

MORRISON & FOERSTER WHITE PAPER: OUTSOURCING IN 2008

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Introduction

The October 2007 Outsourcing Institute Roadshow in New York, was hosted by the law firm, Morrison & Foerster. During a panel discussion on cross-border and global sourcing transactions, “*Going from Good to Great on Cross-Border Deals*,” a panel of Morrison & Foerster attorneys from the United States, Europe, and Asia (including John Delaney, Vivian Hanson, David Skinner, and Nigel Stamp) described a trend toward an expansion of offshoring to Asia, and predicted that Europe is becoming an engine for outsourcing growth. For the most part, these trends have developed over the course of 2007 and, in our view, will continue to develop in 2008, implicating a number of key issues requiring intelligent and informed legal decision-making.

Asia

The success of Indian-origin service providers is a mega-trend of the past decade. Most of the main Indian vendors reported strong earnings and growth for 2007. In the U.S., direct offshoring to India is still a prevalent norm, especially in light of customers’ increasing comfort with Indian vendors due to such vendors’ technical sophistication and English language capabilities, and the broad similarity of Indian and U.S. legal structures.

The continued development of best-of-breed service offerings as an alternative to global mega-deals, combined with current market trends, could leave Indian vendors in an even stronger position than in the last few years. Additionally, native Indian businesses have begun to discover outsourcing, fuelling a growing Indian domestic outsourcing market. But given rising costs in India, cost squeezes could give a real opportunity to other, cheaper offshore jurisdictions. The question is: are those other jurisdictions—particularly China—ready to ride this wave, or will they have to wait for the next one to come along?

2007 saw more work being done in China, although at a modest rather than dramatic rate of increase. Although there has been resistance to outsourcing in Asian markets, there is talk of China becoming the “new India,” particularly in the financial services industry. We expect the growth of sourcing from China to continue in 2008, and probably at a moderately increased rate. Most (but not all) work is being done by lower-cost Chinese subsidiaries of major Indian service providers, rather than by indigenous Chinese service providers. Such deals have proven unwieldy, however, often requiring tripartite agreements between an Indian vendor, its Chinese subsidiary, and a U.S. customer in order to ensure enforceability of the master contract *vis-à-vis* the subsidiary.

Although China does still have clear cost advantages (in particular for application development and maintenance [ADM] work), costs are rising, especially in the major centers on the east coast of China, as major Indian service providers have discovered. Nevertheless, the combination of a weakening U.S. dollar, growing fears of a significant U.S. economic slowdown, a growing confidence in and familiarity with China, and the continuing cost advantage, have still resulted in the main Indian vendors re-routing work increasingly to lower-cost jurisdictions, and in particular their operations in China, as part of their global service delivery model. This trend will likely continue in 2008.

One commonality between India and China is the establishment of captive outsourced entities—i.e., wholly owned outsourcing subsidiaries of large corporations. Such entities have long been a familiar part of the Indian outsourcing scene, and are becoming increasingly common in China. In many cases, these have come full circle and been floated or sold off (e.g., WNS, Genpact). As familiarity with the legal and commercial issues in China increases, mechanisms have been developed to minimize the perceived risks involved. In Asia, we have tracked the development of the captive (or quasi-captive) sourcing model to contain these risks, with several multi-national corporations with operations in Hong Kong and elsewhere in Asia either setting up their own sourcing operations in China, or funding a third-party service provider in China, directly or indirectly, who then has that company’s Asian (and sometimes global) operations as its primary, if not exclusive, customer. This trend will continue this year.

Europe

Late last year, we said that “continental Europe will be an important driver of new deals.” And so it has proved. The sleeping giant on the demand side, continental Europe, has woken up. 2007 saw a marked increase in the European market, and the level of its increases outstripped all other regions. One of the leading outsourcing consultants, TPI, reported that in 2007, Europe outpaced the United States for the first time for IT outsourcing.

From conversations with our clients, we believe this trend will continue in 2008, possibly with fewer mega-deals, but growth will be fueled by “domestic” European deals and the European elements of global deals. Since any economic slowdown in Europe appears likely to be less marked than in the U.S., as the market continues to mature we would also anticipate a move up the value chain to see deals with primary drivers other than cost. However, in light of economic conditions, cost may remain the key consideration for some time to come, with the evidence suggesting that maturity will be delayed until the next cycle when cost is less important than improved service.

While not having the same headline-grabbing power as Indian offshoring, outsourcing to countries in Central and Eastern Europe (CEE) has continued its steady growth, and further developments in 2008 should be expected. The growth in this market is partly customer-driven (i.e., by German, Dutch, and Scandinavian customers who feel comfortable with the culture and language skills of the Czech Republic, Romania, Estonia, etc.) and partly service-provider-driven (i.e., by large service providers who have invested heavily in facilities in CEE states [e.g., IBM in Prague and Poland, Accenture in Romania] and want to see those facilities operating at maximum capacity). As continental Europe increasingly gets the outsourcing bug, the proximity and cultural affinity to CEE states will help to fuel growth in those countries.

Key Issues and Strategies

1. Centralized Enforcement:

A key question in multi-country deals is whether centralized enforcement of the terms of an outsourcing contract is ideal, or whether decisions regarding everyday operations

should be left to local management's discretion. The answer to this question will depend in part on a variety of factors, including (i) how the vendor is actually providing services to the customer, (ii) the customer's organizational structure and requirements and (iii) whether any legal considerations apply. If the customer's organization is decentralized, local direction might be the best approach. In contrast, if a customer is seeking to take advantage of economies of scale offered by a centralized solution, such a centralized approach may be preferable. Another key question will be whether a customer will want to preserve the right to directly enforce a contract against a local entity—for instance, with respect to IP claims. If so, depending upon the legal requirements of the local jurisdiction, the customer may need to require that the local vendor entity directly enter into a particular country.

On the vendor side, one question will be whether the vendor is organized in a fashion that allows provision of centralized management. In some cases, the local operations of the vendor are operated separately (for example, under separate P&Ls), thereby making each such operation a subcontractor to the contracting vendor entity. In this regard, one of the key issues in multi-country deals is whether the contracting parties under a master service agreement would be liable for all obligations under the multi-country transaction or whether liability would be compartmentalized on a country-by-country basis. Deals governed by a single master agreement may be easier to manage, and it is quite common to see such agreements used to deal with global issues such as pricing and risk. At the same time, local agreements are used to set out the local scope and local issues (e.g., employment issues). Although the utility of such a master agreement will ultimately depend on the goals of the underlying outsourcing arrangement and the work to be performed, such agreements offer customers a variety of potential benefits, including centralized management, centralized enforceability, and aggregated liability limits.

2. Risk Allocation:

Another key concern in multi-country outsourcing deals is risk allocation in the various underlying countries. If the risks across those countries are too diverse, it may be harder to pinpoint responsibility and take the necessary steps towards enforcement. For

offshoring deals, practical solutions may be more important than merely ensuring enforceability of the applicable contract or master agreement—especially in China, where local enforcement may be impossible. It may mean creating an effective exit strategy, ensuring security with respect to intellectual property rights, and establishing vendor-management mechanisms that provide early warning about potential issues.

A parent company guarantee may also serve to minimize risk in large-scale outsourcing deals. Where different vendor companies are involved in an outsourcing deal, a parent company guarantee may be especially important in order to require the parent to step in and perform the underlying contract if necessary. A customer will also want the ability to look to the parent for damages for breach of contract. On the other hand, if a customer faces potential permanent establishment concerns as a result of an offshoring arrangement—for example, if outsourcing of call center activities in India gives rise to customer exposure to Indian income taxes on revenue, the customer may wish to have a special-purpose entity enter into the outsourcing contract, in which case the vendor is likely to insist upon a customer-parent company guarantee.

3. Varying Legal Regimes:

As always, the diversity of laws applicable to an outsourcing arrangement can be daunting and must be approached by competent, informed counsel. The bottom line here is that one size does not fit all.

Employment law-related issues frequently arise in offshoring transactions, and it is important to remember that European employment and privacy laws differ greatly from corresponding American laws. Customers will often want to consider: (i) the ease with which employees can be terminated under local laws, (ii) whether there are co-employment concerns depending upon the extent to which the customer exerts control over the employees and depending upon local laws, and (iii) whether employee background checks can be undertaken. It is harder in Europe for a supplier to make staff redundant, a discrepancy that affects exit costs and the ability of vendor to allow customer flexibility. Moreover, drug tests and background checks may not be possible in Europe due to stringent EU laws concerning personal data.

Another central legal concern in outsourcing deals is, of course, intellectual property (IP) ownership. A primary issue is ensuring chain of title to works created by employees of vendors in local jurisdiction. For instance, Morrison & Foerster recently completed a transaction involving Kazakhstan, and the issue we faced pertained to the reversionary right of employees to copyrighted works they create. As a result, the vendor was required to structure its Kazakhstan application development operations so that the developers would be independent contractors who, by law, would not be entitled to reversionary rights. Protection of IP is almost always a primary consideration in offshoring to China, and there are certain legal measures that should be considered to maximize the ability to enforce (e.g. registration of source code, arbitration in HK in contract, understanding local courts, environment for enforcement), but practical measures are as, if not more, important. Also, it is important not to forget the so-called “Technology Transfer Rules” applicable in China.

Tax issues, such as permanent establishment concerns, also give rise to potential problems and may require structuring contracts in a manner to minimize risks for the customer.

4. Governing Law/Arbitration:

Although most deals are governed by the customer’s jurisdiction, sometimes a neutral territory is chosen. Some vendors may be unhappy about various U.S. state laws and may prefer New York law. In terms of dispute resolution, arbitration awards may be more easily enforceable in foreign jurisdictions such as China and India. While U.S. entities may prefer U.S. law, U.S. law may not always be optimal depending upon whether the contract is an offshoring contract or involves a multi-country transaction. Perhaps more important is the question of how to address dispute resolution concerns. Despite some customers’ resistance to arbitration, the vendor’s jurisdiction may necessitate arbitration. For example, in many countries—China and India, for example—a U.S. judicial award may not be locally enforceable. On the other hand, because China and India are signatories to the New York Convention, U.S. arbitral awards generally are enforceable in those jurisdictions.

5. Cultural Issues:

There are big cultural differences between the countries most active in the outsourcing market. Europe, for instance, provides relatively greater protection for employees, which may affect overtime, benefits, holidays, and redundancies. Many European staff take off most of August, and U.S. companies need to plan their demand around this. Deal makers should actually visit the countries in which they plan to do business in order to understand, and attempt to overcome, cultural differences. Language barriers may also pose issues—particularly with respect to drafting and negotiating contracts in Asian languages.

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