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# Outsourcing IT And Business Processes: A Viable Corporate Strategy

*The Editor interviews* ***Michael J. Brito****, Partner, Akin Gump Strauss Hauer & Feld LLP.*

**Editor: Tell us about your background and experience.**

**Brito:** I have been a technology lawyer for over 20 years, focusing on technology transactions, specifically outsourcing and outsourcing-related transactions. My interest in technology was sparked when I was living in the heart of Silicon Valley and attending Stanford Law School. Although I have been in private practice for the vast majority of my professional career, one of my most rewarding professional experiences was working for Electronic Data Systems (now HP). I worked for EDS for six years, three in the U.S. and three in London, before returning to private practice. That experience gave me a much broader view of outsourcing transactions not only from a geographic perspective but also on what will make an outsourcing relationship successful.

**Editor: What are the benefits of outsourcing?**

**Brito:** There are four primary benefits associated with outsourcing. First, outsourcing provides a more transparent view of and ability to control costs. For most large enterprises, the costs for IT and/or business process functions typically are fixed – specifically, the personnel, software, hardware and other assets used to support those functions are fixed costs. With outsourcing, those fixed costs are converted to variable costs because the outsourced services usually are priced using a consumption-based pricing methodology. As a result, what was formerly a fixed cost is converted to a consumption-based variable cost. A second and related benefit is that many outsourcing transactions result in an enterprise paying less for the same service. This occurs primarily because of use of leveraged resources and a greater efficiency in the delivery of the services.

**Michael J. Brito**

The third benefit relates to technology. By outsourcing, the enterprise enjoys technology upgrades without having to incur the associated capital costs because that investment risk has been transferred to the service provider. Finally, outsourcing allows an enterprise to focus on its core competencies, rather than on information technology or on tangential business processes.

**Editor: What business areas are most appropriate for outsourcing?**

**Brito:** IT and business processes are most appropriate for outsourcing. IT services include infrastructure management; applications development and maintenance; data center and desktop outsourcing; and managed network services as well as business functions, including human resources, finance and accounting, procurement and supply chain management.

The outsourcing industry is most experienced with IT services; however, business process capabilities are also maturing. Some outsourcing areas require extensive personnel and a substantial IT component, including functions such as customer care, call centers, help desks or billing support. Most enterprises don't view IT or certain business processes as a core competency; nevertheless, these functions are vital to their employees, customers, vendors and business operations. Outsourcing those functions to a service provider who has the requisite expertise to deliver those services ultimately enhances the overall enterprise. In today's environment, technology is a fundamental part of doing business; an enterprise should ensure that its IT and business process outsourcing (BPO) service providers support strategic business objectives.

**Editor: What particular analysis is required when advising an enterprise about outsourcing a business function?**

**Brito:** First, we ask clients to consider precisely what services they would like to outsource and to develop a high-level matrix of roles and responsibilities for those services. In addition, we ask clients to consider what employee resources are currently used to provide the services and whether or not the affected employees should be transitioned to the new service provider, as well as the related economic cost/benefit analysis.

Next, we want to understand the client's current portfolio of software and hardware assets; the age and amortization status of those assets, associated software licenses or hardware leases; and whether those assets can be assigned to a service provider. We also want to establish a baseline of the costs and expenses associated with the current services, including transaction volumes and other consumption-related metrics and internal budget or spend related to those services.

Finally, we assess performance data, specifically, the metrics associated with the current performance of the services. Careful analysis of these issues will form the basis for a comprehensive assessment of whether outsourcing is a viable option and, if so, the appropriate terms and conditions that should be applicable to an outsourcing transaction.

**Editor: What due diligence is required to minimize the reputational risks inherent in outsourcing?**

**Brito:** A high level of diligence is required and should start with a meeting between the enterprise and the prospective service provider, including the executive sponsor and the proposed delivery team from the service provider to discuss, among other issues, the service provider's commitment to the enterprise and the transaction. We recommend site visits to ensure sufficient understanding of the service delivery location's operational and jurisdictional profiles, current client base, employment protocols and physical infrastructure to manage and protect data.

Traditional due diligence also includes client references, litigation-related searches and reputational assessment from independent third parties. In many instances, we will translate the information obtained during due diligence into operational and contractual provisions that address the risks identified. For example, we may include a contractual provision that requires a service provider to use our client as a reference for all similar transactions. This provides a strong incentive for the service provider to deliver high-quality services so that the client will be a positive reference.

Where an enterprise is particularly sensitive about its brand (e.g., retail or hospitality industry), we will also include a provision that allows for a right to terminate if reputational issues arise, such as those in connection with the Foreign Corrupt Practices Act or a similar claim.

**Editor: What are legal considerations for companies seeking to outsource aspects of their business operations?**

**Brito:** Once critical business issues are addressed, such as generating a comprehensive services description, establishing appropriate service-level metrics, understanding the impact on existing employees, termination rights and determining required resources, the legal considerations usually begin at the locations themselves. Data security and privacy, for example, raise not only technical and policy issues but also jurisdictional concerns, depending on the country in which business is transacted.

For example, in the global scheme of data privacy, the U.S. falls in the middle in terms of required protections, with Europe being more rigorous and certain Latin American jurisdictions being less stringent. In many instances, outsourcing transactions involve multinational corporations and will need to comprehensively address compliance with data protection and privacy laws and regulations. In addition, legal considerations will also typically include allocation of intellectual property rights as well as appropriate limitations on liability and indemnity rights.

**Editor: What are the key elements of effective IT and BPO agreements?**

**Brito:** Effective agreements cover the issues mentioned above, most critically including a comprehensive services description, data security requirements and appropriate performance metrics. Specifically, service levels and other objective performance measurements should be designed to ensure that the services are delivered to the client's satisfaction and that the consequences, remedies and termination rights associated with performance that fails to meet the contracted level of service are clearly specified.

The remedies for failing to perform in accordance with the contracted level of service include payment of service-level credits and implementation of performance improvement plans, including adding resources necessary to deliver contracted services at no additional cost. In addition to basic protections, we also recommend including a series of "interim" remedies – essentially remedies that allow the enterprise to work with the service provider to improve performance before being forced to exercise the nuclear option of terminating the outsourcing agreement, which poses significant operational and transition risks.

Another key element to an outsourcing agreement are the provisions related to termination assistance services – namely, being as specific as possible on the rights and obligations of each party on termination or expiration of the outsourcing agreement, including the treatment of various assets (e.g., a license to proprietary software or transfer rights for third-party software).

We also typically recommend, especially for longer-term agreements, pricing protection provisions, such as benchmarking provisions that allow an enterprise to benchmark its price and service level against similar transactions in the market to ensure that its price and level of service have kept pace with what is currently available in the market.

**Editor: Do preexisting outsourcing agreements affect M&A due diligence and analysis?**

**Brito:** Yes. In fact, this issue comes up in M&A transactions all the time. First, we look at existing termination provisions – specifically, whether there is a termination right for change of control or for convenience; the applicable termination for convenience fees; whether any other termination rights are triggered by the transaction; and whether termination-for-cause or service-level issues have accrued but not yet been acted upon.

The second level of analysis covers contractual provisions related to service requirements. Does the deal involve a requirements contract? Is the target obligated to purchase a prescribed level of services, or is there some flexibility to in-source or re-source those services? Third, we look for divestitures and acquisitions provisions, which are common in outsourcing agreements, to determine whether the outsourcing provider is obligated to continue providing services on the same terms and conditions to the divested or acquired entity. If so, we want to ensure that these terms can be operationalized within the context of the M&A activity.

Finally, we look for pricing protection provisions, particularly for most-favored-customer status. Whether our client is the target or the acquirer, we seek to leverage that provision to get services for the newly created entity at the same favorable rates.

**Editor: What are the cultural and logistical challenges when selecting a foreign outsourcing service provider?**

**Brito:** The broad challenge with selecting a foreign outsourcing provider is about not only successfully navigating cultural differences but also addressing legal issues that are interpreted or handled differently in the foreign outsourcing service provider's jurisdiction. As I discussed above with respect to the EU versus the U.S., there are complex jurisdictional issues relating to data security and privacy, employee transfer and dispute resolution.

Further challenges include tax considerations and enforcement-related issues. In some instances, where the contracting party for the service provider is a U.S. subsidiary of an entity based outside of the U.S., we will require a parent guarantee, which guarantee may itself be subject to varying accounting treatments depending on the applicable jurisdiction. Similarly, addressing ownership of intellectual property involves ensuring that our client has sufficient and enforceable rights across jurisdictions.

**Editor: Do you have any final thoughts?**

**Brito:** Outsourcing is a viable business strategy that offers varying types of enterprises the ability to control costs and to take advantage of technological improvements. In exchange for the economic and technical advantages, the enterprise will have to give up some control over the manner in which the outsourced services are delivered. Implementing this strategy requires establishing a contractual framework that addresses the operational and technical risks; ensures that the pricing model supports the needs of the business but does not undermine the underlying business case; and provides for a high level of service – one that can be objectively measured but that also builds in a sufficient level of flexibility to address a rapidly changing business and technical environment. Structuring a transaction that addresses those issues is the key to making outsourcing a viable corporate strategy.