PRACTICAL LAW COMPANY®

PRACTICAL LAW

MULTI-JURISDICTIONAL GUIDE 2012/13

OUTSOURCING

The law and leading lawyers worldwide

- Essential legal questions answered in 20 key jurisdictions
- Rankings and recommended lawyers in 28 jurisdictions
- Analysis of critical legal issues

AVAILABLE ONLINE AT WWW.PRACTICALLAW.COM/OUTSOURCING-MJG

PRACTICAL LAW COMPANY®

United States

Kenneth A Adler, Steve Semerdjian and Akiba Stern

Loeb & Loeb LLP

www.practicallaw.com/3-501-5071

REGULATION AND REQUIREMENTS

National regulations

1. To what extent does national law specifically regulate outsourcing transactions?

The US legal system is a dual regime of federal and state laws. A combination of federal and state laws may apply to certain issues that relate to outsourcing transactions, including tax and labour law. Parties to an outsourcing transaction must have a clear understanding of the federal and state laws that apply to the particular transaction.

Federal law

Federal law applies in all jurisdictions in the US (and can pre-empt state law) in specific areas, for example:

- Patents.
- Trade marks and copyright.
- Immigration and insolvency.

As yet, there is no comprehensive federal law that regulates outsourcing transactions, although in 2004 a temporary ban was imposed on the offshore outsourcing of certain federal agency contracts (*see Question 2, Public sector*). In the last two years, several attempts have been made to enact outsourcing-related federal laws, none of which have yet been passed or signed into law. One of these attempts, the anti-outsourcing Bill informally known as the Creating American Jobs and End Offshoring Act (S.B. 3816), was defeated. The Bill would have, among other things:

- Provided tax incentives to business entities that move jobs to the US.
- Eliminated tax deductions for expenses incurred by companies when moving work overseas.
- Prohibited US companies from deferring taxes on the income of their foreign subsidiaries.

Another Bill that was recently defeated was the Outsourcing Accountability Act of 2012 (H.R. 3875, introduced in February 2012) which would have required US public companies with annual gross revenues of US$1 billion or more to report annually to both the US Securities and Exchange Commission and their shareholders the number of US and overseas workers they employ (as at 1 February 2012, US$1 was about EUR0.8).

Some of the Bills currently pending in Congress include the following:

- The US Call Center and Consumer Protection Act (H.R. 3596, introduced in December 2011), would make companies that relocate call centres to locations outside of the US ineligible for federal grant or guaranteed loan programmes for five years, and would require employers to provide at least 120 days' notice to the Secretary of Labor prior to relocation. The Bill also separately requires that any call centre agents located outside of the United States to disclose their physical location at the beginning of all calls and to transfer the call back to a US-based call centre on the customer's request.
- The Stop Outsourcing and Create American Jobs Act of 2011 (H.R. 3338, introduced in November 2011) allows the federal government to give contracting preferences to companies that have not offshored jobs and substantially increases penalties for companies that use illegal tax havens.
- The Notification of Origin of Telecommunications and Internet Consumer Exchange (NOTICE) Act (S.1536, introduced in September 2011) would require that non US-based customer service employees or agents of US businesses that either initiate or receive customer service communications must disclose their physical location at the beginning of each customer service communication.

State law

State laws control other areas that federal law does not control (*see above, Federal law*). These include, in relation to outsourcing transactions, real property and general contract law.

In addition, many states have implemented laws relating to offshore outsourcing, and several have enacted laws in relation to state agency contracts (*see Question 2, Public sector*).

Sectoral regulations

2. What additional regulations may be relevant for the following types of outsourcing?

Financial services

The Financial Services Modernization Act 1999 (commonly known as the Gramm-Leach-Bliley Act) (GLBA) allows financial service providers (for example, banks, insurance companies and brokers) to become affiliated and offer a full range of

© This article was first published in the Outsourcing multi-jurisdictional guide 2012/13
and is reproduced with the permission of the publisher, Practical Law Company.

financial services. It also introduced corresponding safeguards on the collection and disclosure of personal consumer information by financial institutions, including:

- Notice requirements.
- Security plans.
- An opt-out process.

The Fair Credit Reporting Act 1999 restricts the disclosure of a consumer's financial and other identifying information. It specifies the information that can be included in a consumer's credit report and the circumstances in which agencies or organisations can be provided with this information.

See also *Question 3* and *Question 18, Data protection and data security*.

Business process

There are no specific national regulations for business process outsourcing (BPO). BPOs can cover many different types of service and there may be industry-specific rules or regulations that affect particular industries (*see above, Financial services*). For example, BPOs that involve finance and accounting services or insurance underwriting services must comply with industry-specific regulatory requirements, for example:

- Rules on generally acceptable accounting principles.
- State regulations on how particular insurance policies are underwritten.

Engaging in a BPO does not relieve public companies from their obligation to ensure the accuracy and reliability of corporate disclosures and reporting of financial data (*see Question 18, Data protection and data security*).

IT

The US Department of Commerce, Bureau of Information and Security has issued Export Administration Regulations (EAR) to control the export of certain items from the US, including:

- Tangible objects.
- Documents.
- Software.
- Technical information.

The EAR can significantly affect outsourcings when these items are exported, particularly in an IT outsourcing where the supplier provides some of its services from a location outside the US.

The EAR control actions that go beyond general export, including, for example:

- Releasing technology to a foreign national in the US through demonstrations or oral briefings.
- Electronically transmitting non-public data to a recipient abroad.

The EAR can impose special licensing requirements and prohibit particular exports based on the:

- Item being exported.
- Reason for export control.
- Country of destination.

Breaching the EAR can have significant consequences, including fines, penalties and the loss of export rights.

Telecommunications

There are no specific laws regulating telecommunications outsourcing arrangements, but parties must be aware of the general laws and regulations regulating the telecommunications industry.

The Federal Communications Commission is the primary telecommunications industry regulatory body.

Public sector

Federal law. In 2004, the Thomas-Voinovich Amendment (contained in the omnibus Consolidated Appropriations Act of 2004) prohibited offshore outsourcing of services provided under certain federal agency contracts. This ban only lasted for a year, although it still applies to federal agency contracts executed during that one-year period.

State law. Several states have enacted laws concerning the outsourcing of state agency contracts, by either:

- Restricting services from being provided offshore. One of the most stringent anti-outsourcing laws is New Jersey's S.494, which prohibits certain state service contracts from being performed outside of the US. Generally, an exemption can be granted under the law when it is certified that either:
  - a service cannot be performed within the US; or
  - application of the law would violate the terms of any grant, funding or financial assistance from the federal government.
- Providing preferences to services provided onshore. Some states, such as North Carolina, Tennessee and Illinois, have adopted this system. For example, Tennessee permits its Commissioner of Finance and Administration to create rules that give a preference when awarding state data entry or call centre services contracts for companies that use US citizens or residents, or persons authorised to work in the US. Illinois requires prospective vendors for state contracts to disclose where services will be performed and whether any of those are expected to be performed outside the US, and the chief procurement officer may consider the disclosure and the economic impact to the State of Illinois and its residents in evaluating and awarding the contracts.
- Other states, such as Alabama, encourage the use of local services but do not restrict state procurement decisions.

Several states have introduced other Bills regulating outsourcing in the following ways:

- Restricting tax, loan and other financial benefits for companies that outsource:
  - for example, Bills introduced in Illinois (the Job Preservation Act of 2011) would make companies that lose 100 or more employees due to outsourcing of jobs ineligible (for a period of seven years) for government grants, loans, tax incentives or other economic incentives, and procurement contracts with the state, units of local government, or school districts;
  - similarly, the Kansas Incentive Protection Act (S.B. 420), introduced in February 2012, would provide that,

as a condition of receiving financial incentives from the state (tax incentives and credits, loans, grants or other financial assistance), companies must agree not to outsource jobs (defined as 50 or more jobs moved from the state to outside the US). Companies that outsource jobs within a 12-month period following receipt of the incentives or during the term of any agreement resulting in a net loss of jobs in the state would have to return the incentives. Businesses that violate the Act would be ineligible for financial incentives for five years.

- Requiring disclosure of job losses. In addition to making companies that outsource jobs ineligible for procurement contracts and financial incentives, the Illinois Job Preservation Act of 2011 would require companies that have a net loss of 100 jobs in the state to annually notify the state Department of Labor and complete a report with information including:
  - the jobs gained and lost;
  - the jobs lost as a result of outsourcing jobs outside the US;
  - the contracts and financial incentives in which the company participates.
- Restricting the location for the provision of services under an agreement. For example, Pennsylvania House Bill 458 would require that all government contracts for services include a provision that requires all services performed under the contract, or performed under any subcontract awarded under the contract, to be performed at a physical location within the US. Companion Bills (H.B. 457 and 459) would also prohibit commonwealth agencies from awarding any contracts to businesses that have outsourced jobs from within the state to outside the US.

Regulation of outsourcing at the state level is not limited to the legislative branch of government. Since 2003, the governors (a state's highest governmental position) of at least nine states have issued executive branch directives or orders. These regulations range from mandates that establish a process to evaluate outsourcing proposals, to various prohibitions on the performance of work offshore.

In addition, outsourcing may also be regulated at the local or municipal level. For example, the City Council of New York unanimously passed (notwithstanding the mayor's veto) the Outsourcing Accountability Act, amending existing law to require the city to perform a detailed cost-benefit analysis to document that any prospective outsourcing contract actually saves the city money. The legislation also requires city agencies to look ahead one year and publicly disclose plans for soliciting outside contractors and vendors.

Other

The Health Insurance Portability and Accountability Act 1996 (HIPAA) and its regulations regulate the use, storage, protection and privacy of personally identifiable health information. Outsourcing transactions involving the use or disclosure of personally identifiable health information, particularly outsourcings in the healthcare industry, must comply with HIPAA and the rules for electronic medical records (*see also Question 18, Data protection and data security*).

3. What further legal or regulatory requirements (formal or informal) are there concerning outsourcing in any industry sector?

Financial services

In practice, financial service providers are also likely to be affected by both governmental regulation and non-governmental or self-regulatory rules specific to their industry. The following have either given formal regulations or issued informal guidance in relation to outsourcing by the entities that they regulate:

- The Financial Regulatory Industry Authority (FINRA).
- The Federal Deposit Insurance Corporation.
- The Board of Governors of the Federal Reserve.

The effect of the regulations on outsourcing transactions varies. For example, FINRA prohibits outsourcing certain classes of a broker-dealer's functions and heavily regulates a second class of specified activities, while other activities are affected minimally or not at all. Parties to an outsourcing transaction must consult with the relevant authority and ensure compliance with the relevant regulations at the earliest planning stages.

4. What requirements (formal or informal) are there for regulatory notification or approval of outsourcing transactions in any industry sector?

Generally, no regulatory approvals are necessary for outsourcing transactions in any industry sector. However, a public reporting company that files periodic reports under the requirements of the Securities Exchange Act of 1934, as amended, is required, under Item 1.01 of Form 8-K, to disclose the terms of any material definitive agreement not made in the ordinary course of a company's business. A material agreement required to be filed under Item 1.01 of Form 8-K must be filed within four business days of that agreement being entered into. In many instances, these companies will also be required to file the agreement as an exhibit to those periodic reports. Item 1.01 of Form 8-K defines a "material definitive agreement" as an agreement that provides for obligations enforceable against the company, or rights enforceable by the company, that are material (even if subject to conditions), including, for example, obtaining third-party approvals or achieving certain milestones.

Item 601 of Regulation S-K identifies contracts that are considered not to be made in the ordinary course of business and that must be reported "unless immaterial in amount or significance", even if they are otherwise of the type that ordinarily accompanies the company's business. Under Item 601(b)(10)(ii)(A)-(D) of Regulation S-K, examples of these contracts include:

- Certain contracts with directors, officers and promoters.
- Situations in which a company's business is substantially dependent on a contract (including any contract under which the company sells the major part of its products or services, or purchases the major part of its requirements of goods, services or raw materials).

- Any contracts for the acquisition or sale of any property, plant or equipment if the consideration represents more than 15% of the company's fixed assets.
- Material leases relating to a property that is sufficiently important to the company.

In light of the lack of an objective materiality threshold in the Form 8-K rules, in determining what constitutes a material outsourcing contract for the company it must consider the particular facts and circumstances applicable to it. Companies should assess materiality in light of both quantitative and qualitative factors. A fact-intensive analysis will be required to address whether an outsourcing agreement outside the company's ordinary course of business is material, or whether a reporting company is substantially dependent on such agreement, regardless of whether it is otherwise of the type that ordinarily accompanies the company's business.

LEGAL STRUCTURES

5. What legal structures are commonly used in an outsourcing?

There are various legal structures that can be used in outsourcing, which provide the customer with different benefits and levels of control. However, greater customer control can mean that the supplier is less willing to assume risk.

Traditional structure

Description of structure. The most traditional legal structure for an outsourcing arrangement is for the customer and the supplier to implement a services agreement, where the supplier provides a described set of services under a specified payment schedule. Customers that outsource a non-core function generally rely on the supplier's skill and experience to provide the services. Typically, the services agreement contains general governance and contingency procedures, but the supplier generally controls how the services are provided under the agreement (provided it complies with the service descriptions, service levels and so on).

Advantages and disadvantages. This structure involves the customer giving up a degree of control. However, it gives the customer a predictable and stable pricing structure and can reduce start-up costs.

Joint venture

Description of structure. A customer and a supplier can set up a joint venture, where each party contributes certain assets, know-how and capital to a newly created entity that performs the services for the customer.

Advantages and disadvantages. The customer has a greater degree of control than in a traditional structure (*see above, Traditional structure*). However, the upfront costs are likely to be higher and the customer shares more of the outsourcing's risks with the supplier.

Wholly owned subsidiary

Description of structure. A customer can set up a wholly owned subsidiary to provide the outsourced services, commonly known as a captive entity.

Advantages and disadvantages. While this gives the customer significant control over the outsourced services, it must also bear greater costs and risk. When the captive entity matures, the customer can divest or spin off the captive entity (that is, separate the captive entity from itself) to achieve profit and recoup investment.

Build, operate and transfer (BOT)

Description of structure. Under a BOT structure, a customer enlists the supplier to build the infrastructure (including facilities, technology and people) necessary to provide the outsourced services. The supplier operates the infrastructure for a term (this is similar to the traditional structure (*see above, Traditional structure*)), and transfers ownership of the entire infrastructure to the customer. The customer then continues to provide the outsourced services (this is similar to the captive entity structure (*see above, Wholly owned subsidiary*)).

Advantages and disadvantages. Although the upfront set-up costs are greater, this structure allows a customer to ease into an outsourcing (with a level of control similar to that in a traditional structure), with the ultimate goal of taking back control of the outsourced service (as in a captive entity structure (*see above, Wholly owned subsidiary*)).

Supplier models

Description of structure. In addition, several different supplier models can be used in combination with the above structures, including the following examples:

- A customer can multi-source the work, spreading the services across multiple suppliers so that:
  - one supplier's failure is limited to a portion of the total services;
  - the customer has greater freedom to move or add services between suppliers.
- A customer can enter into a services agreement with one supplier as the general contractor. The supplier can subcontract the services to other suppliers. Under this arrangement, the prime contractor is primarily liable for all services, including subcontracted services.

Advantages and disadvantages. Where the customer multi-sources the work, spreading the services across multiple suppliers, a customer must have additional internal resources and processes in place to manage multiple supplier relationships (including to address issues of responsibility among suppliers in the event of a performance failure). Where the customer enters into a services agreement with one supplier, this creates a single point of accountability. However, since the customer does not have a contractual relationship with the subcontractors, it must rely on the prime contractor to enforce any rights or remedies against them.

PROCUREMENT PROCESSES

6. What procurement processes are used to select a supplier of outsourced services?

The procurement process generally involves the stages outlined below.

Request for information (RFI)

Usually, a customer sends an RFI to potential suppliers. This is a fact-finding document intended to gather general information from each supplier as to its capabilities.

Request for proposal (RFP)

If the results of the RFI are satisfactory, the customer can create and distribute an RFP to each prospective supplier. This contains relevant information about the outsourcing to allow each supplier to submit a proposal to the customer. It is usually a very complex document and many customers employ a consultant or lawyers to assist in its drafting.

Proposals

The suppliers then submit proposals and the customer reviews them to decide which suppliers to consider. Typically, the customer meets with each prospective supplier to obtain clarification on its proposal.

Supplier selection

The customer selects one or two suppliers and performs due diligence. This further assists the customer in making its decision. In addition, the supplier can use this to clarify any assumptions that it made when preparing its proposal.

Negotiations

The customer then starts contract negotiations. Often, the customer selects two suppliers and enters into parallel negotiations. This forces the suppliers to actively compete against one another to provide the most favourable terms to the customer.

TRANSFERRING OR LEASING ASSETS

Formalities for transfer

7. What formalities are required to transfer assets on an outsourcing?

Immovable property

The transfer of immovable property should be in writing and signed by both parties. Applicable state law can require that the transfer be in writing, for example, for real property transfers. The transfer of immovable property can be publicly recorded in the appropriate governmental office. This recording serves as public notice of the transfer so as to avoid any disputes over subsequent transfers.

IP rights and licences

The transfer of IP rights must be in writing. The transfer of IP licences should be in writing (this may be required for exclusive licences) and may require the consent of the owner of the IP rights. The transfer of both IP rights and licences can be publicly recorded in the appropriate governmental office. This recording, when made within statutory time frames, serves as public notice of the transfer so as to avoid any disputes over subsequent transfers.

Movable property

The transfer of movable property (other than of nominal value) should be in writing and signed by the transferring party. If movable property is leased, a transfer of the leased property usually requires the owner's consent along with written confirmation that the transferee accepts the terms of the lease.

Key contracts

Transfers of key contracts should be in writing and signed by the transferor and transferee. However, the contract can contain restrictions on its assignment, which requires the other contracting party's consent or notice to be given. The transferor can remain responsible for certain obligations under the contract after it is transferred, depending on the contract's terms.

Formalities for leasing or licensing

8. What formalities are required to lease or license assets on an outsourcing?

Immovable property

Leases or licences of immovable property should be in writing and signed by both parties. Applicable state law may require that leases or licences be in writing, for example, for real property leases. If the property is under a lease or licence, the owner's consent may be required. Some leases or licences may prohibit subletting or sublicensing.

IP rights and licences

Licences of IP rights should be in writing and may require the owner's consent. Failure to use a written agreement may create an implied licence and lead to the terms of the licence being unenforceable or ambiguous. Some IP licences prohibit sublicensing without the owner's consent, or limit the parties' rights to access or use the IP.

Movable property

A lease or licence of movable property should be in writing, signed by the owner, and the transferee must agree to the lease or licence's terms. Some leases of movable property coincide with the licensing of IP rights, for example, the transfer of computer hardware that has installed software (*see above, IP rights and licences*).

Key contracts

The formalities are the same as for transfers (*see Question 7, Key contracts*). In addition, contracts may prohibit sublicensing or require the owner's prior written consent to grant a sub-licence or effect a transfer.

TRANSFERRING EMPLOYEES

Transfer by operation of law

9. In what circumstances (if any) are employees transferred by operation of law?

Initial outsourcing

There are no circumstances in which employees are transferred by operation of law. The employment contracts with the customer are terminated and the supplier re-hires the employees.

Change of supplier

See above, *Initial outsourcing*.

FOR MORE INFORMATION about this publication, please visit www.practicallaw.com/outsourcing-mjg
about Practical Law Company, please visit www.practicallaw.com/about/practicallaw

Termination

See above, *Initial outsourcing*.

10. If employees transfer by operation of law, what are the terms on which they do so?

General terms

Not applicable (*see Question 9, Initial outsourcing*). The customer must terminate the employment of employees who will perform services for the supplier and the supplier must re-hire them.

Pensions

Employees' participation in the customer's health, welfare and pension plans ends on termination of their employment with the customer.

Employee benefits

See above, *Pensions*.

Other matters

If the supplier hires all, or substantially all, of the members of a bargaining unit that is subject to a collective bargaining agreement (CBA), the supplier may have a duty to bargain with the unit and/or honour the CBA.

Redundancy pay

11. How is redundancy pay calculated?

There is generally no right, statutory or otherwise, to redundancy (or severance) pay in the US, except as may be expressly provided by a CBA or an employment agreement. In the event a CBA or an employment agreement provides for redundancy pay, its calculation will be in line with what is provided for in the CBA or employment agreement.

Harmonisation

12. To what extent can a transferee harmonise terms and conditions of transferring employees with those of its existing workforce?

There is no legal requirement to provide any particular terms and conditions of employment to the transferring employees in the absence of a CBA or other pre-existing contractual provision to this effect. Therefore, the supplier can harmonise the terms and conditions of the transferring employees with its existing workforce. This is generally the subject of negotiation of the outsourcing agreement between the parties.

Dismissals

13. To what extent can dismissals be implemented before or after the outsourcing?

Employment in the US is generally "at will" (that is, either the employer or the employee can terminate the employment relationship without liability at any time or for any reason, including before or after an outsourcing), in the absence of a CBA or employment agreement to the contrary. It may be necessary for the customer and supplier to issue WARN Act notices (under the Worker Adjustment Retraining and Notification Act 1988 (WARN Act)) (*see Question 17*).

In addition, when employees are dismissed, the customer and supplier must comply with federal, state and local discrimination laws that prohibit dismissals based on an employee's membership in a protected class, including:

- Race.
- Colour.
- Gender.
- Age.
- National origin.
- Religion.
- Disability.

Employees may also be protected from dismissal if they are on a leave of absence, for example:

- Medical leave under the Family and Medical Leave Act 1993.
- Military leave under the Uniformed Services Employment and Reemployment Rights Act 1994.

National restrictions

14. To what extent can particular services only be performed by a local national trained in your jurisdiction?

Where particular outsourced services are provided to customers in regulated fields, individuals providing those services may need to be appropriately licensed. For example, in the financial sector, FINRA has recently adopted a rule (FINRA Rule 1230(b)(6)) that requires the registration and licensing of covered operations staff who perform covered functions. Covered persons include:

- Senior management.
- Supervisors and managers that can approve or authorise work in covered areas.
- Staff that can commit the firm's capital, or commit it to any contracts.

Advisory areas such as auditors and compliance are excluded, as are clerical and ministerial roles.

Functions covered include:

- Trade confirmations.
- Account statements.
- Margin collection.
- Maintenance.
- Re-investment and disbursement of funds.
- Custody, depository and firm account management.
- Reconciliation.

- Segregation and fails.
- Buy-ins.
- Client on-boarding.
- Customer account data.
- Stock loans.
- Prime broker.
- Financial controller.
- Regulatory reporting.
- Approving valuation and pricing models.

Where a global function is supervised by a broker-dealer, the firm must obtain copies of records such as trading statements for the overseas employees. Where an outsourcing firm has an employee that works for multiple broker-dealers in a capacity that requires registration under the rule, these individuals will need licences for all of the firms and must be covered by all of the firms' policies and procedures.

Secondment

15. In what circumstances (if any) can the parties structure the employee arrangements of an outsourcing as a secondment?

There are no legal prohibitions on structuring the employee arrangements of an outsourcing as a secondment. The customer and supplier may, however, be deemed to be co-employers of the employees and, therefore, share potential liability for violations of employment laws.

Information, notice and consultation obligations

16. What information must the transferor or the transferee provide to the other party in relation to any employees?

There are no legal requirements for either the customer or the supplier to provide any particular information to the other party in relation to its employees.

17. What are the notice, information and consultation obligations which arise for the transferor and the transferee in relation to employees or employees' representatives?

Customers with 100 or more employees must, under the Worker Adjustment Retraining and Notification Act 1988 (WARN Act), provide employees with 60 days' prior written notice of termination if the outsourcing will result in either:

- A plant closure resulting in employment loss for 50 or more employees at any single site of employment.
- A mass lay-off resulting in employment loss, at a single site of employment, for either:
  - 50 or more employees constituting at least one-third of the workforce; or
  - 500 employees.

Some states have also enacted their own WARN Act-type statutes with which customers must comply.

DATA PROTECTION

18. What legal or regulatory requirements and issues may arise on an outsourcing concerning data protection?

Data protection and data security

There is no comprehensive US data protection law. The federal and state laws, and specific industry regulations, impose various data protection obligations in a piecemeal way.

Federal law. There are several laws, which each apply to different types of industries, activities and information:

- **Consumer information.** The privacy and security of consumer information is protected, for example, in the areas of:
  - financial services, under the GLBA and the Fair Credit Reporting Act (*see Question 2, Financial services*);
  - healthcare, under the HIPAA (*see Question 2, Other*).
- **Public companies.** Public companies must ensure the accuracy and reliability of corporate disclosures and reporting of financial data (*Sarbanes-Oxley Act 2002*). This applies even if the company engages in a BPO (for example, HR management) either within the US or overseas (*see Question 2, Business process*).
- **Consumer protection.** Under its consumer protection authority, the US Federal Trade Commission has imposed privacy and data security obligations on entities that collect or process consumer data.

State law. Individual states also have data security laws. Most states require entities that collect or process sensitive consumer data to give notice to consumers of breaches in the security of this data in certain circumstances. Under some data security laws, data licensees must report breaches in the security of the data to the licensor within specified time periods. Other state data security laws require companies to protect the sensitive consumer information that they possess, and in particular to restrict their use of, and protect, social security numbers.

Industry rules. In addition to these federal and state data security laws, the Payment Card Industry (through an independent council originally formed by the major credit card companies) has established its own comprehensive requirements to contractually protect customer cardholder data through its Data Security Standards. These require that companies that store, process or transmit payment card data comply with specific security requirements.

Contract documentation

Contract documentation varies based on the type of industry, business activities and information involved, and the risks that the outsourcing poses. An outsourcing contract typically includes requirements that:

- Data is protected from unauthorised access.
- Reporting obligations are complied with.
- The risk allocation between the supplier and customer in relation to data security breaches is addressed.

Specific security requirements are often imposed, for example, technological limitations on the supplier's access to data.

SERVICE SPECIFICATION AND LEVELS

19. How is the services specification typically drawn up and by whom?

The customer typically draws up an initial services specification itself or with a third party consultant's assistance. Third party consultants or lawyers can assist the customer to:

- Develop an outsourcing strategy.
- Create preliminary services specifications in greater detail.
- Confirm the historical service levels that the customer achieved.

The services specification is a significant contract document that must address various stages in the outsourcing of services, particularly if the outsourcing involves significant changes to the customer's processes or infrastructure. Ideally, the initial services specification is created before the RFP process starts (*see Question 6*).

The parties work together throughout the negotiation process to refine the initial services specification as more details about the supplier's capabilities and customer's needs emerge.

20. How are the service levels and the service credits scheme typically dealt with in the contract documentation?

Contracts typically contain a mutually agreed set of measurable service levels and specified remedies, including service credits. The contract should also contain a process for determining the supplier's performance in relation to the service levels.

Service levels can be included in the main agreement or included in a schedule (a service level agreement). Service levels and credits generally apply to the aspects of performance that are most important to the customer and are often weighted to reflect this.

CHARGING METHODS AND KEY TERMS

21. What charging methods are commonly used on an outsourcing?

Outsourcing contracts may have multiple charging mechanisms to address the differences in services in a single agreement. As outsourcing has become more common, various new (and sometimes complex) charging methods are used. The methods below are the most commonly used.

Fixed price

Fixed price methods used to be the most common pricing arrangement. The customer pays a fixed fee to the supplier, usually on a monthly basis (a monthly recurring charge), for providing the agreed service. This is an appropriate structure in situations where the scope and amount of work is well defined and unlikely to fluctuate.

Pay as you go

In situations where the scope or amount of work is not fixed or is more difficult to define, suppliers typically use time and materials, or pay as you go, charging mechanisms. Under these structures, services performed by the supplier are charged at time-based rates (such as hourly, daily, weekly, and so on) and materials are charged with a mark-up.

Cost plus

In a cost plus outsourcing, the customer is charged the supplier's actual costs to perform services, plus a mark-up that is intended to represent a reasonable profit for the supplier. Cost plus depends on what is included in the supplier's costs, for example, overheads and assets depreciated over time.

Resource-based charges

A common approach is an upfront fixed recurring charge (based on an assumed service volume), plus a resource-based charging mechanism to adjust the fixed charge up or down incrementally, depending on the actual volume of resources used.

22. What other key terms are used in relation to costs?

The following key terms in relation to costs may be used:

- Resource-based charges (*see Question 21, Resource-based charges*).
- Benchmarking, to ensure that the charges (and other key terms of the agreement) are competitive when compared with similar charges in the relevant industry.
- "Most favoured customer" clauses. These require suppliers to ensure that their charges to the customer are equivalent or more favourable than those charged to its other customers.
- Gain-sharing. In certain agreements, it may be appropriate for the parties to share in certain cost savings achieved. It is often difficult for the parties to agree on the details about when this applies and how the specific terms of gain-sharing operate.

CUSTOMER REMEDIES AND PROTECTIONS

23. If the supplier fails to perform its obligations, what remedies and relief are available to the customer under general law?

The customer can bring an action for damages resulting from the supplier's failure to perform its obligations (including seeking recovery of the expense incurred to replace the services), and if the breach is material, it can terminate the agreement. While the customer may have the right to seek specific performance by the supplier, this type of remedy is difficult to obtain. If the contract is silent on these issues, applicable state law may provide particular remedies for contract breaches.

24. What customer protections are typically included in the contract documentation to supplement relief available under general law?

Protections that can be included in the contract documentation to supplement relief available under the law include:

- Service level agreements for measuring and reporting the supplier's performance against specified levels with credits and other remedies if service levels are not met (*see Question 19*).
- The right for the customer to step in or terminate the agreement or the affected services, and receive a refund in certain circumstances (*see Questions 31* and *32*).
- A requirement that the supplier provides post-termination assistance to the customer when transferring outsourced functions back in-house (or to another supplier in the case of termination).
- A governance structure requiring the supplier to appoint a relationship manager to act as a primary liaison between the parties, and informal dispute resolution procedures to expedite any escalation of problems to higher levels of authority within the parties' organisations.
- A requirement that the supplier maintains specified types and levels of insurance coverage and to identify the customer as an additional insured party on its policies.
- A parent company guarantee to ensure supplier performance and reduce risks related to the supplier's financial problems or insolvency (this can increase the chances of enforcing the agreement if the contracting supplier is not a US entity).
- Provisions requiring the supplier to indemnify the customer for its losses in specified circumstances.

WARRANTIES AND INDEMNITIES

25. What warranties and/or indemnities are typically included in the contract documentation?

The warranties and indemnities included in an outsourcing agreement depend on the nature of the transaction and negotiations between the parties. Usually, each party warrants that it has the authority to enter into and perform the agreement.

In addition, the customer typically requests the supplier to warrant that it will:

- Perform the services in a professional manner.
- Ensure that the services and any resulting deliverables (that is, the items promised under the contract) meet the contractually required specifications.
- Comply with all applicable laws and regulations.
- Ensure that the services and deliverables do not infringe a third party's IP rights.
- Not introduce any viruses, disabling procedures, trojan horses or other disabling codes into the customer's computer systems.

Suppliers may also be required to make warranties in relation to the types of services being supplied or the customer's industry.

Each party usually indemnifies the other party against claims of personal injury or property damage. The supplier usually also indemnifies the customer in relation to:

- Claims that the services or deliverables breach third party IP rights.
- Claims by transferred employees in relation to the period before the transfer.
- Claims based on the supplier's failure to comply with federal or state law.

Other indemnities may be appropriate depending on the types of services being supplied or the customer's industry.

26. What limitations are imposed by national law on fitness for purpose and quality of service warranties?

Generally, state contract law recognises implied warranties of fitness for a particular purpose and merchantability. However, the supplier can exclude these through an explicit provision in the outsourcing agreement.

27. What provisions may be included in the contractual documentation to protect the customer or supplier regarding any liabilities and obligations arising in connection with outsourcing?

Provisions customarily included in contractual documentation include warranties and indemnities (*see Question 25*) and a limitation of liability clause (*see Questions 35* and *36*).

Insurance

28. What types of insurance are available in your jurisdiction concerning outsourcing, and to what extent are they available?

The types of insurance that the customer may require the supplier to obtain and maintain during the duration of an outsourcing include:

- Employer's liability.
- Worker's compensation.
- General commercial liability.
- Automotive liability.
- Errors and omissions/professional liability.
- Commercial crime.
- Property.
- Umbrella liability.

These types of insurance are readily available from the supplier's insurance carriers. Additional, more specialised, insurance may be obtained from certain insurance carriers to protect against data security breaches and data loss.

TERM AND NOTICE PERIOD

29. Does national law impose any maximum or minimum term on an outsourcing? If so, can the parties vary this by agreement?

There is no national law imposing a maximum or minimum term on outsourcing agreements, so parties can negotiate term limits specific to their arrangement. Generally, an outsourcing arrangement is for a fixed term of between three and ten years.

30. Does national law regulate the length of notice period required (maximum or minimum)? If so, can the parties vary this by agreement?

National law does not regulate the notice period required to terminate an outsourcing agreement. The parties can agree on termination rights and notice periods. Generally, the customer requires an extended notice period to transfer the services back in-house or to another supplier.

Usually, the contract contains terms requiring the supplier to continue to provide services during the transfer, and to provide other services necessary for a smooth transition. The notice period varies depending on the type of termination.

TERMINATION AND TERMINATION CONSEQUENCES

Events justifying termination

31. What events justify termination of an outsourcing without giving rise to a claim in damages against the terminating party?

Breach

Usually, the customer and supplier include specific termination rights in an outsourcing agreement. However, state law (including case law) generally grants a party certain rights to terminate a contract, including an outsourcing agreement.

While the law differs between states, the following are generally considered sufficient to justify termination:

- A material breach of the agreement by a party.
- An anticipatory repudiation (that is, breaking the contract before the required performance time).

Insolvency events

Under national bankruptcy law, a party's insolvency does not, by itself, necessarily give rise to a termination right. While many agreements include such a provision, this right may not be enforceable under bankruptcy law.

32. In what circumstances can the parties exclude or agree additional termination rights?

Parties have the discretion to include or exclude particular termination rights. Typical termination rights include:

- A material breach of the agreement that is neither waived nor remedied within a reasonable period of time after notice by the non-breaching party (the remedy period can vary according to the parties' agreement). This termination right can also address minor but recurring breaches.
- A party's insolvency, including, without limitation:
  - a petition or proceeding in:
    - bankruptcy;
    - receivership;
    - liquidation;
  - assignment for the benefit of creditors.

  The parties can define the particular qualifying events in the agreement. They can also include termination rights based on a significant adverse change in the supplier's financial condition.
- A change of control of the supplier, particularly to one of the customer's competitors.
- Termination for convenience, which typically requires significant advance notice and/or significant termination fees. This allows the customer to change suppliers at its discretion.

IP rights and know-how post-termination

33. What implied rights are there for the supplier to continue to use licensed IP rights post-termination? To what extent can the parties exclude or include these by agreement?

The outsourcing agreement (or a separate licence) typically addresses the rights of the supplier to use licensed IP rights, including the period of permitted use. In the absence of specific contract terms addressing this issue, the rights to use the customer's IP are based on implied rights that are likely to end on termination of the outsourcing agreement (and completion of transition services) (*see Question 30*).

The parties must address specific licence rights in the outsourcing agreement to avoid disputes over implied rights.

34. To what extent can the customer gain access to the supplier's know-how post-termination and what use can it make of it?

Supplier know-how that exists before the outsourcing is confidential information belonging to the supplier. Confidentiality terms in the agreement regulate this information; there is usually an express requirement that the customer maintain confidentiality post-termination, which may be limited to a specified term.

However, the parties can agree that the customer be licensed to use the supplier's know-how, particularly in relation to the items delivered under the outsourcing agreement that incorporate or are based on the supplier's pre-existing know-how. Ownership and licence rights in relation to know-how that the supplier develops during the provision of services must be addressed in the agreement's proprietary rights provisions.

LIABILITY, EXCLUSIONS AND CAPS

35. What liability can be excluded?

The general rule under state law is that damages, including incidental and consequential damages and loss of business, profit or revenue, can be limited or excluded entirely if the limitations or exclusions are not unconscionable or otherwise violate public policy.

However, state laws vary and may have specific conditions or limitations on this general rule. For example, state law may examine:

- The parties' relative bargaining power.
- Whether the limitation or exclusion of liability allows for recovery of damages sufficient to protect the contracting parties against unreasonable risk or harm.

36. Are the parties free to agree a cap on liability? If so, how is this usually fixed?

The parties are free to agree on a liability cap subject to certain limitations (*see Question 35*). The factors that should be taken into consideration when setting the liability cap include the:

- Fee structure.
- Length of the agreement.
- Supplier's profit margin.
- Relative risks of the parties.

In many cases, the liability cap is set at either:

- A multiple of the monthly fees (if a there is a fixed monthly fee).
- The total fees over a previous period.

TAX

37. What are the main tax issues that arise on an outsourcing?

Transfers of assets to the supplier

If the supplier purchases assets from the customer for less than the assets' fair market value, the difference may be treated as an additional payment by the customer to the supplier for services. In that case, the supplier recognises ordinary income equal to the fair market value of the assets minus the purchase price, and the supplier's tax basis in the assets is their fair market value.

Sales tax or other transfer tax may also be imposed. However, the transfer of assets from a customer to a supplier rarely occurs in an outsourcing transaction.

Transfers of employees to the supplier

If employees are transferred to a supplier, the supplier is generally responsible for withholding and paying certain payroll taxes from the compensation paid to the employees, as well as paying other taxes from its own funds with respect to those employees. For US federal tax purposes, the payroll taxes include:

- Federal income taxes.
- Federal Insurance Contributions Act taxes.
- Federal Unemployment Taxes.

Additionally, individual states and certain local jurisdictions within a state have different employer tax responsibilities, including withholding obligations.

VAT or sales tax

The US does not have a national sales tax. However, the individual states and certain local jurisdictions within a state impose their own sales taxes. Transfers in jurisdictions outside of the US may be subject to VAT or other similar tax.

Service taxes

Certain jurisdictions may impose a sales tax on specified services (*see above, VAT or sales tax*).

Stamp duty

The US does not have a stamp tax. Certain states impose documentary stamp taxes on the transfer of interests in real property.

Corporation tax

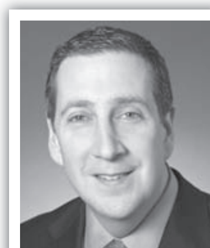
Corporations are subject to franchise taxes in the jurisdiction in which they are organised. In addition, corporations (and unincorporated entities treated as corporations for income tax purposes) are generally subject to income tax in jurisdictions where they do business.

Other tax issues

Before entering into an outsourcing relationship with a supplier, a customer that is not otherwise subject to income taxation in the jurisdiction where the supplier is located should review the income tax laws of that jurisdiction to determine:

- Whether the nature of the proposed relationship can result in the customer becoming subject to income tax in the supplier's jurisdiction.
- How the proposed relationship might affect the customer's overall tax liability.

CONTRIBUTOR DETAILS



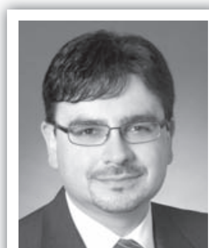
KENNETH A ADLER
Loeb & Loeb LLP
T +1 212 407 4284
F +1 212 202 6039
E *kadler@loeb.com*
W *www.loeb.com*

Qualified. US (New York), 1986

Areas of practice. Outsourcing and technology; strategic sourcing and emerging media; intellectual property; corporate and commercial transactions.

Recent transactions

- Currently representing a major retail company with respect to the outsourcing of applications development and maintenance services to a major offshore service provider.
- Represented a major investment bank with respect to a business process outsourcing and technology services agreement with Broadridge Financial Solutions, Inc for its US securities processing systems (on a software-as-a-service basis).
- Represented a global investment bank with respect to the outsourcing of its North American securities processing systems (on a software-as-a-service basis) and back-office business processes.



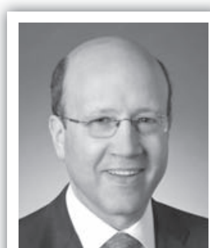
STEVE SEMERDJIAN
Loeb & Loeb LLP
T +1 212 407 4218
F +1 212 504 2746
E *ssemerdjian@loeb.com*
W *www.loeb.com*

Qualified. US (New York), 1997

Areas of practice. Outsourcing and technology; strategic sourcing and emerging media; intellectual property; corporate and commercial transactions.

Recent transactions

- Currently representing a major life insurance company with respect to the outsourcing of its policy administration systems (on a software-as-a-service basis) to a major global service provider.
- Represented a major life insurance company with respect to the outsourcing of its claims processing functions to McCamish Systems LLC, an Infosys company.
- Represented two North American department store chains with respect to the outsourcing of finance and accounting services to Accenture.



AKIBA STERN
Loeb & Loeb LLP
T +1 212 407 4235
F +1 212 428 6745
E *astern@loeb.com*
W *www.loeb.com*

Qualified. US (New York), 1981

Areas of practice. Outsourcing and technology; strategic sourcing and emerging media; intellectual property; corporate and commercial transactions.

Recent transactions

- Currently representing a global entertainment company with respect to the renegotiation of its multi-tower IT outsourcing to a major technology service provider.
- Represented a global sports, entertainment and media business with respect the outsourcing of finance and accounting services to WNS, the outsourcing of IT functions to HCL Technologies, the outsourcing of legal services to Integreon, and the outsourcing of travel services to Orbitz.

EVERY DETAIL.
EVERY CLIENT.
EVERY MATTER.

LOEB & LOEB's premier Outsourcing Group takes a results-driven, strategic approach to the outsourcing of complex information technology and business process functions. We offer a full range of resources to assist in the transaction life cycle, from strategic planning to contract negotiation to renegotiation/exit strategies. Our comprehensive legal services include matters relating to onshore, near-shore and offshore solutions; multi-sourced environments; cloud-based service offerings; dispute resolution; privacy and data security; and mergers, acquisitions and divestitures. With decades of experience in the outsourcing arena, we are trusted advisors on market trends and market standards. It all adds to the bottom line:

LOEB & LOEB adds Value.

345 Park Avenue ■ New York, NY 10154 ■ 212.407.4000

Los Angeles New York Chicago Nashville Washington, DC Beijing www.loeb.com