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Transition in outsourcing

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Transition is a key stage in the outsourcing process under which certain business functions are migrated to the new provider. This Practice Note considers the following legal and commercial aspects of transition in outsourcing agreements:

For an example transition schedule, see **Precedent:** Transition schedule.

For the transition considerations arising at the end of an outsourcing transaction, see **Practice Note:** IT outsourcing—transition and termination issues.

1. What is transition?

Transition is usually the first stage in the outsourcing process following signature of the outsourcing agreement and involves the new supplier taking over responsibility for the provision of the outsourced services. The existing supplier may be an outgoing contractor or an in-house team within the customer's organisation.

This phase is critically important in a new outsourcing relationship. It will be the first time that the supplier and the customer will work together to achieve the outcomes discussed at length during negotiations and it will shape the future provision of the services. Any shortcuts taken during due diligence may also come to light and so both parties need to be proactive and responsive to solve any problems that arise.

Transition contrasted with transformation

Transformation is the process of enhancing and streamlining the provision of the outsourced services, primarily in order to achieve cost savings. Whilst transition moves the services from the customer to the supplier in the state that they are currently in, transformation modifies them, introduces efficiencies and moves the services towards the way that they will be provided in the future (sometimes referred to as 'stable' or 'future' state).

In the context of the outsourcing of payroll services, for example, the transition phase would involve the transition of the existing systems and staff to the new supplier. Having taken over operational control of the services, the supplier would then proceed to transform these services. This may involve using different software or utilising overseas personnel.

The transformation phase is usually conducted by the supplier after the services have been transitioned, although there may be overlap and some transformation process may continue for a number of years beyond the commencement of the services.

Terminology

Any terms used in outsourcing agreements should be clearly defined, but it can useful to be aware of key terminology commonly used during outsourcing negotiations.

The following is a selection of transition and transformation related terms, some of which are explained in greater detail in this Practice Note:

Current mode of operation (or CMO)	the operational state of the services as they are before they have been transformed by the supplier
Future mode of operation (or FMO)	the operational state of the services as they are having been transformed by the supplier
Go-live	also referred to as services commencement, this is the moment at which the supplier assumes responsibility for the provision of the services
Retained organisation	the division or unit within the customer that the customer has retained following the outsourcing, usually to provide core on-the-ground services or to manage the outsourcing agreement
Steady or stable state	similar to the future mode of operation, steady or stable state is the operational state of the services once they have been transitioned, transformed and are being provided by the supplier as envisaged by the outsourcing agreement

2. Transition process

Exactly how the transition is conducted will depend on the nature of the services being transitioned and the size and complexity of the customer's business. Some phases of transition will overlap and the planning phases may be largely completed as part of due diligence prior to the signature of the outsourcing agreement.

Most transitions will involve elements of the following:

Due diligence

Suppliers need to fully understand the customer's business and, in particular, the functions that the supplier will be taking over. This is usually achieved through a period of due diligence undertaken prior to signature of the agreement.

It is in the customer's interests to do all it reasonably can to assist the supplier's due diligence in order to ensure that transition can be undertaken as planned and to ensure that the supplier's charges are based on accurate information as to the size and scale of the customer's business.

A failure of the supplier to conduct appropriate due diligence may result in disputes or time-consuming change requests if it later transpires that the customer's business is not what the supplier thought it was. Where time permits, customers should encourage suppliers to complete their due diligence prior to signature of the agreement.

For more detailed information see **Practice Note:** Due diligence in outsourcing.

Planning

The supplier should put together a detailed transition plan which will explain the steps necessary to migrate the services to the supplier, the timing of those steps and any dependencies on the customer.

The transition plan ideally should be completed before signature of the agreement and annexed to it. Where this is not possible, the supplier should provide a draft plan and be obliged to deliver a full plan for the customer's approval within a defined period of time. These issues are explored in more detail in the section Transition plan below.

Transfer of staff, assets and knowledge

The core element of transition is the transfer of staff, assets and knowledge to the supplier. This can be a complex task and should be planned carefully.

The Transfer of Undertakings (Protection of Employment) Regulations 2006 may apply to the transfer of staff. See further **Practice Note:** IT outsourcing and TUPE.

It is not always the case that assets need to be transferred to the supplier; frequently the cost savings resulting from an outsourcing come in part from the supplier's ability to utilise its own assets which may be cheaper due to the ability of the supplier to use them in the provision of services to its other customers. However, if assets do need to be transferred they may include IT equipment, premises and software. It is especially important that the nature, extent and ownership of the assets are ascertained by the supplier before the outsourcing agreement is signed, because the agreement is likely to need to set out how the assets will be transferred to the supplier and at what price.

If there are relatively few assets, the terms of sale can be included in the main outsourcing agreement. Where there are significant assets (or where the transfer process may be complex, such as the assignment of the lease of premises) then a separate business sale agreement should be entered into.

The parties should also plan for the transfer of information from the customer to the supplier. This may take place through staff training sessions, workshops or the physical transfer of documents.

Creation of supplier business units and customer retained organisation

The supplier will need to engage staff, subcontractors and to set up new systems for the provisions of the services. At the same time, the customer will need to restructure any affected divisions and departments. Customers commonly retain core employees to manage the outsourcing services on an ongoing basis or to deal with elements of the services that the supplier cannot. This is known as the 'retained organisation'. For example, if an IT helpdesk is outsourced to an offshore provider, the customer may retain some employees who are able to be physically present at the customer's premises to deal with queries that cannot be resolved remotely.

Testing

Testing is conducted prior to the commencement of the services to ensure that the suppliers systems and procedures are functioning correctly.

The nature of the testing (which may be done in phases in relation to different services or in one go) will depend on type of services being outsourced.

Services commencement

The date that the services go live is a key milestone in the outsourcing process. The services may commence all at the same time or, more commonly, in phases. The phasing may take place in relation to services (or parts of services) or in relation to geographical locations. In multi-jurisdictional outsourcing, each country is likely to have its own services commencement date.

Outsourcing agreements commonly link the services commencement date to a number of important contractual provisions. For example, sometimes service levels will start to be measured from that date (unless the parties have agreed to a 'baselining' period) and the contractual term is often specified as being a number of years from the services commence date. If there is to be more than one services commencement date, the agreement should reflect this by making it clear which particular services commencement date will trigger the relevant time period or obligation.

3. Drafting the transition schedule

The transition provisions of an outsourcing agreement are commonly included as a schedule. Alternatively, they may be set out as an element of the services and contained within the detailed services description.

Although sometimes seen as a commercial document, the transition schedule is critical and lawyers should take the lead in the drafting. Lawyers will, however, need to work closely with their client's commercial teams as much of the schedule will contain commercial and technical content.

Regardless of how it is structured within the agreement, the transition provisions should deal with the follow matters (to the extent appropriate for the particular transaction):

- Transition plan
- Milestones and milestone credits
- Suspension of transition
- Management and reporting

These elements are explored below. Consider also the charges to be paid to the supplier for the transition. These may be included in the transition schedule or in a separate charges schedule.

4. Transition plan

The transition plan describes each stage of the transition process and the date by which it must be completed. It is primarily a commercial document, but lawyer should review it as it will usually form part of the contract.

An example of a simple transition plan is included in our **Precedent:** Transition schedule.

Does a full plan need to be agreed before signature?

Ideally, the parties should agree a full transition plan in advance which can be annexed to the agreement.

Sometimes this is not possible. For example, the size of the customer's business may be such that significant resources will need to be committed to it and the supplier may be reluctant to do this without an agreement in place.

If this is the case, then the parties should agree a high-level or draft transition plan prior to signature with a more detailed plan to be finalised early in the transition process.

What should the plan contain?

Although dependent on the nature of the transaction, transition plans typically cover the following:

- Reference number for each stage
- Description of requirements or services
- Deliverables
- Any related customer dependencies or responsibilities
- Date for completion (see Milestones and milestone credits section below)
- Whether the stage is a key milestone and/or whether failure attracts a milestone credit
- Acceptance criteria

5. Milestones and milestone credits

The transition process is broken down into stages scheduled for completion on or before a specified date. The completion of each stage (or, in some cases, each key stage) is commonly referred to as a milestone, although terminology will vary.

Milestone credits

To motivate the supplier to meet the milestone dates, the agreement may contain a mechanism for the payment to the customer of credits in the event that the relevant deadline is missed. These credits operate in a similar way to service credits and may be deducted from the charges payable by the customer for transition. If there are no transition charges, or if they are deferred until the services become operational, the agreement should be drafted accordingly with payment of the milestone credits also deferred or a right for the customer to invoice them directly.

Care should be taken to ensure that the milestone credits are not held to be unenforceable penalties. To mitigate the risk, they should be structured as adjustments to the price and the wording of the relevant provision should reflect this. The customer should retain any relevant documentation (including board minutes) which demonstrates the calculation of the credits. See further **Practice Note:** Distinguishing between liquidated damages and penalty clauses.

Consider the effect of ongoing delays and whether each milestone will be a one-off payment (regardless of the delay) or a daily amount payable for each day of delay. The latter formulation is likely to be more agreeable to suppliers who will not want to suffer significant financial consequences for what may be a short delay. This may however reduce the deterrent effect of the milestone credit regime.

Milestone credits should be reviewed alongside other provisions of the agreement, particularly limitations of liability. Where the financial cap on the supplier's liability is linked to the amount paid or payable by the customer to supplier, the parties should agree whether the payment of any milestone credits will reduce the supplier's liability (on the basis that the customer has paid less). This point is also relevant in relation to service credits.

Finally, ensure that the parties have agreed whether the milestone credits are to be the customer's sole remedy. In the event that the losses suffered by the customer as a result of the delay exceed the amount of the credit, the customer may wish to bring an action in damages against the supplier. If the parties have agreed wording that the payment of the credit is the sole remedy, then this is unlikely to be possible.

Earnback

Although more commonly a feature of service level agreements, the parties may agree that the supplier can earn back credits paid to the customer if the supplier promptly remedies a failure to meet a milestone. The benefit of such provisions to the customer is that the supplier will have a continued incentive to perform even though it might have missed the milestone.

Using earnback in transition can also help to maintain the parties' relationship at a critical stage. Whilst the customer will want to ensure that the supplier is motivated to perform, it may not wish to impose such stringent financial penalties that its relationship with the supplier is damaged before the services have even commenced.

6. Right of suspension

Due to the potential for transition activities to cause significant disruption to the customer's business, the parties may agree that the customer can require that the supplier stops work while the issues are rectified.

Issues that should be considered when drafting suspension provisions include:

> Can the customer suspend for any reason or must it be able to demonstrate that transition was causing harm to its business?

> What is the impact on the contractual charges during the suspension?

> What happens if the issue cannot be resolved? Customers may want a right to terminate the agreement

For example wording, see paragraph 3 of **Precedent:** Transition schedule.

7. Management and reporting

Close collaboration between the supplier and the customer during transition is vital. Although the agreement is likely to contain general governance and management provisions (including the appointment of contract managers and various supervisory boards), a separate or additional regime should be put in place to manage transition.

Management

The transition management provisions may closely mirror the general management provisions of the agreement. Both parties should appoint a transition manager and the transition schedule should specify their roles and responsibilities and how they may be removed or replaced. Customers should request a right to demand the removal and replacement of the supplier's transition manager if the customer feels that they are not performing to the required standards.

There may be a separate transition board, comprising senior members of the supplier and the customer. If so, the parties should ensure that the parties have agreed and documented remit and mechanics of the board including:

- Who is entitled to attend
- The quorum for valid meetings (usually, at least one person should be present on behalf of each of the customer and supplier)
- How often the board should meet
- Where the board should meet and whether meetings by conference call are allowed
- Escalation of disputes or deadlocks

Reporting

In addition to the routine reporting requirements of the supplier (which should be set out elsewhere in the agreement), the customer should specify that transition-related information is provided on a regular basis. Such information may include the following:

- Details of the daily activities of the transition team
- Progress made against each milestone
- Any issues encountered in transition together with steps taken or proposed to be taken
- Milestone dates that the supplier considers may not be met
- An updated risk register

8. Further Reading

This Practice note forms part our Outsourcing transaction toolkit written and designed by the Lexis®PSL Commercial team. If you are not already a subscriber, you can access the toolkit and much more by taking a free trial by following the links below.