

## Transformational Outsourcing: 10 Best Practices for Enterprise Counsel

Outsourcing has always been transformational, changing the way that enterprises operate to focus on core competencies, improve critical business functions and reduce costs. That has not changed. But what is changing is the use of outsourcing to empower the large-scale migration of applications and data from legacy infrastructure to secure hyperscale environments. This change is being driven by (i) legacy application providers, who are moving away from perpetual software licensing models to as a service delivery models, (ii) enterprise customers that recognize the value of the scale and flexibility of enterprise cloud, (iii) system integrators that have invested millions of dollars into transformational service delivery and (iv) hyperscale providers eager to capture long term consumption commitments. The time is right to transform the digital back-office, and outsourcing is the way to do it.

When taking a decision to outsource, from the choice to replace a licensed ERP system with a cloud-based alternative to a large-scale migration of legacy IT infrastructure to the cloud, there are key legal issues to consider. This article highlights the 10 best practices when advising clients on these projects.

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### **Diligence legacy application contracts**

A migration of legacy applications from co-located servers (i.e., servers owned by the enterprise) to a hyperscale cloud requires understanding what legal constraints, if any, apply to those legacy applications. Those constraints are typically set out in the licensing agreements accompanying those applications. May the applications be deployed on infrastructure not owned or controlled by the enterprise? If code changes are necessary to migrate to hyperscale, are such changes permitted? If a third-party system integrator will be migrating the application to the cloud, may such third parties' access, use and deploy the legacy applications? Undertaking this diligence upfront is critical to ensuring that any long-pole issues related to the migration of legacy applications are identified early and addressed timely to avoid complications. Increasingly, automated tools and databases can support this due diligence – especially where hundreds or thousands of applications are involved. Counsel to any enterprise contemplating such a migration should undertake such due diligence proactively to avoid surprises.

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## New application considerations

In some situations, the enterprise will not be migrating legacy applications to the cloud, but will instead replace those applications with as a service offerings that perform the same or similar business functions. Where an enterprise has already made a long-term investment in a suite of legacy applications, it is important to assess how that investment is going to be protected, or not, when moved to the cloud. The time is ripe to have those discussions early with the legacy application providers, many of whom are already planning to phase out licensed applications with replacement offerings. Enterprises have more leverage now to negotiate with legacy application providers for discounts and offsets to protect those prior investments and to fund the costs of migrating data from legacy licensed software to enterprise cloud than ever before. In addition, by starting early, the enterprise can negotiate protections for the legacy environment in the event of cloud migration delay. Such protections may include rights to continue to obtain maintenance and support for legacy licensed applications and to reinstate terminated licenses in the event of transition delays.

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## Understand the participants

It is critical that enterprise counsel understand who the participants are in the current outsourcing environment. These participants include (i) application providers, both with respect to legacy applications and as a service delivery models, (ii) system integrators that manage the migration of legacy products and databases to the cloud and who may also provide long term support following migrations, (iii) hyperscale cloud providers, who compete to provide the long term, scalable infrastructure to host cloud deployments, intermediaries that help plan and optimize transformational outsourcing projects, and developers who provide new functionality to optimize deployments. These parties have different interests and goals, and it is critical for enterprise counsel to identify and understand these motivations to best align them with the interests of the enterprise.

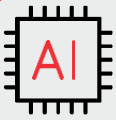
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## Protect long term commitments

To maximize discounts and incentives to fund a transformational outsourcing, hyperscale cloud providers and system integrators may require long term, fixed consumption commitments from an enterprise, similar to the long-term commitments required by outsourcing providers 10 or 15 years ago to fund large scale transitions. These commitments are demanded in exchange for the significant investments being made to fund the enterprise customer's transformation from legacy back-office systems to enterprise cloud. These commitments are typically reflected in long term purchase commitments or service contracts. Counsel for the enterprise must consider how to best protect the interests of the enterprise when making such long-term consumption commitments. Counsel should consider how to protect year over year fluctuations in demand, how to obtain pricing protections for significant increases or decreases in demand, and how to address corporate and business changes that will inevitably arise over the term of a long-term contract. Such protections are available for those who ask, but may not be included in a provider's template documents. The enterprise has more leverage to negotiate those protections before taking its purchase decision, and counsel for the enterprise should address such long-term protections.

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## Guidance regarding use of artificial intelligence

To facilitate and streamline digital transformation, it is increasingly common for system integrators to leverage artificial intelligence and generative artificial intelligence tools in delivery. The legacy outsourcing contracts in place with such system integrators likely say little, if anything, about the use of artificial intelligence tools. In fact, those contracts likely include provisions that do not even consider the potential creation of software by non-human developers. Likewise, many enterprises have or are developing internal guidance about how and when artificial intelligence may or should be used in their organizations. As a consequence, it is essential that counsel for the enterprise understand what gaps, if any, exist in their current master service agreements and address those gaps before entrusting a critical digital transformation project to a third party. Counsel for the enterprise must expect that artificial intelligence tools may be used to deliver transformational outsourcing projects, and should make sure that such use is consistent with the enterprise's AI usage policies.

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## Scope of services

When contracting for digital transformation, it is critical that the enterprise clearly document the full scope of services expected from all parties involved. Possible service scope includes not only application and data migration, testing, and operation, but also application rationalization and simplification. There are also likely long-term support and maintenance and optimization services that must be addressed. Some services may be best performed by the platform provider. The optimal provider for other services may be the system integrator or a third-party consultant. Counsel for the enterprise should understand which party will be responsible for which services, how delays or failures in one area may impact other areas, and whether the enterprise or a third party should be responsible for management of the various work streams and parties involved for a successful outcome.

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## Fees

Fees will depend on the commercial construct of the deal. Fees for implementation services may be contingent on successful delivery, after the achievement of relevant milestones. Alternatively, implementation fees may be deferred or absorbed by the system integrator and recovered during operation. Hyperscale providers may help fund the cost of transformation, through direct compensation to the enterprise or by defraying system integrator costs. Counsel to the enterprise should understand how the transformation is being funded and should ensure that the contractual documents underpinning the transaction reflect the intentions of the parties. Fees for operational services may be payable upfront, and could be invoiced annual, quarterly, or monthly. Where fees for operational services are paid in advance, the pro rata portion of fees not utilized should be refundable in the event of early termination. For long term projects, counsel should understand if the enterprise is obligated to make any minimum annual purchase commitments, and, if so, whether those purchase commitments at risk in the event of transformation delays.

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## Service levels and credits

Service levels document the minimum acceptable level of service, and are a critical tool to align the long-term interests of the cloud provider and the enterprise. Service levels also align the incentives of the system integrator and other outsourcing partners with the enterprise. As in a traditional outsourcing model, service levels should be aligned with the business objectives and desired outcomes of the enterprise. In addition, in a transformational outsourcing that includes a migration to third party cloud infrastructure, the ownership and operation of the underlying technology supporting the enterprise's business may pass from the enterprise to a third-party system integrator or cloud platform provider. Counsel for the enterprise should understand what underlying infrastructure service levels are being measured, which party is responsible for measuring and reporting compliance, and what the consequences of service level failure are. In a long-term sourcing contract, service levels and service level credits are intended to help align the interests of the enterprise and the service provider. They also help preserve the leverage and negotiating power of the enterprise following migration of the services to the third-party provider.

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## Intellectual property

In a transformational outsourcing engagement, enterprise counsel should understand how intellectual property rights are allocated between the various parties involved. As already noted, counsel must validate that the enterprise has appropriate rights to make third party applications available to system integrators and cloud platform providers. Counsel must also determine whether such parties may be permitted to modify or amend such third-party products, and, if so, how intellectual property rights in such modifications must be allocated. Likewise, counsel must verify that rights in pre-existing intellectual property and newly developed intellectual property are appropriately allocated between the parties. Typically, all parties retain their rights in pre-existing intellectual property. Intellectual property developed by a service provider in the course of supplying services or deliverables to the enterprise and that has been paid for by the enterprise, such as developed software, web materials, data, literary works, and other works, is often intellectual property that the enterprise negotiates to own. However, in a highly leveraged delivery model, service providers may insist on owning developed intellectual property in order to re-use such intellectual property on other accounts. It is important that in such instances, that the enterprise acquire, at least: (i) broad license rights in respect of the developed intellectual property to use such intellectual property as intended by the enterprise; (ii) protections over any customer data or confidential information used in the development of such intellectual property; and (iii) the right to prevent the reuse of sensitive information. In addition, enterprise data may be proprietary or otherwise confidential or may be subject to privacy laws. Service providers may seek broad rights to access and use such enterprise data, beyond the access and use strictly necessary to provide the services. Such usage may not be appropriate, and enterprise counsel must be diligent in ensuring that any usage rights provided to partners are appropriate and made in compliance with applicable law.

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## Suspension/termination

The cloud provider may insist that it has broad rights to suspend or terminate access to the cloud platform to safeguard its infrastructure and other customers from the potential implications of a security threat associated with the enterprise's access to the services. In many cases, though, the service provider's right to suspend the cloud services may be qualified or subject to reasonable notice. The enterprise should consider what assistance might be required from the service provider if (i) the transaction is terminated before the implementation services are completed and accepted, or (ii) the transaction is terminated after acceptance of the implementation services while operational services are being provided. In any event, the operation of the enterprise's business should be protected. The enterprise should have the right to transition applications and enterprise data back the enterprise or to a third party. Negotiating appropriate exit and transition assistance provisions at the outset of the transaction is critical to protecting the long-term interests of the enterprise in a transformational outsourcing engagement.

While outsourcing has always been transformational, the current trend towards longer term deals as a means of financing material changes in the technology underpinning the enterprise raises significant legal risks. Counsel for the enterprise must anticipate these risks and take proactive steps to mitigate them. The best practices identified above are intended to help enterprise counsel understand what is driving today's trends, who the parties are behind these trends, and best practices for identifying and resolving these risks.



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