

# The outsourcing contract



One of the critical tools for both DC plan sponsors and their outsourcing providers is the outsourcing contract. The contract serves three purposes. First, and perhaps most important: During the process of negotiating the terms of the contract, the sponsor and the outsourcing provider can clarify the terms of their relationship. Second, the contract serves as a guide to “who does what” – a roadmap for the outsourcing relationship. Finally, a well-written contract should describe how any disputes between the parties will be resolved.

## Style

Before we discuss the substance of the outsourcing contract, a brief note about style: Different firms favor different approaches. Some favor highly detailed rules and definitions often accompanied by copious legal jargon. Others prefer plain English.

Both approaches have their virtues. But given the importance of the day-to-day operations of an outsourcing relationship and the interaction of sponsor and outsourcing provider officials, an outsourcing contract should at minimum be *useable* by the non-lawyers who have to make that relationship work. The use of technical, non-intuitive legal terms should, generally, be limited. Indeed, ideally the business operations people who will be living with the outsourcing relationship should be significantly involved in contractually defining it.

Such a business-driven approach will not only make the contract easier to understand; it will also make it more likely that, when problems arise, there won't be a wrangle over contract language but rather a solution generated by those with their hands on the practical issues.

Whatever contracting style is used – technical or plain language – sponsors must be comfortable that they understand clearly what they are getting and what they are giving up. Thus, the most important “style” objective is *clarity*.

## The keys to an effective outsourcing contract

To be an effective “roadmap for the relationship,” a contract must lay out exactly what elements of the program are outsourced, which functions are delegated to the provider and which are retained by the sponsor, and what other services may be provided. This is critical, both legally and practically.

Effective delegation under ERISA requires explicit transfer and acceptance of fiduciary duty. Setting clear expectations for roles and responsibilities is essential as the basis for accountability.

## Defining the assignment

There is a temptation, in defining an outsourcing assignment, to immediately start with the issue of ERISA fiduciary status. While this issue – whether the outsourcing provider is an “ERISA fiduciary,” and for what functions – is critical, beginning with it can result in a contract that is driven by legal, rather than business, issues.

Outsourcing assignments usually include a combination of discretionary management and expert advice, along with other services or information that may or may not fit the ERISA definition of “fiduciary.”

Rather than getting sidetracked by issues of ERISA interpretation, it is generally more effective to start by first defining the parties' actual, “real life” roles – what they are actually going to do – and then decide for which of those purposes the outsourcing provider is going to carry the “fiduciary” label. Having business officials (rather than lawyers) at the sponsor and outsourcing provider organizations spell out their operational responsibilities encourages them to develop the procedures, controls and reports that will make the contract work and not be just something that lawyers haggle over and then put in a drawer, never to be looked at again.

Thus, the focus of contracting should be how the two parties will operate together, not who has which rights when they sue each other.

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All of that said, there is one critical, technical “i” to dot: If the outsourcing provider is to serve as a fiduciary with respect to a particular function, it should explicitly acknowledge that it is doing so – that it is an ERISA “fiduciary.”

## Getting clarity about how the provider will be paid

The *alignment* of the interests of the outsourcing provider and the sponsor is absolutely critical in any outsourcing relationship. The contract cannot spell out every single action the outsourcing provider must take. The sponsor must have confidence that, when the outsourcing provider makes a judgment call, that call will be made in the interests of the plan and plan participants.

A critical element of alignment (perhaps *the* critical element) is how the provider will be paid. The contract should include a clear, understandable fee section, with supporting representations.

In some arrangements, getting “clear and understandable fee disclosure” may be relatively easy – it may simply involve a specification of an assets-under-management fee and a representation that there is no undisclosed compensation. As arrangements become more complicated, however, achieving clarity and understandability can be more challenging. In these cases, stick to the fundamentals: plain English and careful review by the sponsor.

## Providing a clear standard of care

Sponsors should expect that an outsourcing provider will stand behind its work, regardless of whether, for ERISA purposes, it is a fiduciary. For functions that are fiduciary by definition, the standard of care is set by ERISA. But that does not mean that where the provider is not a fiduciary there is no standard. The contract should spell out exactly what that means. Typically, the standard of care and any related limit on the damages the sponsor may seek are more important than the indemnification provision (which often just establishes a right to attorneys’ fees). And, with respect to the issue of remedies, a critical element may not always be the sponsor’s ability to sue, but rather the provider’s ability to pay.

## Rules for partners

A healthy outsourcing relationship should be a partnership between the sponsor and the outsourcing provider. The critical elements of the outsourcing contract are that both partners understand their roles and expectations of what they are to do; that the compensation supports the alignment of the interests of the outsourcing partners; and that the outsourcing provider stands behind the services it is delivering. If the contract is clear on these points, then the rest is a matter of business and operations people at the sponsor and provider organizations determining how they will work together.

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## About Russell Investments

As a leading provider of outsourced investment solutions, Russell Investments understands that as DC plan sponsors explore fiduciary outsourcing, they need to fully understand what can be outsourced and how outsourcing works in practice. Russell Investments has partnered with retirement plan expert Michael Barry, a nationally recognized ERISA expert, to bring you a series of papers on DC plan outsourcing.

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