dispute escalation processes to the letter."*

*"Disputes over scope and price ("scope creep") are typical ..."*

## **Practical Uses of ADR in Outsourcing Relationships**

**By Julian Millstein and Sherman Kahn**

Outsourcing relationships are guaranteed to produce disputes! Often complicated by business and technology change, these long-term agreements are never performed without disagreements over scope, price, adequacy of performance, reasons for delay, and changed requirements. Handling these disputes is one aspect of the day-to-day governance of outsourcing relationships. Therefore, in most cases, outsourcing relationships can benefit from planned use of alternative dispute resolution (ADR).

In outsourcing, a business process or technology process is transferred from one organization (the "customer") to another organization (the "service provider") so that the customer can focus on its "core competencies". But the transfer does not mean the process is unimportant to the customer. In fact the process that has been transferred is often very important to the customer's continued business success, even its survival. Failure to deliver the services in a timely and accurate manner, and at expected cost savings, can have serious repercussions to the customer's business.

And when problems arise, the customer has good reason to try to resolve the dispute short of litigating. Contractual damage remedies are usually restricted by limitation of liability provisions. Other remedies such as self-help, rights to injunctive relief, and termination, may not ease the customer's burden all that much. Litigation, an expensive and time-consuming last resort in most commercial relationships, can not usually address the customer's business risks associated with a failing outsourcing relationship. Litigation is especially unsuited for resolving problems that are not-threatening to the overall outsourcing relationship. Also, by its nature, litigation creates a public record of strong adversarial dispute, and it may not be in the interest of the customer to publicize its difficulties with the provider of key services in such a manner.

The outsourcing provider likewise has reasons to settle its disputes outside of court. Its business success depends very much on its reputation as a professional, competent supplier of services. Consequently, most service providers prefer to settle disputes without public airing, and will work very hard to retain relationships which were expensive to obtain, and may have required substantial up front investments which cannot be recovered unless the agreement continues for several years.

Disputes come in all shapes and sizes in outsourcing relationships. They frequently arise during the initial transfer to the provider's process, often as a result of delay by one or both parties. Disputes over scope and price ("scope creep") are typical, with the customer concerned about paying extra for services which it determines should be included in the provider's services,

while the provider determines that such services are extras, and were never intended to be delivered at the initial pricing.

Parties also dispute the cause of performance failures, or indeed whether such failures were correctly measured. Agreements contain various pricing mechanisms which often call for “equitable” price adjustments or benchmarking to market price, and the parties may not be able to come to mutual agreement about such forward pricing. In all of these situations, the parties managing the outsourcing attempt to resolve their differences, and frequently they are able to do so. What should they do when, as often happens, they reach an impasse?

Creative use of Alternative Dispute Resolution is one answer. ADR is a continuum of techniques and processes used to help parties resolve disputes without resorting to public litigation. It is considered more efficient and effective than litigation, although this is not always the case. At the low end of the spectrum, ADR can refer to conflict escalation to different levels within the disputing entities, perhaps involving executives from other business units who have no “skin in the game” (so-called “distant executives”) regarding the issues in dispute, and eventually to the CEO level. A second type of ADR is the use of mediation, where a neutral third party is called upon to facilitate, but has no authority to impose, an agreed upon resolution. Technical disputes can be resolved by a neutral technician appointed by the parties. Finally, on the far end of the spectrum, binding arbitration by a single arbitrator or a panel of arbitrators can be used in lieu of litigation.

Indeed, providing for arbitration can be essential when the outsourcing relationship crosses international borders. Even after the long and arduous process of obtaining a judgment in court, it is often very difficult to enforce such 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 not hospitable to foreigners, some are corrupt, and many have arduous and time consuming procedures that make real relief untenable. International arbitration can solve this problem. In the more than 150 jurisdictions that are signatories to the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“the New York Convention”), arbitration awards can be routinely enforced with very little opportunity for challenge or relitigation even if the award was obtained and confirmed overseas. Arbitration, a private procedure, also avoids corruption issues, and allows for efficient resolution of disputes in jurisdictions with slow or procedure-laden court systems.

This brings us to our first principle:

**A. ADR should be used routinely in the ongoing and regular management of outsourcing relationships.**

Disputes get in the way of good relationships. But disputes that are not resolved and fester are much, much worse than disputes that are quickly resolved, however painfully. Outsourcing relationships are complicated and most are long-term. Books have been written about their governance. However, human beings almost always shrink from tackling disputes if there is a way to sweep them under the rug, primarily because they believe that if they do not acknowledge a dispute, their bosses will think they are doing a better job. But disputes swept under the rug grow virulent – they need to see the light of day.

To improve outsourcing relationships, the parties should follow contractual dispute escalation processes **to the letter**. Project management office (“PMO”) minutes should maintain a tickler of unresolved disputes and track their escalation toward top executives. Those top executives should not see the existence of disputes as the fault of their employees, but should look at the dispute as suggesting issues in the relationship that can be improved upon.

For example, often a dispute arises because the parties have not really reached agreement on a matter of scope, performance or price. In those cases, the dispute may just mean it is time to nail that issue down. A dispute may arise because one party has not disclosed to the other an important cost or risk or weakness that affects its performance. Resolution puts this issue to bed. Active management of disputes, therefore, leads to more, not less, success.

Now, our second principle:

**B. Use a neutral third party facilitator to resolve disputes which cannot be resolved internally**

Mediation can help cut through communication difficulties about who said what to whom, and help focus the parties’ attention to getting real issues resolved. Mediation in this regard is similar to marriage counseling. Because it is usually in the interest of both the customer and the provider to reach a resolution that allows for the ongoing viability of the relationship, they can borrow from the playbook used by parties to 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 is not itself considered a failure of the relationship.

A knowledgeable third party may be able to identify creative ways to resolve disputes, in a manner that the parties cannot. Mediators are trained to look for value which can be traded in such a way that an item that is valued highly by one party, but not by the other, may be traded for a reciprocal item. Often, the mediator can identify these while the parties themselves cannot. For example, a mediator can act as a bridge, receiving confidential information from both sides, and, without disclosing it to the other side, use it to help the parties reach an accord.

Often outsourcing relationships give rise to disputes that are essentially technical in nature. It is often useful to appoint a technically savvy mediator to resolve these types of issues as they arise. A number of the leading arbitral institutions administer proceedings in which experts can be brought in to mediate or resolve disputes. If an agreement has a technical component, providing for dispute resolution by a neutral expert can go a long way to smoothing the relationship.

Marriage counseling has saved many a marriage, and the same holds true for commercial relationships. The parties’ agreement to devote time and energy to the mediation process is itself an important indicator of the likelihood of success.

The third principle:

**C. Use binding arbitration, rather than litigation, to resolve other disputes**

Binding arbitration may or may not be more efficient than litigation, but it will be kept private. Also, arbitration awards are more easily enforced internationally than court judgments. These are advantages for both parties. On the other hand, one potential downside of arbitration is that the arbitral award may be appealed only on narrow grounds, generally the bias of the arbitrator. Arbitration clauses must therefore be carefully crafted to deliver a fair and enforceable process, especially for agreements that are trans-border. Use of a panel of three arbitrators, although more costly, is preferable for high-stakes disputes, since the use of a single arbitrator without appeal has more risk of a surprising result which then cannot be remedied. It is often useful to provide for a single arbitrator for smaller, more routine, disputes and three arbitrators for more significant disputes.

Often, it is useful to try to resolve a dispute through a combination of mediation and arbitration. A mediator can help the parties narrow down a dispute. For example, with the help of a mediator, general displeasure with service performance may be tracked to a root cause. Both parties can settle on an agreed solution, with only the cost of the solution left to be arbitrated.

Finally, even if your company believes litigation is best handled in court, arbitration is an important tool when a dispute must be adjudicated (or enforced) in a court system which has problems in rendering timely decisions. For example, under Indian law, a dispute under an agreement between the Indian affiliates of two contracting companies must be litigated in Indian courts, which are notoriously slow, unless the parties agree to arbitration. Thus a global deal which provides for litigation between the parties should at a minimum contain an exception providing that disputes between certain local country affiliates will be arbitrated. Similarly, agreements involving parties residing in countries where courts are not reliable or may be unlikely to enforce foreign judgments should include arbitration provisions.

Parties may wish to accept that in these complicated multi-year (and often multi-party) relationships, difficult disputes will be inevitable, and therefore designate arbitration panels which are available on call should an impasse occur. So-called Dispute Resolution Boards are used in the construction industry, where large multi-year projects cannot be put at risk of being side-tracked by disputes between developers, contractors and sub-contractors. The building must go on, just as the process must go on in an outsourcing.

The Fourth Principle:

**D. ADR is most effective when a well thought out dispute resolution process appropriate to the particular situation is included in the original outsourcing agreement**

No one wants to think about disputes when they are working on building a relationship. However, a carefully thought through dispute resolution process incorporated in the outsourcing agreement can be a powerful tool to resolve issues before they expand to damage the relationship.

By developing a procedure set forth in the agreement for the resolution of disputes, parties can avoid spending inordinate time determining "the shape of the table." Clear and unambiguous dispute resolution procedures will also help both the provider and the customer document and resolve issues, thereby reducing the possibility that either party will have unreasonable expectations.

If the agreement includes a step-clause (*e.g.*, negotiation, mediation, arbitration), ensure that the clause is clear as to how each step is initiated and how each step must be completed. Be sure to place time limits on all preliminary stages. If the agreement provides for specialized proceedings for certain kinds of disputes, be careful to carefully define the applicability of disputes to those proceedings.

If the agreement provides for arbitration, make sure that the agreement provides for a choice of substantive law, a place of arbitration, a specific set of arbitration rules and, if applicable, an administering organization. Be sure to specify that arbitration awards will be final and binding. If the parties to the agreement are from different countries, choose a language of the arbitration.

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.

#### **E. Practice Tips**

Alternative Dispute Resolution is the best way to manage most disputes in outsourcing arrangements, particularly international outsourcing arrangements. The following practice tips should be helpful:

1. Provide for timely escalation of disputes. Escalation provisions should be strictly drafted and followed. Disputes should be tracked through the governance process. All billing disagreements should be memorialized in writing and a procedure for such memorialization is often best included in the outsourcing agreement.
2. Draft a change control process that the parties can actually follow. Often, the outsourcing agreement has a template for a change control process that does not conform to how the parties actually govern change. In negotiating the agreement, make sure that the agreed upon change process will be consistent with the governance structure, and that both are adopted operationally.
3. Contractually identify specific areas which could be resolved by mediation, and the process to be used. For example, parties often know in advance that certain pricing, scope or performance issues will arise because solutions are not complete or change is expected. The resolution or filling of these "holes" could be supported by mediation, if necessary.
4. Consider employing an "expert" proceeding to resolve routine technical disputes that may arise during the course of performance.

5. Consider using arbitration when litigation resolutions will not be easily enforceable or where litigation will not yield fruitful and timely results for either party.

6. Certain disputes are good candidates for resolution through so-called “baseball” arbitration, where both sides suggest a resolution and the arbitrator must select one or the other, but may not interpolate. The process of preparing a proposal for this type of arbitration requires both sides to “seek the middle” and tends to narrow the dispute.

7. Be specific in the dispute resolution clause. Address whether you wish arbitrations to be administered by an organization (e.g., the American Arbitration Association ("AAA"), the International Chamber of Commerce ("ICC"), JAMS) or whether you would prefer an ad hoc or non-administered procedure. Also consider which rules will apply to mediation or arbitration, identify a place of arbitration, the language of arbitration and a method of choosing the arbitrator(s). Most administering organizations have several sets of rules for different types of arbitrations. Be specific as to which rules should apply. Other rules can be used for non-administered arbitrations (e.g. UNCITRAL, CPR, etc.)

8. In developing dispute resolution clauses, try to avoid complicated or ambiguous procedures. Consider providing for expedited or simplified procedures to speed up the process where disputes may be routine and/or where early resolution is important to the on-going transaction. Consider how much discovery should be exchanged in the arbitration. If there are specific needs for providing or limiting discovery, to the extent they can be itemized up front in the Agreement, there will be less opportunity for problems to arise later. Often these concerns can be addressed through the choice of administering organization and/or arbitration/mediation rules.

\* \* \* \* \*

**Julian S. Millstein, JMillstein@mofocom, a mediator and arbitrator, is Senior Counselor at Morrison & Foerster LLP. He has over 30 years of experience negotiating and litigating complex outsourcing, e-commerce, and technology-related matters, across a wide range of industries and is ranked as a “Senior Statesman” in Chambers USA 2010. He is co-author of “Doing Business on the Internet – Forms and Analysis” and for served as Adjunct Professor of Law at Fordham University School of Law for many years.**

**Sherman Kahn is of-counsel with the New York office of Morrison & Foerster LLP and co-chair of the Arbitration Committee of the Dispute Resolution Section of the New York State Bar Association. He can be reached at skahn@mofocom.**

\* \* \* \* \*