

Truth in Outsourcing

Is that great deal too good to be true?

Outsourcing attorneys help their clients realize legitimate commercial expectations in negotiating (and renegotiating) complex infrastructure service contracts. For end users, outsourcing contracts hold the promise of achieving multiple goals with various downside risks.

Goals include partnership with a specialist to absorb the shocks of technological change, predictable service-level agreements that guarantee a particular quality of service, fixed prices for baseline services, and variable pricing for services beyond an agreed-upon baseline. The downside, however, frequently comes from a mismatch of end-user expectations and a vendor's sales pitch. For that reason, both end users and prospective service providers should explore the concept of *truth in outsourcing*.

Fraud in Outsourcing

There is no truth-in-outsourcing law. There are many laws and unwritten "common laws" relating to fraud, misrepresentation, consumer warranties, implied warranties, and the like. Such laws deal with the

William Bierce is a corporate lawyer in New York City concentrating on technology procurement, outsourcing services, joint ventures, and other complex or long-term business relationships, wbierce@outsourcing-law.com. Contributing editor

Jim Miller is publisher of the *Bio/Pharmaceutical Outsourcing Report (B/POR)*, PO BOX 8163, Springfield, VA 22151-8153, 703.322.4971, fax 703.503.4506, info@pharmsource.com, www.pharmsource.com.

potential for disparity between a customer's legitimate expectations and what that customer feels was actually provided. Once a contract is signed, the law imposes limits on claims of fraud when one party is merely in breach of contract.

Under New York law, for example, a breach-of-contract claim cannot be converted into a fraud claim simply because the other party could not or did not perform up to expectations. Measures of damages in fraud cases involve indemnifying the injured party for out-of-pocket losses, not including any lost profit. In a typical contract, the user's lost profits are similarly excluded.

In fraud, the loss compensable by law is only that caused by a rightful reliance on a misrepresentation by the other party. "Under New York law, a plaintiff must establish that his reliance on the other party's misrepresentation was justifiable, both in the sense that the party claiming to have been defrauded was justified in believing the representation and that he was justified in acting upon it" (1).

In any case of fraud, the person defrauded took the risk because the offer was "too good to be true." To avoid making bad deals in outsourcing, end users must carefully examine whether each service offering is too good to be true.

Truth in outsourcing depends on both parties. Vendors must avoid knowingly making misleading statements. What is said or not said could lead users to unjustified expectations. Yet prudent users must refuse to be fooled by wishful expectations that are not solidly supported by experience in the outsourcing industry.

Risky Business

Four areas in a typical outsourcing relationship pose the greatest risk of disappointment. They involve defining the scope of the outsourcing, identifying methods for keeping the relationship flexible, human resource planning, and managing the outsourcing process.

Truth in scope requires introspection by end users as to the tasks to be outsourced and ability to manage the process after the contract is signed. Outsourcing is most likely to be successful when clients understand both the scope of the work that the vendor will perform and that which the end user will perform. Most clients understand the need to create a monitoring team of senior personnel that specifies the tasks and provides guidance for future mission-critical activities that the vendor can perform. The challenge in successfully defining the scope of work is to identify and plan for the interrelationship of both parties after the contract is signed.

Truth in flexibility requires an understanding of the vendor's limitations relative to change. Typically, outsourcing is successful when the nature of the services provided is predictable, with economies of scale. Flexibility cannot be achieved through outsourcing when too many unpredictable changes occur because changes usually affect pricing and budgets. Flexibility should be built into both parties' obligations, and end users should be realistic about the probability that external environmental changes could require restructuring of service levels, pricing, the scope of work, or even the terms of the contract.

Outlook Commentary

The 2001 POMA Sourcing Survey declares 2001 to be a good year for drug development and manufacturing outsourcing, but predicts that 2002 may not show such robust growth. The Pharmaceutical Outsourcing Management Association (POMA, www.pomasite.com) is a professional group whose members manage the outsourcing processes at many of the world's largest pharmaceutical and biopharmaceutical companies. It has carried out an annual Sourcing Survey since 1999; this year's was conducted in September.

Nearly 75% of respondents reported higher spending in 2001; the comparable figure for the 2000 survey was 90%. Just 45% indicated it had increased by more than 10% this year. Preferred providers (prequalified contractors that have negotiated a master legal agreement and price schedule in advance) are getting a substantial share of outsourcing expenditures. Nearly 50% of the clinical research respondents reported that preferred providers are getting more than 50% of their outsourcing spending. Preferred providers are getting a smaller share of CMC and manufacturing spending, reflecting less mature outsourcing practices in those segments. Overall, 60% of respondents expect their spending to grow in 2002, down from the almost 90% who projected spending growth in 2001 over 2000 levels. Moreover, just 35% of the respondents expect year-to-year growth in excess of 10%, compared with 71% in last year's survey.

Quintiles Restructures

For the second time in 18 months, Quintiles Transnational Inc.

(www.quintiles.com) is restructuring operations as it struggles to climb out of a low-growth, low-margin slump. The company will cut 1,000 staff from its contract sales, research, and software businesses. Other savings will be realized by moving data management operations to lower-cost locations and closing offices where business volume does not justify a permanent presence. The restructuring will cost an estimated \$50 million in 2001, but management expects to achieve annual savings between \$50 million and \$55 million as a result of the changes.

The company intends to put more resources behind its most promising revenue growth opportunities. Those include Phase I testing, clinical trial supplies, and electronic data capture in the product development (CRO) business; gain-sharing arrangements with biotech and specialty pharmaceutical companies; e-detailing initiatives in the commercialization business; and new informatics products.

Quintiles also will expand its program of investing in small pharmaceutical companies through its PharmaBio Development operation. The company has used investment in biotech and specialty pharmaceutical businesses to secure service contracts while positioning itself to share in the upside of successful new products.

Those moves are in response to continued lackluster financial performance in Quintiles's principal operating units. Although its CRO business has returned to profitability after a difficult year 2000, its revenue growth in 2001 is only half what competitors have achieved, and its operating margins have been low. The

commercialization business, which includes contract sales and marketing services, has had four quarters of declining revenues and profits. Finally, revenues in the informatics business, which had been expected to be a major growth driver, have been stuck around \$15 million for the past 10 quarters and generated cumulative losses of \$25 million during the past two years.

Oread Redux

Disposition of documents relating to GMP compliance has become an important issue in the bankruptcy proceedings for Oread, Inc. (www.oread.com). Citing the costs of indexing and storing thousands of documents relating to projects and facilities, the bankruptcy trustee asked the judge for permission to destroy those documents not yet claimed by former clients.

Concerned that their clients might need those documents to support future regulatory filings, attorneys representing sponsors proposed forming a new entity to purchase from the bankruptcy estates all documents relating to the general conditions of the buildings and equipment where tests were performed. The purchase price will include a modest amount of cash and a release from any sponsor claims against the trustee and estates. Documents relating to specific projects would have to be picked up by a specified date; all documents not retrieved by that date would be destroyed.

Interested parties can contact Paul Hoffmann, special council to the bankruptcy trustee at 816.691.2746.

Jim Miller

Truth in personnel requires a sober analysis of the staffing needs for the end user's benefit. In some cases, the speed of technological change suggests that training is best handled by the outsourcing vendor. Frequently, however, it is to a client's advantage to retain and retrain personnel or to give flexibility to certain personnel

(especially government or union personnel) who wish to remain employed by it. Most companies are undoubtedly aware that change in the "knowledge capital" of human resources can be costly, whether it amounts to training, retraining, retaining, or reacquiring skilled and knowledgeable people. Human resources planning is a key

driver for scoping and structuring any successful outsourcing effort.

Truth in postcontract management requires an understanding of the change in roles once outsourcing has begun. After a contract is signed, the vendor will be responsible for providing contractually agreed-upon services. But clients accustomed to

managing people must now measure work performed under contractual metrics. If such metrics fail to anticipate changes in the outputs required for running the user's business, the contract will cause a mismatch of expectations.

End users should not be fooled by "hyper" sales pitches or by the desire to unload all problems on someone else. Outsourcing is no panacea for managing a poorly defined process. Vendors should ensure that their clients' senior management personnel have properly aligned expectations and a willingness to manage toward metrics.

Truth in outsourcing can be achieved only in the context of mutual responsibility for success. Although outsourcing is not a traditional partnership with shared risks and rewards, it certainly depends on constantly working to align expectations and realities with respect and a shared commitment to efficiency and achievement.

References

- (1) *Compania Sud-America de Vapores, S.A. v IBJ Schroder Bank & Trust Co.*, 785 F. Supp. 411, 419 (SD NY, 1992). **BP**