

MISQ Archivist

Optimal Asset Transfer in IT Outsourcing Contracts

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Abstract

Many IT outsourcing arrangements include the purchase of the client's IT assets by the vendor. Asset transfer benefits the client who can recapture some value through the sale and may even negotiate a lower price because the vendor may be more efficient in using these assets. On the other hand, asset transfer creates lock-in for the client and limits future contractual options. To study these tradeoffs, we develop a game-theoretic framework wherein asset transfer creates a one-sided switching cost to the client, and vendors have private information both on their intrinsic capabilities, either high or low, and on the level of quality-improving effort they exert. The quality of IT services depends on the vendor's capability and quality-improving effort. In a two-period model, we show that when quality is verifiable, the client uses asset transfer as a device to design efficient screening contracts, so that a high capability vendor is selected. On the other hand, when quality is non-verifiable, the client mitigates contractual inefficiency by voluntarily locking into a long-term relationship with the vendor and may transfer assets at a lower than efficient level, even to a high-capability vendor. Our results show that asset transfer can play a strategic role in outsourcing relationships, not just an operational one.

Keywords: Adverse selection, asset transfer, IT-services, outsourcing, monopolistic screening, non-verifiable quality