

Outsourcing Contracts Insights

This paper is intended to raise the awareness of law firms and legal departments of the issues they need to address while writing an outsourcing contract. These contracts can be classified into two broad categories – IT outsourcing and process outsourcing. There is significant overlap between these contracts, but there are also significant differences which are described below.

IT OUTSOURCING

Turnkey or ongoing outsourcing contracts are billed on a time and material basis. Hourly rates and delivery schedule are agreed upon, and the agreement is signed with specific clauses important to both parties. IT contracts can be project- or process-based. Process-based contracts are discussed further in the Process Outsourcing section below.

Due diligence on the vendor or client is very important. This research can provide information regarding whether the company is registered in US and whether it has a valid tax ID. Lexis or other databases can also report yearly income of the company and the date of initial registration. And, of course, you will want to be on the lookout for any recent news regarding the credibility of the company.

Typically, lawyers suggest that customers initiate the contract, but since contracts are drafted on a regular basis by vendors, most contracts ends up being drafted by those vendors, and reviewed and signed by the customer. Whenever possible, contracts should be initiated the customer.

Any high-risk or high-value IT contract should address the following topics.

Jurisdiction or Governing Law

In outsourcing, it is important to know where the work will be performed. Depending on the location and the legal status of company in the U.S., the client's attorney must propose jurisdiction. If the outsourcing company is foreign-based with no U.S. legal presence (no legal entity or tax presence), the company should employ attorneys knowledgeable in these types of contracts. It is preferable to have the outsourcing vendor's presence in the U.S. Even more preferable is they be in the same state. If the states are different, then the governing law and jurisdiction should be clearly defined in the contract. Different states in the U.S. deal differently with jurisdictional issues, so state laws should also be checked.

Scope of Work

Scope of work (SOW) is very important and should be drafted with extreme attention to detail. The entire process and the work to be performed should be cleared defined. This is usually done by the customer's IT manager. If the scope is not properly defined, all other clauses become ineffective as the SOW guides the entire contract. Define whether *all* individual tasks are captured, the *end result* is captured, or the *skill level of resource* is captured, among other things.

Confidentiality and Nondisclosure

A confidentiality and nondisclosure clause is common, but given the kind of work being performed it should be modified. For example, the confidentiality requirements of someone working on building a database for beer producers should be different from someone working with social security data. The customer and vendor should do due diligence to find out whether the confidential information already exists in the public domain and structure the clause accordingly. There should be binding clauses on use of confidential information for the vendor.

Nondisclosure is especially important for customers who fear losing their information to their competitors. Sometimes it is not in the best interest of the customer to disclose the terms of an agreement, such as pricing, to the public.

Intellectual Property

Intellectual property clauses have become increasingly important for technology, research, innovation and discovery companies. Ownership clause of intellectual property should be included in outsourcing contracts. Any discovery or idea generated while working on client's time should belong to the client. For example, if the vendor is developing a knowledge management database for a law firm, and they discover a way to structure the database which gives them a competitive edge, or write a program which searches relevant cases across multiple documents quickly, that code or method should belong to the law firm.

Warranty, Indemnity and Limitation of Liability

Both parties should limit their liabilities to the task at hand. Some liability clauses state: "Under no circumstances will either party's aggregate liability arising under this agreement exceed three months of revenues in U.S. dollars." The client should indemnify the vendor of any third-party liabilities and in any actions taken by vendor on behalf of client.

Service Level Agreements

Service level agreements (SLA) should exist to make certain client and vendor expectations are clearly defined. Quality and delivery concerns should be memorialized, as well as mutual agreement on the terms. We have seen the downside of not having an SLA and the downside of having an SLA that is difficult to enforce. Care should be taken to keep reasonable margins, as there is always a margin of error. When writing an SLA for new and complex projects, we know that the first draft is usually written and signed without the complete understanding of the process and technology. For this reason, we always have a 3- to 6-month renewal clause. For example, if the parties agree on certain quality standards and delivery schedules and these are not met, it is reasonable to expect that the deadline will not be met. A renewal clause will help fine tune this process. It is good to set high expectations in the agreement, but it is also important that these expectations be realistic.

Pricing and Payment Terms

In the outsourcing industry, commitments run back-to-back. This means that when a client commits to the vendor, the vendor makes a commitment to its resources. If the payment terms are not clearly defined and followed, the relationship will likely suffer.

There are several pricing models in the outsourcing industry: fixed-price; time and material; or performance-based. There can also be combinations of these models. Fixed-price contracts are generally turnkey projects which time and resources can be reasonably assessed. Time and material contracts are used in process outsourcing when the vendor is supporting a process and has demands for scaling up or down. It can also be used for lengthy IT outsourcing contracts or contracts where the client is managing the IT project. Performance-based contracts are used in call center operations, sales-related functions, data entry and generally in repetitive manual work.

Dispute Resolution

In the case of a dispute, a dispute resolution clause outlines the approach the two parties will follow in order to come to a consensus. Usually companies decide to go to arbitration before going to court. A lawyer with expertise in this area should be hired to draft this clause.

PROCESS OUTSOURCING

The main difference between IT and process outsourcing regarding contracts is that process outsourcing **is** mission critical for an organization and IT outsourcing may or may not be mission critical. Process outsourcing contracts are generally long-term. IT projects have a requirements gathering phase, ongoing communication to define the requirements and deliver, and a final delivery date. However, some IT projects can also be mission critical. For example, outsourced helpdesk service for a company is mission critical. Most processes have an hourly/daily/weekly delivery schedule and because of this, a delivery and quality clause is essential.

Below are clauses that should be considered in a process outsourcing contract in addition to the IT outsourcing clauses.

Detailed Scope of Work

The client and vendor need to make certain they document the process, systems, handoffs and feedback loops. The best practice is for the vendor to study the process to be outsourced, document it and present the results to the client. Documentation is not an easy job, and that is what differentiates a good contract from a bad one. Documentation has to be very detailed – if possible, every small task, system interface, and handoff should be captured. Study of the process also determines the performance matrix that the vendor and client may decide to follow. This performance matrix ultimately determines whether the client's cost and efficiency objectives are met. We have come across situations where clients do not want to disclose their entire process and this lack of transparency is against the interest of the client in a process outsourcing deal. We strongly encourage potential clients to share as much information as possible to enable a smoother operation and high quality delivery.

Duration

The duration of contracts for process outsourcing is generally six months or longer. Typically, it takes a couple of months to arrive at a steady state in process and quality. Consequently, duration is an important point. If the duration is short, the vendor might not be able to offer a good price. Vendor commitment is based on contract duration – the longer the commitment, the better the price.

Termination Clause

In process outsourcing, an early termination clause is essential. Early termination of a project can mean the vendor has to terminate some staff or maintain others who are “on bench” (waiting for next project). It is only fair that the vendor expect some compensation for early termination. This should be clearly addressed and agreed upon in the contract.

Escalation Procedure

Well-written contracts by experienced contract attorneys include the escalation procedure in the event of a dispute. It generally outlines the management hierarchy regarding who will negotiate and ultimately resolve any conflict.

Data Security

We find instances of these types of clauses increasing as companies rely on data communication and do not want to lose any proprietary data. Strict guidelines should be established so vendors use the necessary communication infrastructure, including firewalls, encryption, secure data transfer over the Internet and other protocols to guarantee security of confidential data. Existing data security laws include: HIPAA; GLB; COPPA; FTC § 5; Cal. SB 1386; EU Data Protection Directive; and non-U.S. data protection laws.

Subcontracting

Certain smaller vendors might be tempted to further subcontract to another vendor. The motivation might be to increase the margin, unavailability of resources within the company or ease in subcontracting. The client should be aware of this and include language preventing further subcontracting.

Ethics and Sarbanes Oxley Compliance Requirements

Many process outsourcing vendors provide training on ethics. This has become more important as U.S. corporations have faced tough scrutiny over the issue of ethical business practices. It is important to have a vendor who is aware of the general business practices and extends the same ethical practices to its offshore location.

Sarbanes Oxley requires that all processes be documented and evaluated periodically for compliance with accounting principles (GAAP, FASB, etc.). All processes can be audited for compliance and for that reason, outsourced processes have to be treated as any other in-house process. The vendor, therefore, is usually required to follow the guidelines established by *Sarbanes Oxley* and the ethical standards followed within the

client organization. Essentially, this means that the internal control functions of the company should encompass the outsourced process as well. Attorneys working on high-impact and high-value outsourcing contracts should research all public company regulations and all industry sector regulations. Sources to keep track of are PCAOB releases, SOX section 404(A) and 404(B), AU324 and other state-specific regulations.

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