

Outsourcing, at home and abroad

OUTSOURCING IS *IN*.

Believe it. If they aren't already doing it, most corporate clients have at least considered outsourcing. For attorneys with clients in service or manufacturing industries, understanding the concepts and complexities involved in this increasingly common business practice is essential. Working with a client through the development and execution of an outsourcing arrangement often requires experience in both complex licensing and contractual matters.

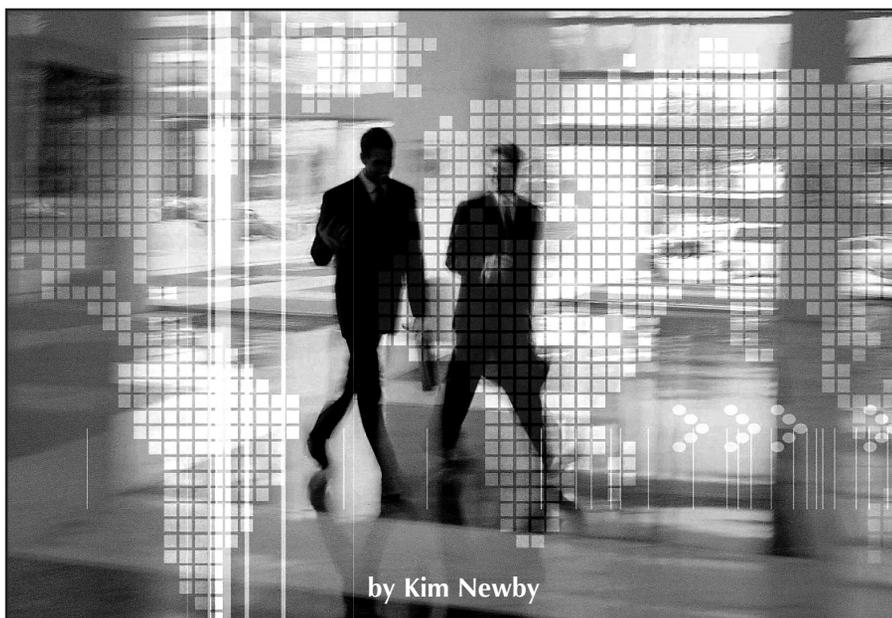
However, introducing a client to the main issues involved in outsourcing does not require specialized legal skills and is something most corporate lawyers should be prepared to do.

What is it? Outsourcing is defined as the process where one party contracts with a second party to provide services that traditionally were handled internally. Outsourcing occurs both domestically and internationally. Recently, outsourcing of services and manufacturing to China and India has received significant press, making it seem as if the practice were a novel one. However, domestic outsourcing has been a common business practice for

decades. What has changed is the proliferation of services and activities that companies of all sizes are delegating to outside sources. Whether down the street, across the country, or across the

call centers, employee benefits programs, employee food services, janitorial services, and computer systems support. Typically, these are not considered revenue-producing activities by the delegating company.

Outsourcing certain operations also may allow a company to access a higher quality of these operations than it could afford to maintain internally. For example, a company that outsources its software licensing through an application service provider can utilize cutting-edge appli-



by Kim Newby

world, transferring control of inside processes to outside parties is a robustly growing phenomenon.

Why do it? Companies choose to bring in a third-party service provider for many reasons. Contrary to popular opinion, the motivation isn't always just to find the lowest-cost provider. The decision to outsource often occurs after a company has undergone a comprehensive examination of its operations and business strategies. Some organizations then decide to delegate processes not directly relevant to their core missions in order to focus and reinvigorate these missions. Examples of non-core business functions include handling customer

cations as required, minimizing the capital outlays and risks involved with designing, purchasing, and integrating new systems and programs. Moreover, the resources that would be devoted to training information technology staff are reduced. Thus, for companies with limited capital, outsourcing technology and computer systems can make state-of-the-art services available at a fraction of the cost needed to purchase such systems.

If a company's plan for strategic growth includes a new area of business or support, outsourcing can play an important role. Through outsourcing a company could, for example, have

customer web and telephone support established relatively quickly at a fraction of the cost and effort it would take to develop such systems internally. This strategy makes sense for many smaller companies intent on growth but lacking immediate manpower and capital resources.

Many such considerations entice businesses to pursue outsourcing. Nevertheless, businesses should be advised of outsourcing risks and alternatives, particularly with offshore options. Due diligence is critical in these situations. Not only must the client know the outsourcing company, but he or she must also fully understand the political, economic, and legal environment of the country where the outsourcing will occur. For clients with sensitive intellectual property, an attorney should advise against outsourcing to countries with high rates of piracy and poor records of enforcing intellectual property laws. Clients should also be advised of the range of non-outsourcing options available to achieve their goals. Developing internal corporate resources, establishing joint ventures or partnerships, and setting up wholly-owned foreign entities are all paths that can be taken instead of, or in conjunction with, outsourcing arrangements, and it is

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important for the client to consider all options before making a final decision on outsourcing.

What gets outsourced? Generally speaking, outsourcing is undertaken to streamline business operations. Successful outsourcing arrangements will help a business reallocate risk, increase efficiencies, and concentrate on activities that generate the most value for the company. In this context, practically any activity can be outsourced. Currently, the most popular outsourced activities are in the areas of information technology, business processing, professional services, and manufacturing.

Information Technology Commonly outsourced functions in the area of information technology (IT) include software development, computer systems maintenance, computer software deployment, and software administration. Last fall, the Dutch bank ABN Amro announced one of the largest and most comprehensive IT outsourcing arrangements to date. For the next five years, this banking giant has contracted with five outside companies to handle nearly all of its IT services. IBM was hired to manage the majority of the bank's computer systems. Other companies were hired to support and enhance the bank's software applications and develop new ones. For these services, the outsourcing companies will receive \$2.2 billion.

Business Processing Commonly outsourced functions in the area of business processing include customer billing, call center operations, order fulfillment, recruitment and staffing, payroll management, and employee benefits administration. These are necessary functions that support the strategic goals of a company but do not necessarily impact a company's market

position or bottom line. Call centers are the outsourcing activity with which most consumers have had contact. Given the high number of educated English-speaking persons in India, many large companies (including Dell, Intuit, and Sony) now route their customer service calls through Bangalore, New Delhi, or Hyderabad. However, there also is a growing trend in "homesourcing." This is the practice of hiring stay-at-home moms, retirees, and other at-home workers in the United States to answer customer service calls (in the case of companies such as J.Crew and Office Depot) or reservation inquiries (in the case of companies such as Wyndham Hotels and JetBlue). This practice is popular with companies committed to keeping these jobs in the United States and wary of the adverse effects of having non-native speakers answering their customer calls.

Professional Services Commonly outsourced functions in the area of professional services include the roles of tax advisors, legal compliance officers, medical laboratory technicians, and product designers. In addition to finding domestic sources for these services, many companies are now looking geographically much farther for skilled resources. India has excelled in producing many high level professional outsourcing services. The Indian IT outsourcing and product engineering company HCL has established itself at the highest level of outsourcing services, winning a contract to design the backup navigation systems for Europe's Airbus aircraft. The Indian outsourcing company Tata Consultancy Services was recently hired by an Italian biotechnology company to identify organic compounds for use in pharmaceutical development. Other

English speaking countries, such as South Africa, Ireland, and Canada, also offer attractive opportunities for professional service outsourcing. However, investment incentives and tax breaks are necessary to make the relatively high cost of labor and resources in these developed countries competitive with their Indian counterparts.

Manufacturing The history of manufacturing has always involved movement from higher to lower cost areas of production. American factories have migrated from northern cities to northern suburbs, then to the South, then overseas. This evolution was driven by a continual search for low-cost manufacturing. Although many companies in Maine would prefer to keep operations in the state, globalization often provides the lowest manufacturing costs. Companies must therefore operate on a global scale even if goods are sold locally. The case for manufacturing in a foreign country can be even more compelling if a company sees potential sales growth in that country. Low labor costs in Eastern Europe or Asia combined with a target growth market in the same region could be a weighty factor in the decision to relocate manufacturing capacity abroad.

The Legal Components of Outsourcing Arrangements Once contacts are established, due diligence satisfactorily completed, and letters of intent signed, the client is ready to negotiate an outsourcing agreement. What are the next steps in making the arrangement work?

Fitting all the Pieces Together It is the attorney's responsibility to recognize the various components of the business arrangements contemplated by an outsourcing transaction. The deal should be broken down into its compo-

nent parts, with an understanding of the legal considerations that need to go into each part. In an offshore manufacturing arrangement, for example, the attorney should consider technology licensing, trademark licensing, the manufacturing process, and distribution arrangements. For each functional component, the attorney needs to determine what contracts should be prepared, how to structure and inter-relate the contracts, and what laws will apply.

The attorney also must determine what cannot be outsourced. For example, the client's licenses with software vendors or other third-party providers may have restrictions on transferring rights to an outsourcing entity. If such contractual restrictions are in place, the attorney must ensure that waivers or transfer rights are secured prior to entering into an outsourcing arrangement involving licensed assets.

Scope of Services One of the most important and time-consuming aspects of developing an outsourcing agreement is defining the scope of services. A statement of work will often be incorporated in the outsourcing agreement to specify in great detail the scope of work to be performed and the manner in which it will be performed. When a series of future projects are contemplated as part of the outsourcing arrangement, the attorney should ensure that the parties agree upon the form of the statement of work to be utilized for each individual project as well as methods for changing the statement of work as the project progresses.

For projects that involve creating definable deliverables or completing a concrete project, the attorney should negotiate progress milestones to enable each party to monitor the progress of the

work being performed and determine when a payment is justified. In addition to developing understandable, objectively measurable milestones, remunerative consequences for failing to meet a milestone must be included in the agreement.

For outsourcing arrangements with a service component, the service level agreement (SLA) is the key document. SLAs define performance and success under the outsourcing agreement and lay out concrete remedies for performance failures. In order to arrive at an SLA negotiating position, the client should perform internal audits of its current service levels and determine its requirements in this regard. Once these requirements are known and put into the outsourcing agreement, the attorney should ensure that the SLA provides detailed and objective standards by which both parties can measure the delivery of services against these requirements. Complex performance matrices frequently are negotiated and technical details are typically included in the SLA.

Clarify Rights and Ownership All outsourcing arrangements should include clear provisions regarding ownership rights. If no one document covers this topic, then the attorney should prepare a separate agreement to address this. The attorney should protect a client's technology and intellectual property by specifying the precise manner in which the outsourcing partner may use a client's trademarks, patents, and copyrights. In addition, the attorney should address who owns the rights to any technology or intellectual property that may be developed during the outsourcing relationship. When working with overseas parties, the attorney should research local laws relating to independent contractors and ownership of developed work product.

The attorney should prepare all contracts to correct any default provision under local laws that might transfer the rights in any such work to the foreign entity. Finally, trade secrets must be addressed in the outsourcing agreements if the client anticipates disclosing them.

Outsourcing companies often work for many customers in the same industry. Therefore, it is possible that one outsourcing company may be providing the same or similar services for several competing customers. In such a situation, to protect the client's competitive position the attorney must negotiate restrictions on the use of the client's intellectual property, confidential information, and market strategy, and include practical and appropriate remedies in the event of breach.

Additional Concerns in the International Context There are special issues that arise in the international outsourcing context. For example, many countries have regulations pertaining to transfer and control of data and protection of consumers' personal information. As with all international transactions, export controls on dual-use technologies, adherence to the U.S. Foreign Corrupt Practices Act, and other U.S. and foreign trade- and investment-related law may apply. When considering the client's vendor relationships in the outsourcing context (for example, when a client outsources IT services which require access to the client's licensed software programs) the attorney must examine the client's existing contracts for any geographic limitations on licenses, warranties, or indemnifications.

Standard Clauses Need Extra Care As with any complex transaction, outsourcing (particularly offshore outsourcing) requires that the attorney give standard business and boilerplate

clauses extra consideration. Do not rely on standard confidentiality provisions and non-competition restrictions to cover the complexities involved in an outsourcing arrangement. Careful crafting of intellectual property representations and warranties, limitations on liability, and indemnification provisions is imperative to reflect precisely the nature of the outsourcing relationship. The attorney should attempt to negotiate liberal rights for the client to terminate an unsatisfactory outsourcing relationship. Any such agreement should require that the outsourcing partner assist with transition of services to another vendor upon termination of the original agreement. As with general subcontracting agreements, the attorney should clarify any rights to assign or subcontract work to third parties. Finally, the right for a client to revisit key issues in the documents and make appropriate adjustments is particularly important given the nature of fluid outsourcing arrangements.

More to Come Outsourcing is a growing trend and new sourcing solutions are constantly emerging. The expansion of web-based outsourcing and the increased scope of outsourced professional services are just two examples of emergent areas. Whether outsourcing takes place at home or abroad, these are sophisticated arrangements that offer corporate clients opportunities to grow and develop their businesses in ways not previously contemplated. Corporate lawyers should anticipate their clients' needs in this area. By understanding the driving forces behind a decision to outsource and knowing the main components of an outsourcing arrangement, a general corporate attorney will be prepared when a client raises the question of outsourcing. ▀

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