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A Practical Guide

GEORGE KIMBALL

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Preface

More than two decades ago, a colleague strolled into my office with a request. A client selling businesses had agreed to provide buyers with what was then called data processing for a year or two after the closing. Since I had a personal computer in my office (odd in those days) perhaps I could prepare a contract? This was my introduction to outsourcing.

Since then, outsourcing has become the bread and butter of my law practice, an important business trend and, at times, a political issue. In a 'flat' world, companies routinely entrust critical operations to outsiders, moving them outside and often offshore to Asia or Eastern Europe. Companies are transforming themselves from integrated businesses into extended enterprises with worldwide operations, outside as well as beneath the corporate umbrella, all stitched together by broadband communications and (more to our point) contracts written in English and governed by common law principles.

For the executives, managers, and lawyers asked to build, sustain, manage, and (at least occasionally) unwind these relationships, the process can be disconcerting, even bewildering; and for many directly affected or displaced, traumatic. Companies new to the game often ask their lawyers and consultants to train interested executives, managers, and lawyers. What follows has evolved, in part, from many such training sessions. The purpose is to distill fifteen years' experience into a coherent and (it is hoped) readable guide to the process, risks, contract terms, and other lore.

There are differences among outsourced functions, as among particular companies and industries. Yet common themes predominate. Good contracts define the scope of service, assure quality, and adjust scope and charges as conditions change. If things go badly wrong, remedies are essential. There are also differences in applicable law, but most outsourcing contracts are written in English under legal principles broadly familiar wherever business is conducted in English. Commercial realities are much the same everywhere.

Practicing lawyers serve clients. Although we are not reptiles (contrary to some popular impressions) we do assume the colors of our surroundings. Every client, situation, and transaction is, to some extent, unique, with particular goals, priorities, and complexities. The views expressed do not necessarily reflect those of any firm or client, and might vary in particular situations for a host of reasons.

Examples in the text are drawn from experience, but without revealing specifics. As in television or on the screen, names and other particulars have been changed (or omitted) to protect the innocent and, for that matter, the guilty.

There is a distinct, consistent point of view in favor of clarity, simplicity, and balance. Outsourcing contracts can fill large binders, but, although some complexity is unavoidable, bulk is not always necessary or desirable. In negotiation, long hours may be devoted to nuances, details, and remote contingencies for which business people have scant patience. Endless complexity may be an interesting intellectual exercise for the specialist, but is more likely to confuse than to fascinate the poor client who must later make sense of what the lawyers leave behind.

Outsourcing involves elements of other, more familiar, transactions. Yet outsourcing differs from those patterns in important respects, because of the outsourcer's unique position within and without the customer's organization and, above all, the imperatives of mutual success through collaboration. Conventional adversarial thinking (so common among lawyers) often proves counterproductive. 'Scorched earth' tactics singe both sides. Concessions may come more readily when negotiations are cordial and used as an opportunity to build working relationships rather than seek unilateral advantage. Stringent, overreaching terms—of the kind still found in too many ostensibly 'standard' forms—are rarely acceptable. Time wasted crab-walking toward sensible middle ground is expensive, not only in legal and consulting fees, but lost goodwill and distractions from more important practical issues.

For these reasons, the reader will see a clear preference for reasonably balanced terms that respect both sides' interests, permit both sides to succeed, and, in general, motivate them to preserve the business relationship for mutual benefit. This is not, of course, the only possible approach, and many respected professionals seek more stringent terms with different tactics, but observation of clients and results over the years has led this writer to believe that kinder and gentler often proves wiser.

The philosophy and other views are my own. Errors, too, are entirely my responsibility, but profuse thanks are in order to many friends and colleagues who have assisted me along the way, answering questions, pointing me to good sources, serving as sounding boards and especially reading and commenting upon the manuscript—to its benefit and mine. Several of my Baker & McKenzie colleagues have kindly found time to read and comment upon portions of the manuscript, including Tina Gavel, Peter George, Brian Hengesbaugh, Steve Holmes, Ute Krudewagen, Ross McKean, Michael Mensik, Ali Mojdehi, and Harry Small.

I have been fortunate to find many friends willing to read and comment upon the manuscript, or to advise and otherwise assist upon particular topics or points of law, including Edward Arnold, Michael Cammarota, Sameer Desai, Harry Glasspiegel, Navneet Hrishikesan, Andy Johnson, Dave Leonard, Michael Murphy, and Mark Ross. Luke Adams and Clódagh McAteer of Oxford University Press, and their predecessors, Chris Rycroft and Kirsty Allen, provided indispensable guidance and wise counsel along the way, together with liberal doses of confidence, enthusiasm and encouragement. Fiona Stables and Alison Floyd provided invaluable and expert assistance editing the text, which Wendy Telfer skilfully proofread. Special thanks go to my friend and former colleague Andrew Hooles, who started all this by suggesting that Oxford ask me to review a book proposal. Thanks are also in order to many unnamed friends with whom I have been privileged to work over the years—clients, colleagues, consultants, professional peers, and business people on all sides—from whom I have learned much. To anyone inadvertently overlooked in these acknowledgements go my regrets as well as my thanks.

My wife Diana tolerated nights and weekends devoted to the book with remarkable equanimity, then volunteered to proofread the manuscript—once more saving her husband from the error of his ways. Our daughters, Katie, Kelley, and Susan, have wisely eschewed the law, but offered unstinting moral support.

George Kimball
June 2009
Seal Beach, California

Abbreviations

AAA	American Arbitration Association
ADM	applications development and maintenance
ARC	additional resource charge—the incremental charge for additional chargeable resources (for example so many dollars for each additional network connection, help desk call, or gigabyte of storage)
BPO	business process outsourcing—the outsourcing of HR, purchasing, logistics, or other functions (excluding IT)
COLA	cost-of-living adjustment
F&A	Finance and accounting
FFIEC	Federal Financial Institutions Examination Council (US)
FINRA	Finance Industry Regulatory Authority (US)
FSA	Financial Services Authority (UK)
FTC	Federal Trade Commission (US)
FTE	full-time equivalent
GST	goods and service tax
HIPAA	Health Insurance Portability and Accountability Act of 1996 (US), Pub L No 104-191, 110 Stat 1936 (1996)
HRO	human resources outsourcing—the outsourcing of payroll, benefits administration, and a wide variety of other HR functions
ICC	International Chamber of Commerce
ITO	information technology outsourcing—the outsourcing of data centers, networks, help desks, PC support, software development and maintenance, and other IT operations. Sometimes the term refers to the outsourcing of IT infrastructure, as opposed to applications maintenance and development (ADM)
KPI	key performance indicator
LPO	legal process outsourcing
MACs	moves, adds, and changes
MiFID	Refers to two directives concerning markets in financial instruments, Directive (EC) 2004/39 and Directive (EC) 2006/73
RFP	request for proposals

RRC	Reduced resource credit—the incremental credit received by the customer for reduced consumption of chargeable resources (for example so many dollars for each server or PC withdrawn from service)
SEC	Securities and Exchange Commission (US)
UNCITRAL	United Nations Commission on International Trade Law
WARN Act	Worker Adjustment and Retraining Notification Act of 1988 (US), Pub L 100-379, 102 Stat 890 (1988), 29 USC §§ 2101 *et seq*

Glossary

Outsourcing has its own peculiar jargon. Here are a few terms in common use.

Additional Resource Charge (ARC)	The incremental charge for additional chargeable resources (for example, so many dollars for each additional network connection, help desk call or gigabyte of storage).
Annual service charge	This means just what it says, but may be a fixed fee (divisible by twelve to compute monthly charges) or (more often) an estimate derived from baseline consumption, and likely to be adjusted up or down as the year progresses, based upon actual consumption or agreed changes. The most common adjustments are ARCs and RRCs.
Applications Development and Maintenance (ADM)	Outsourced software development and maintenance services, often performed in India or other offshore destinations.
Base case	Budget for outsourced activities, derived from the customer's historic cost data.
Baseline	Estimated consumption, usually based upon recent, current, or anticipated consumption, and often used as the touchstone for base charges and adjustments.
Benchmarking	The independent assessment of quality and cost against current market standards, generally performed by an independent firm.
Best of breed	This catch-phrase refers to the selective outsourcing of various functions among several service providers (as opposed to outsourcing to a single prime contractor).
Business Process Outsourcing (BPO)	The outsourcing of HR, purchasing, logistics or other functions (excluding IT).

Change control	(or 'change management') disciplined, written process for proposing or requesting, reviewing, and then authorizing changes. Often these processes involve the preparation of a proposal or change request, and then approval of a change order. Sometimes, contracts classify various kinds of changes, such as technical or operational changes, as opposed to contract changes.
Dead band	A narrow band on either side of the baseline, within which charges are fixed.[1]
Disaster and disaster recovery	Fires, hurricanes, earthquakes, and other similar events that may destroy facilities and otherwise disrupt or interrupt the performance of services. Sophisticated customers and suppliers have elaborate plans to restore services, or at least critical services, promptly following a disaster, often from a remote facility. These plans should be kept up-to-date, tested periodically, and coordinated with overall business continuity plans to carry on the customer's business.
Earn-back	Recovery or reversal of service credits, usually based upon sustained satisfactory or superior performance following a failure.
Key Performance Indicator (KPI)	Measure of service quality that is measured and reported at regular intervals, but generally without exposing the supplier to liability for service credits in the event of unexcused failures to meet desired levels.

[1] eg if a customer agrees to pay (i) US$100 per month for baseline consumption of 100 units, with (ii) incremental charges (ARCs) and credits (RRCs) of $1 per unit, and (iii) a two per cent (2%) 'dead band,' then the customer would pay $100 per month whenever consumption fell between 98 and 102 units. Outside those limits, ARCs and RRCs would apply. They could be added or deducted from the outer limits of the 'dead band', so that the 103rd unit raises the monthly charge to $101 ($100+$1), or 97 units cost $99 ($100–$1). Alternatively, they could be added to or deducted from the 100 unit baseline, so that 105 units would cost $105 and 95 units would cost $95.

Legal Process Outsourcing (LPO)	Outsourcing of legal support services of various kinds, such as document review, patent searches, and legal research, among others.
Most-favored customer	Charges and other terms at least as favorable as the supplier offers to any other customer for the similar volumes of the same or similar services.
Moves, Adds and Changes (MACs)	Installations, relocation, removal or modification of computers and other devices, individually or in groups, usually by dispatching technicians ('physical MACs') although some software upgrades and modifications may be installed remotely ('logical MACs').
Near-shore	The performance of services in neighboring countries. For US companies, this usually means Canada or Mexico, rather than, say, India. For Western European companies, this may mean an Eastern European country.
Offshore	The performance of services in remote countries, oceans apart from the customer's operations.
Project	Discrete, non-recurring tasks or other services that are in addition to the normal performance necessary to meet service levels. Generally, projects are separately authorized and may be separately managed.
Reduced Resource Credits (RRC)	The incremental credit received by the customer for reduced consumption of chargeable resources (for example, so many dollars for each server or PC withdrawn from service).
Refresh	Periodic replacements of hardware or software. Software is often required to be kept on current, or near-current releases.
Schedule	A common term for exhibits, attachments, and other documents related to an outsourcing contract that may be incorporated by reference and form part of the larger agreement. The most important describe the scope of service

	('statement of work' or 'service description'), service levels and credits, and the computation of charges. Other examples may include a transition plan; lists of assets, personnel, ongoing projects, approved subcontractors, and locations; security policies; disaster recovery requirements; financial or performance guarantees (for example from a supplier's parent company); and contract documents for related transactions (for example contracts, bills of sale, and the like for purchases of facilities and assets, or assignments of third party contracts transferred to the supplier).
Service credit	An amount payable by the service provider for unexcused failures to meet service levels. Business people commonly refer to these as 'penalties,' but, technically, they should be characterized as 'liquidated damages' or reductions in charges, rather than penalties (since the law generally declines to enforce penalties).
Service levels	Objective performance standards that suppliers measure and report periodically, and for which they may pay service credits in the event of unexcused failures. Typical examples include response times, availability of systems (measured as a percentage of scheduled availability), and mean times to respond to or resolve incidents.[2]
Termination assistance	Support provided by an incumbent supplier to effect a smooth transition (or 'reverse transition') when an outsourcing contract expires or terminates for any reason.
Tower	A common description for large categories of service (such as data center operations, help

[2] Service levels are sometimes referred to as 'service level agreements,' a term that originally referred to performance commitments of corporate IT departments. Specific service levels are not, strictly speaking, agreements, but performance commitments; and the tables and metrics attached to outsourcing contracts are not separate contracts. The term nevertheless persists, and both suppliers and users commonly refer to 'service level agreements' and 'SLAs.'

desks, or software maintenance). In large relationships, these may be documented and to some extent administered separately. This author prefers more descriptive terms, such as 'service category.'

Transition	The process of transferring operations from the customer to a supplier during the first few months after a contract is signed. This may involve on-site or remote management of the customer's operation ('facilities management'); the relocation of operations to the supplier's site ('lift and shift'); or the transformation of operations to a wholly-new model (such as the replacement of conventional procurement forms and processes with web-based catalogs and automated processes). Transformation generally involves the relocation of some or all operations to the supplier's facilities. Contract documents commonly include a transition plan.

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