

Technology Transactions Group's Areas of Practice

Commercial Transactions

Cross-Border / Import &
Export / Customs

e-Discovery

e-Payments

e-Signatures

Information Management
and Privacy

IP Protection

IT Disputes and Litigation

Outsourcing Transactions
and IT Transactions

Security Breaches

Telecommunications

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Companies considering entering into an outsourcing agreement will be confronted with a host of complex issues typical for these types of arrangements. Some of these issues will include defining the products and services that the vendor will provide and the service levels upon which they will be provided, limiting your company's and the vendor's liability, complying with regulatory requirements (including Sarbanes-Oxley and privacy requirements), and ensuring an orderly transition to a new vendor (or to your company) on termination of the arrangement.

Locke Lord Bissell & Liddell can provide insights into various alternatives to address these issues based on our experience in numerous outsourcing agreements.

Outsourcing Basics

What is Outsourcing?

Outsourcing occurs when a company engages one or more vendors to provide to the company services that the company once provided to itself. For example, in the financial services sector, outsourcing occurs when an insurance company pays a vendor to perform various aspects of the insurance company's back office administrative processes (e.g., receiving and processing applications, underwriting in accordance with rules provided by the insurance company, performing billing and collections functions or operating call centers).

Types of Outsourcing

There are two broad categories of outsourcing:

- **Business Process Outsourcing (BPO).** In BPO outsourcing, the vendor performs for the company business processes or administrative functions that the company once performed for itself. These processes may include billing and collection, payroll or benefit plan administration, claims processing, and inventory management. In regulated industries such as the financial services and insurance industries, the outsourced business processes may be regulated processes, such as processing applications for insurance.
- **Information Technology Outsourcing (ITO).** In ITO outsourcing, the vendor provides to the company services relating to some or all

information technology functions, such as operating and maintaining computer hardware, executing software, managing networks, hosting application systems or developing and maintaining software. Like BPO transactions, ITO transactions often have regulatory aspects, such as privacy issues. *(For more detailed information on IT Transactions, please see the Locke Lord publication, "IT Transactions.")*

Benefits of Outsourcing

Companies can obtain numerous benefits by entering into outsourcing relationships. The number and magnitude of those benefits can be increased if the outsourcing agreement is well structured and reflects the knowledge of attorneys and consultants who have experience with other outsourcing relationships. Some of the potential benefits are as follows:

- Prompt access to new technologies. Companies can more easily stay current with technology trends at lower costs by taking advantage of the vendor's technological expertise and ability to leverage scale.
- Scalability. Companies can more quickly increase or decrease processing capacity in response to business developments by using processing capacity provided by the vendor.
- Access to better technology expertise. Companies can shift responsibility for managing technology to a vendor whose core competency is technology management.
- Variable cost structure. Companies can convert their fixed costs to variable costs and avoid paying for resources that the company does not actually use.
- Lower labor costs. Companies can reduce labor costs by having work done offshore.

Risks of Outsourcing

Balanced against the benefits are risks inherent in poorly structured outsourcing agreements. These risks can include:

- Limited vendor accountability. Limits on the vendor's liability and other contractual terms

can decrease the vendor's accountability for its breaches and expose the company to losses for which the vendor is not financially responsible.

- Loss of control. By transferring control of processes and IT functions to the vendor, the company may lose the ability to mandate or influence the manner in which those processes and IT functions are performed or provided and the manner in which corrective actions are implemented.
- Loss of negotiating leverage. Unless the outsourcing agreement is well structured and unambiguous about the responsibilities of the company and the vendor, the company may lose significant bargaining leverage after entering into the outsourcing agreement because the company's obligations to pay are usually clear, but the scope of the vendor's obligations can be uncertain.
- Loss of ability to change vendors. After the vendor has performed business processes or IT functions for a company for a material period of time, bringing the processing and functions back in-house or transferring the processing and functions to another vendor at the end of the relationship can be difficult unless the outsourcing agreement protects the customer's ability to implement such a transfer.

Companies that have outsourced successfully have found ways to assess and mitigate these and other risks of outsourcing. One of the most powerful tools that companies can use to mitigate these risks is to use an outsourcing agreement that reflects the knowledge base of attorneys and consultants who have experience with other outsourcing relationships.

Complexities of Outsourcing

Outsourcing relationships present many unique challenges. These challenges can include:

Managing Unforeseeable Change

Outsourcing agreements are typically for a long term, often for 5-10 years. Consequently, outsourcing agreements must accommodate unforeseeable technological changes that will occur during the term. For example, many of the outsourcing agreements that will expire in 2006 were entered into when most companies did not



have a website, use e-mail or communicate over wireless networks. "Change control" provisions help the company manage the implementation of such changes. For example, the importance of appropriate security safeguards and documentation to evidence such safeguards has increased in only the last few years. The outsourcing agreement should include a mechanism for integrating such new standards into the relationship without having to re-negotiate the entire outsourcing agreement. Further, the outsourcing agreement should include adequate controls on who in the company is authorized to agree to changes to the outsourcing agreement.

Complying with Regulatory Requirements

If the vendor will perform regulated activities such as settling claims, sending non-renewal notices, responding to consumer complaints, bureau reporting deadlines, and providing notices of adverse underwriting decisions, the outsourcing contract must address the vendor's responsibility to perform those activities in compliance with applicable laws and allocate financial liability for the vendor's failure to comply.

Defining the Services

Defining the scope of the vendor's services can be difficult because companies rarely have detailed internal descriptions of the services, processes and functions that the company seeks to have the vendor perform and because those services, processes and functions will evolve over the term of the outsourcing agreement. Not having a clear standard for determining the vendor's responsibility can lead to serious problems, such as disputes over what is in-scope and therefore included in the pricing and what is out of scope and therefore costs extra. These disputes can be difficult to resolve because of the loss of negotiating leverage that companies can experience after entering into the outsourcing agreement.

Developing Service Level Agreements (SLA's)

Service levels are the parameters used to measure the vendor's performance. Different services levels are appropriate for different services. For example, if vendor will perform billing processes, one service level might be the percentage of invoices sent within specific periods after month end. The outsourcing agreement would specify the target percentages for each period (e.g. 95 percent within 10 calendar days of month end and 100 percent within 15 calendar days of month end), and the vendor's actual performance would be periodically compared to the target service levels.

The customer's remedies for the vendor's failure to achieve a target service level should vary with the importance of the service measured by that service level. For example, important service levels should be backed up by financial consequences called "Service Level Credits." Additionally, for critical service levels (or groups of service levels), the magnitude of the Service Level Credits and the scope of customer's other remedies should increase with each new failure and with the magnitude of each failure. Further, if the vendor's achieved service levels for critical services falls too far

below the target service level or if the vendor fails to achieve the target service levels too frequently, the customer's remedies may include terminating all or part of the agreement.

The amounts of the Service Level Credits should be selected to create an incentive for the vendor to achieve the applicable service level—the Service Level Credits that the vendor pays should cost more than the amount the vendor would spend to remedy the vendor's performance. Additionally, outsourcing agreements sometimes include “earn-backs” as a way to provide the vendor an incentive to correct promptly sub-par performance problems.

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Complying with Privacy Laws

Because the vendor's performance of some services can result in the customer violating state and federal privacy laws, such as FCRA, GLBA and HIPAA, the outsourcing agreement should include terms requiring the vendor to perform its obligations so that the customer is in compliance with those laws. Additionally, some privacy laws require that specific terms and conditions be included in the outsourcing agreement. For example, if the vendor is using “protected health information” to provide the services, HIPAA may require that the outsourcing contract include certain “business associate” provisions.

Maintaining Security

Outsourcing agreements should require the vendor to maintain security safeguards. The outsourcing agreement should describe required security safeguards and permit the customer to periodically review and assess the vendor's security safeguards in practice. This could include the right to obtain or perform security audits or tests, such as SAS-70 type reviews.

Limiting Remedies

Vendors always propose significant limitations on the vendor's liability. These limitations include caps on damages, exclusions of consequential damages, limited indemnification rights for the benefit of the customer, and broad indemnification provisions protecting the vendor. Such limits expose the customer to significant losses caused by the vendor's failures while having limited or no recourse against the vendor. Understanding these limited remedies and their practical impact can be difficult. Negotiating remedies which provide practical and meaningful protections for the customer is often one of the most adversarial and difficult elements of the negotiation of an outsourcing agreement.

Using Offshore Subcontractors/Affiliates

The appeal of using lower cost offshore resources can be irresistible. However, using offshore resources may impose hidden costs and burdens on the customer. For example, using offshore labor can limit the customer's ability to actually monitor the vendor's performance, may result in VAT or other taxes that would not have been incurred onshore, and may require the customer to comply with laws in other countries (e.g. the EU Data Protection and privacy laws). Further, intellectual property laws in some countries. Additionally, using offshore labor has dramatic practical impact on “soft landing” rights (discussed below), and may require the customer to obtain approval from regulators in many regulated industries.

Intellectual Property Rights

The ownership of, and licenses to, the intellectual property rights in software and other tools used by the vendor to provide services (whether the software and tools was in existence prior to execution of the outsourcing agreement or is developed to perform the vendor's obligations) and in the customer's software, data and information, is one of the most complicated elements of any outsourcing agreement. Vendors often use pre-existing intellectual property, intellectual property developed specifically for the customer, intellectual property of third parties, and intellectual property that is not pre-existing and which was not developed specifically for the Customer. Customers typically share their know-how (some of which the customer does not want shared with its competitors) and assist the vendor in customizing the vendor's systems to process the customer's business. Vendors also obtain access to data and information about the customer, the customer's suppliers and clients, and the customer's marketing, financial and business plans. Unless the customer has the right to use a wide range of intellectual property the vendor used to perform the services often the outsourcing agreement expires, then termination of the relationship could be very costly and burdensome for the company. (For more detailed information on intellectual property, please see the Locke Lord publication, *Protecting and Leveraging Intellectual Property*.)

Maintaining IT Currency

Outsourcing vendors claim to perform the services more efficiently and at a lower cost than the customer can, because the vendor has better technology and the vendor can spread the cost of maintaining the latest technology among all the vendor's clients to achieve economies of scale that the customer alone could not attain. While these economies of scale can save the customer money, they can also have adverse effects on the customer that can be managed in the outsourcing agreement. For example, the customer may want to control whether the customer is required to

migrate to new versions of the software used to perform the services to retain features in the prior version or to avoid the expense of migration.

Addressing eBusiness Issues

Outsourcing transactions involving electronic signatures and other uses of the internet for receiving and sending documents require a thorough understanding of how these methods can be used consistent with the customer's regulatory obligations. For example, for electronic signatures, there are complexities relating to authenticating the person whose electronic signature is accepted and storing the details of that process. Further, there may be required disclosures and other record retention obligations needed if documents will be received or delivered exclusively through electronic means. (For more detailed information on electronic signatures, please see the Locke Lord publication, *Framework for Designing an Effective ESIGN Process*.)

Soft Landings

Vendors typically do not address, or address only casually, what happens when the relationship ends. However, the vendor's obligations at the end of the outsourcing relationship are critical to the company—without the vendor's cooperation and assistance, the company may not be able to reconstitute its operations, transition to another outsourcing vendor or wind down the operation. Failing to adequately address the vendor's obligations upon termination of the outsourcing agreement can render meaningless the customer's right to terminate the agreement upon a breach by the vendor.

Complexities for Insurers

In addition to the complexities inherent in outsourcing and IT transactions, for insurance companies there are additional concerns, such as:

- Must the outsourced services be provided by a licensed TPA? If so, are there termination rights if the out-

sourcer loses a license in one or more states?

- Are there any Holding Company Act implications if several affiliates receive the benefits of the outsourcing or IT services under a single agreement?
- Must the outsourcing agreement be filed with any Department of Insurance as a material management contract and if so, what is the standard of review?
- Are any of the outsourced processes subject to regulation at the federal level or state level. If so, are there adequate assurances in the outsourcing agreement that the vendor must perform according to those laws and regulations, as they may change over time?
- Increasingly, the privacy and security laws are impacting the operations of insurers and how compliance with these topics is handled in the contract is critical.

Negotiating Approach

Discussed below is an approach for just one of the more adversarial issues in outsourcing and IT agreements. Using this example, we then identify an approach that can improve a client company's position in a way that is palatable to vendors. Resolving the vendor's limit of liability is typically very highly contested. The limit of liability issue illustrates the importance of including in the outsourcing agreement a number of provisions vendors typically omit from their drafts.

The Vendor's Mantra

Historically, outsourcing and IT vendors have provided limited assurances backed by very limited remedies if the vendor fails to perform properly. The vendors' mantra has been, "We'll process your business as you instruct us, and if we make a mistake, we'll attempt to correct it. If we

breach, you can terminate the agreement. In no event may you recover from us more than the amount you paid us for three or six months." The realities of re-provisioning a data center operation (including implementing the necessary systems and interfaces) and re-hiring the skilled workforce in 30 or even 90 days can render the termination remedy inadequate. Consequently, companies are vulnerable to losses from the vendor's failure without a meaningful, practical remedy.



Usual Approach

Companies often spend considerable energy attempting to negotiate higher limits of liability. Pursuing higher limits of liability (or accountability) is important, but should be pursued in tandem with other provisions. Most credible outsourcers have only limited flexibility in their limits of liability.

Alternative Approach

Focusing on the limits of liability in tandem with other provisions can improve a client company's position considerably. For example, focusing on a few important exceptions to the limits on the vendor's liability and on the termination assistance provisions thereby making the termination remedy more meaningful, can reduce the client company's vulnerability. This approach increases the vendor's incentive to perform better to avoid triggering a termination right.

LLB&L Outsourcing Transactions

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Why Locke Lord Bissell & Liddell?

Among the ways client companies have benefited from our assistance:

- Clients leverage our extensive experience with outsourcing and a broad range of IT transactions to their advantage in negotiating outsourcing and IT agreements, small or large;
- For transactions involving insurance or financial services clients, our breadth of experience and depth of skills specific to the insurance and financial services industry is second to none;
- Solving regulatory issues is what we have done for years, few IT vendors have the experience of our insurance lawyers within the regulatory environment;
- We can supplement a client's in-house legal resources in a variety of ways:
 - complete drafting, coordinating with the company's business people to assisting in negotiating the details, and reporting to the in-house counsel progress and problems as they arise;
 - serving as the "second chair" to in-house lawyers who have the time and experience to lead all facets of the transaction; and
 - provide a full range of support options, from "quick reviews" to extensive drafting and negotiating assistance as our clients request because not all outsourcing and IT contracts need the same scrutiny.

We help clients design, implement and execute tactics and strategies to navigate the rapidly changing eBusiness landscape, including all aspects of marketing, soliciting and completing business over the internet and via other electronic means.

The Technology Transactions Group includes attorneys with diverse backgrounds to effectively and efficiently respond to all client needs. We can help you exploit strategic opportunities and to protect your interests because we have the experience to help you execute your objectives. We don't just help you compete, we help you win.

For additional information about our experience or to obtain additional information on how we may assist you, please refer to any of our articles, or contact any of the attorneys at the end of this brochure.

Representative Transactions

- Represented an outsourcing vendor in providing to a telecommunications hardware manufacturer more than \$20 million in information technology services;
- Represented an outsourcing vendor in providing network communications outsourcing services to a media communications company;
- Represented a prominent life insurance and financial services company, in connection with its acquisition of an outsourcing entity in India;
- Represented US operations of Japanese financial services group in outsourcing transaction involving all of its data processing and policy administration functions; and
- Represented Fortune 50 financial services subsidiary, in connection with its acquisition of outsourcing capabilities in India and a number of other strategically significant outsourcing initiatives, including automating all of the new business processes for its life insurance operations.